SMALL CAP ADVANTAGE

Portfolio Comments
December 31, 2023

Distinguishing Features

GIM builds the Small Cap Advantage portfolio from the bottom-up; sector weightings are secondary to stock selection. As of December 31, 2023, the Small Cap Advantage portfolio was overweight its Russell 2000 Growth benchmark in Technology and Health Care. We are equal weight in Financials, Real Estate, Utilities, Consumer Discretionary and Basic Materials and underweight the benchmark in all other sectors. The portfolio continues to have no exposure to Consumer Staples.

Commentary

Market Environment

Despite stock markets being up in 2023, smaller companies struggled as valuations and earnings were significantly impacted by higher interest rates and inflation. It is important to note that the S&P 500 and the Russell 2000, on an equally weighted basis, both hit lows in October from their peaks in 2021. This suggests we have been in a bear market for most stocks for two years despite strong performance coming from some of the largest market cap stocks. While there are plenty of macro uncertainties still in the mix, we see noteworthy positives. In the middle of December, the Fed signaled a more dovish stance on interest rates and lower inflation data points have also been encouraging.

Performance

The Granahan Small Cap Advantage strategy returned +14.0% in Q4, outperforming the +12.8% return of its Russell 2000 Growth benchmark. Selection in Health Care, Basic Materials, Telecommunications, Industrials, and Materials contributed positively for the quarter along with our underweight in Energy. Penalties came from stock selection in Technology, Consumer Discretionary, Financials, and Real Estate.

With respect to LifeCycles, Pioneers nicely outperformed the benchmark this quarter while Core Growth and Special Situation categories lagged.

The largest contributors to the strategy this quarter were Core Growth names **Olink Holding** (Health Care) and **Axon Enterprise** (Industrials) and Pioneers **Porch Group** (Financials), **Oddity** (Technology), and **Sprout Social** (Technology).

- **Olink** emerged as the leading company in the high-plex segment of the proteomics market, which focuses on the role of proteins to better understand diseases. The company was acquired by Thermo Fisher in October, and we sold out of the stock.
- **Axon** is a mission-driven company designed to improve law-enforcement efficiency and efficacy, reduce social conflict, enable a fair and effective justice system, and aspires, with its Taser non-lethal weapon, to "obsolete the bullet". AXON shares contributed +128 basis points to performance in the wake of very strong Q3 results and forward guidance. While we have trimmed, we maintain a large position.
- Technology company **Porch Group** reported a strong quarter with better profitability in its home insurance division. We are holding the stock.
- **Oddity** is a direct-to-consumer company targeting the health and beauty market which combines machine learning, AI and molecule discovery, aimed at better product/customer matching and an overall better consumer experience. The company currently has two brands in market, Il Makiage and Spoiled

Child. ODD shares rose and contributed +50 basis points as the company reported strong Q3 results and raised guidance for Q4. While we sold some stock on the rise, we maintain a mid-sized position.

- **Sprout Social** is a leading cloud software solution for enterprises used to manage their social presence. SPT contributed +44 basis points as the company reported strong Q3 results and Q4 guidance. We continue to hold a large position in SPT share believing the industry and Sprout will enjoy strong tailwinds for a number of years.

Top detractors during the quarter were three Technology names; **Paycom Software** (Core Growth), **Paylocity** (Core Growth), and **Toast** (Pioneer). **Kinsale Capital** (Financials, Core Growth) and **WW International** (Consumer Discretionary, Special Situation) round out the bottom five.

