SMALL CAP DISCOVERIES

Portfolio Comments
September 30, 2023

Distinguishing Features

GIM builds the Small Cap Discoveries portfolio from the bottom-up; sector weightings are secondary to stock selection. Since last quarter, the Small Cap Discoveries portfolio has reduced weights in Information Technology and Consumer Discretionary while maintaining a significant overweight in Health Care versus the Russell Microcap Growth benchmark. The portfolio is equal weight to the benchmark in Basic Materials and underweight in all other sectors. The portfolio has no exposure to Utilities, Real Estate, Communication Services, or Energy.

Market Environment

It was a rough quarter for the stock market. All indices suffered losses this quarter, battered by surging oil prices and fears that the Fed's higher-for-longer rates strategy means another hike this year. Also weighing on investor minds was the US government shutdown, which is now temporarily resolved.

There are many concerns creating a wall of worry for stocks to climb, but inflation could continue to decline in favor of higher oil prices, a stabilizing China, and a temporarily averted government shutdown. So far, we had a have resilient US consumer, but this consumer now has to deal with higher mortgage rates, student loan paybacks, higher gasoline prices, and the UAW strike perhaps driving the price of cars higher. The massive spending and subsidies from the Federal government targeted at upgrading the nation's roads and bridges, expanding domestic manufacturing of semiconductors, and modernizing the electrical grid could blunt a downturn from the recession that the consensus believes is likely.

The big questions today are: 1) will the Fed continue to raise rates 2) will the Fed lower interest rates next year and 3) will the Fed conquer inflation without triggering a recession?

Performance Discussion

The Granahan Discoveries strategy returned -13.3%, lagging the Russell Microcap Growth Index return of -12.0%, and the -7.3% return of the secondary Russell 2000 Growth benchmark.

The largest detractors this quarter were **BioLife Solutions** (Health Care, Pioneer), **Alta Equipment** (Industrials, Special Situation), **Portillo's** (Consumer Discretionary, Core Growth), **Stoke Therapeutics** (Health Care, Pioneer), and **OthoPediatrics** (Health Care, Core Growth).

The strategy's best performing stocks for the quarter were **Quanterix** (Health Care, Pioneer), **PROS Holdings** (Information Technology, Pioneer), **Texas Capital Bancshares** (Financials, Special Situation), **Castle Biosciences** (Health Care, Pioneer), and **Veeco Instruments** (Information Technology, Special Situation).

In terms of Lifecycles, Pioneer, Core Growth, and Special Situation categories all underperformed the benchmark this quarter.

Positioning

The U.S. 10-year Treasury reached a new 15-year high exiting the quarter due to concerns about the economy and the path ahead for interest rates. The shift from quantitative easing to tightening will lead to an excess supply of treasuries keeping interest rates at a high level. While continuing inflationary pressures and elevated interest rates stoke fears of an economic slowdown, we continue to feel encouraged about the underlying developments occurring at many companies within the portfolio. During the quarter, we made changes to the portfolio to focus on our highest conviction ideas. We eliminated those we expect will face some challenges over the next year. We sold **GRBK** (a homebuilder), **HLIT** (cable TV equipment provider), **AXTI** (semiconductor materials) and **RVNC** (aesthetics). We added new positions **AIP** (semiconductor IP company focused on artificial intelligence and automotive) and **MEC** (engineered component manufacturer) given very compelling valuations coupled with strong multi-year outlooks for both companies.

Volatility has pressured many of the stocks in the portfolio regardless of the underlying fundamental outlook. During this period of turmoil, GIM has remained diligent employing the same discipline and proven investment process for which Granahan Investment Management is known. We added to several of our highest conviction stocks, one of which is **OrthoPediatrics**, a company that develops orthopedic implants that have been specifically designed to improve the lives of children. There are unique requirements to effectively treat children and the company has internally developed or acquired innovative technology to address the many needs within children's hospitals. Today, the company has a broad product portfolio addressing most of the needs of these hospitals, leading to an opportunity for significant market share gains. We expect the company to deliver over 20% revenue growth for the next several years due to the adoption of new technology and market share gains. Despite the growth and maturity of the company, the stock currently trades at the lowest valuation in its public history. We have a high degree of confidence in the company's long-term growth outlook and is now trading at less than 4x enterprise value to estimated 2024 revenue, representing a very compelling investment.

Outlook

Valuation on our portfolio has come down. In many cases, but not all, reported earnings have been better than expected. It is almost always the case that misses are hurt disproportionately versus the gains that stocks realize when they beat expectations. Response to earnings was extreme in this regard. There were modest positive moves in stocks on very strong earnings and brutal stock moves downward on misses. We even saw a number of stocks report strong earnings, only to go down in their wake. While there are more headwinds to growth broadly, the companies in the GIM portfolios are ones we believe can sustain strong secular growth.