- **Paycom** sells payroll services and human capital management (HCM) software to small and medium enterprises. This was a long-term holding in the portfolio which multiplied many times since we originally purchased the stock at $35 per share in early 2016. But it overstayed its welcome in the portfolio. PAYC shares dropped sharply in Q4 hurting performance. This was the second consecutive quarter in which Paycom had a big negative earnings surprise. Here is what happened. Approximately three years ago Paycom introduced a self-service module called Beti. The idea is to enable self-service, which tends to lead to better customer satisfaction and retention. The company has been migrating existing customers to Beti over this period, and as of about a year and a half ago all new customers were on Beti. The company announced on its Q2 call that it was reducing H2 guidance as it was taking sales resources from cross-selling and re-directing them to its efforts to migrate the remaining existing clients onto Beti. This hit the stock hard. We eliminated the stock.
- **Paylocity**, similar to Paycom, also sells payroll services and human capital management (HCM) software to small and medium enterprises. PCTY shares fell 9% in Q4 which hurt the portfolio's performance. Although Paylocity reported FY Q1 (September) results and guidance that were generally in line with expectations, investors are concerned Paylocity's growth will slow in upcoming quarters due to recessionary and employment headwinds. We believe such concerns are overblown and hold a medium-size position in the stock.
- **Toast** sells a platform for restaurants with a broad range of features including point-of-sale (POS), payments, inventory management, payroll, online ordering. TOST shares fell in the wake of the company providing a moderately disappointing outlook for the fourth quarter. We viewed the share price weakness as an opportunity and added to the position.
- **Kinsale** delivered a very strong quarterly report with some of the best metrics in the P&C insurance industry. Investors were concerned because Gross Written Premium growth slowed to 33% down from 40%+ in recent quarters. The company's move into the property segment of the market will lead to more quarterly volatility in premium growth but there remains a significant runway for superior earnings growth given the attractive tailwinds in the industry. Pricing and activity trends are attractive for Kinsale, and its meaningful cost advantage over competitors should lead to continued share gains. We increased our position meaningfully during the quarter.
- **WW** is the holding company for Weight Watchers. The quarter's results were mixed. Their number of subscribers grew, although a shift to more digital subscribers with longer subscriptions resulted in a revenue shortfall. The company's new Sequence clinical business performed modestly better than expectations. We continue to hold a small position in WW shares believing the company has a unique opportunity to leverage its strong brand, customer base, and goodwill to help a segment of weight-conscious consumers navigate the GLP-1 weight loss journey.

Sector Spotlight on Health Care

During the past couple of years, rising interest rates negatively impacted long-duration assets, particularly many of the portfolio's healthcare stocks. While the sector was among the weakest performers in the Russell 2000 Growth during 2021, 2022, and through 3Q 2023, it was the top contributor to portfolio performance in 4Q23 as several developments drove strong relative performance. Moreover, there have been exciting developments within the industry recently that bode well for improved stock performance during 2024 and beyond.

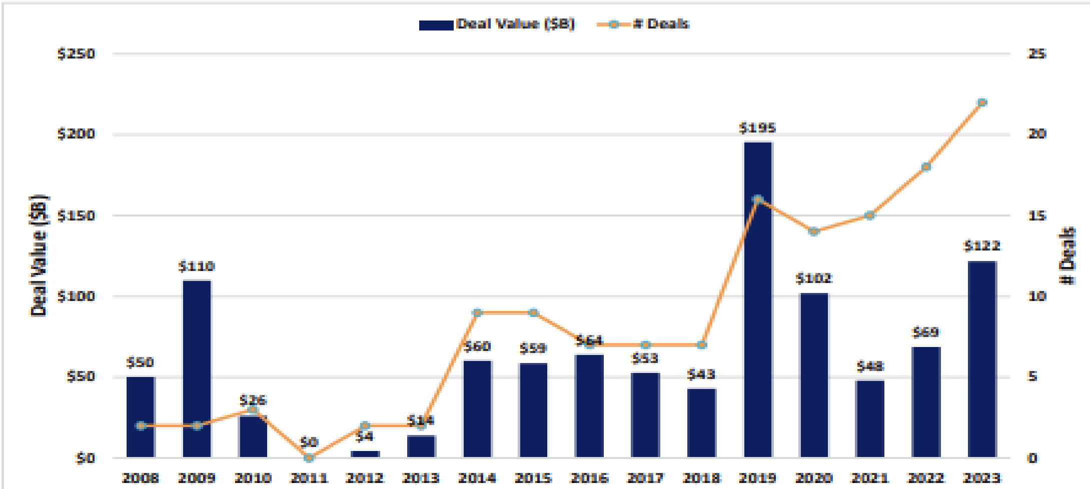
Small cap healthcare is bursting with companies investing in potentially disruptive treatments for some of the most debilitating medical conditions. For example, Edgewise Therapeutics is developing small molecules to treat muscular dystrophies through a new mechanism of action. We see Edgewise as a microcosm for the performance of the entire small-cap health care sector during the past few years, and it embodies our approach to investing in the sector. The company came public through an IPO when growth investing was in favor, only to be severely punished when sentiment reversed in late 2021. It subsequently traded below cash at some points, suggesting the street assigned zero value to Edgewise's technology and pipeline. Meanwhile, the company continued to accumulate promising data for its therapies presenting us with an opportunity to build our position. The stock has been a top performer during the recent rally, and we expect its technology will yield tremendous long-term shareholder value. That said, we remain highly cognizant of the risks for companies like Edgewise and we manage our position sizes accordingly.

FDA drug approvals in 2023 were very strong with 60 approved applications, the highest level since 2018 and above the 5-year rolling average of 51. Importantly, many of these approvals were for novel technologies, including antibody drug conjugates (ADCs), cell & gene therapies, and even the first CRISPR-based gene editing therapy. The portfolio includes biotech companies that directly benefited from these approvals. For example, Immunogen received FDA approval for its ovarian cancer drug Elahere and Blueprint Medicines won approval for Avakit, the first precision medicine for a debilitating immunologic condition known as indolent systemic mastocytosis. Both drugs enjoyed rapid commercial uptake, underscoring the benefits of our investing approach, which seeks to identify products addressing major unmet needs.

We also hold stocks of companies that help bring these drugs through the clinical development process and into the commercial market. As novel therapies are approved, there are incremental services required to deliver treatments to patients. For example, Repligen develops consumable equipment used specifically in the manufacturing of biologics, and cell & gene therapies. BioLife Solutions focuses on specialized products that enable the development, manufacturing, and delivery of therapies. These products are essential as they maintain cell viability critical for the effectiveness of therapies.

We were encouraged by increased healthcare M&A activity during the quarter, which implies strategic value and attractive valuations in the sector. In the biotech arena, M&A further accelerated in 2023 with over 20 announced deals for over $120 billion in deal value. As we head into 2024, SMID-cap biotech stocks trade near all-time lows, while large cap pharma holds plenty of cash to bolster their pipelines and address looming patent expirations through M&A and business development.

In Q4, Immunogen received a takeover proposal from a large pharma company at a substantial premium. The portfolio also benefitted from the acquisition of Olink Holdings by Thermo Fisher. Olink is a life sciences company that provides equipment used by researchers to study the role proteins play in drug development.



Source: Company Reports, Jefferies Research.

Finally, we'd be remiss not to mention what is arguably the most disruptive force to have emerged in the history of health care…GLP-1 drugs. By now, names like Ozempic, Wegovy, and Mounjaro have become widely recognized as mega-blockbusters poised to transform medicine, consumerism, and beyond. Wall Street even created a new disease modality known as "diabesity" to describe the myriad benefits of the drugs, including weight loss and glucose lowering. August 2023 marked an inflection when Novo Nordisk's Semaglutide (active ingredient in Ozempic & Wegovy) demonstrated improved cardiovascular outcomes, followed by a subsequent study showing benefits in kidney disease. The ensuing months saw a basket of "GLP-1 at-risk" stocks created by Goldman Sachs decline nearly 30%. This included everything from medical device stocks to restaurants. While we are carefully considering small-cap companies poised to benefit fundamentally from the GLP-1 wave, we are not chasing the countless companies seeking to cash-in with me-too versions of GLP-1s. Likewise, we will continue to delineate between companies at true fundamental risk from GLP-1s versus those being unduly punished as part of a Wall Street narrative. Above all, we remain on the lookout for franchises with GLP-1-like disruptive potential before they are widely recognized as such.

Outlook

Earnings for small cap companies, as measured by the Russell 2000, are estimated to increase almost 20% in 2024 following two years of declining EPS. According to both Lori Calvasina from RBC and Steve DeSanctis of Jefferies, balance sheets of Russell 2000 companies have near-record levels of cash. We believe our portfolio valuations are at extremely low levels, and a handful of our portfolio companies are trading at or near cash levels. While it is not possible to predict outcomes, this combination of low valuations and expected growth in earnings leaves us optimistic regarding the outlook for our portfolios.