SMALL CAP CORE GROWTH

Portfolio Comments
March 31, 2024

Commentary

In the first quarter of 2024, the Granahan Small Cap Core Growth strategy returned +3.6% compared with the Russell 2000 Growth benchmark return of +7.6%. At first look our performance versus the benchmark appears challenged. During the quarter, **Super Micro Computers** (SMCI), an AI commodity server producer, and **MicroStrategy** (MSTR), a bitcoin play, represented the largest single-stock weights in the Russell 2000 Growth Index and the largest combined weight of any two stocks ever, going back to 1986. These two stocks, both with larger market caps, drove about half of the performance of the Index. Excluding these two companies, the Q1 Index return would have been +3.4%.

Pioneers pulled back this quarter after their runup from the October 27, 2023 bottom and represented our largest detractors this quarter.

- **908 Devices** (Health Care) is a life science tools company focused on miniaturized mass spectrometry devices that bring powerful chemical analysis capabilities to the point of need. The significant long-term market opportunity is utilizing the technology in the production of next generation drug therapies. Optimizing cell culture in the manufacturing of biologic therapies can lead to significantly improved yields and more efficacious therapies. The stock was under pressure in 1Q despite the company's improving financial results. We believe the pressure was a result of the significant strength in 4Q23 and related to trading dynamics of a small cap life sciences company. We maintain our position.
- **indie Semiconductor** (Technology) estimates for the year were reduced reflecting an auto industry inventory correction, but with industry leading technology, a solid pipeline and design wins our share gain outlook is intact. We are buying the stock.
- Health Care companies **10X Genomics** and **Pac BioSciences** represent two of many life science stocks that underperformed after disappointing 2024 guidance due to macro pressures. We sold out of Pac Bio due to balance sheet concerns but maintain our position in 10X, as they beat estimates with continued momentum in their spatial imaging platform and the slate of new products coming out in 2024.
- **SI-BONE** (Healthcare) is a medical device company developing implants to treat disorders of the sacroiliac joint. The company has executed very well over the past year with new product launches, impressive improvement in salesforce productivity, 30% revenue growth and meaningful operating leverage. While the stock performed very well in 2023, it came under pressure in 1Q23 as investors shifted focus away from smaller cap healthcare companies. The stock trades at an all-time low valuation. Given the strong execution and financial outlook, we increased our position.

The strength in the portfolio was more broadly based, both by sector and lifecycle.

- **Kinsale Capital Group** (Financials) stock was under meaningful pressure at the end of 2023 given concerns about slowing growth. We used that period of weakness to materially increase our position as we believed the company's expansion into new markets within the P&C industry was not well understood. Kinsale delivered a very strong 4th quarter report that showed robust underlying growth and profitability well ahead of industry peers. We trimmed our position after a meaningful rebound in the stock given a full valuation that more appropriately reflects the company's strong growth.
- **Stoke Therapeutics** (Health Care) was up on strong data for their lead drug, which treats a rare epileptic condition. We trimmed some on the strength.
- **Pure Storage** (Technology) provides scalable flash memory storage to enterprise customers. In Q4, they saw increasing demand for subscription-based offerings and signed an eight-figure deal with a leading GPU-service provider and received initial orders of AI-related mandates. We are holding the stock.
- Johnson & Johnson purchased **Shockwave Medical** (Health Care) for their product that transforms the way calcified cardiovascular disease is treated.
- **Edgewise** (Health Care) was strong despite no noteworthy catalysts other than continued advancement of their pipeline for muscular dystrophy and hypertrophic cardiomyopathy. We maintain our position.

Attribution

Our worst performing sector this quarter versus the Russell 2000 Growth benchmark was Information Technology. The impact of Super Micro and MicroStrategy on the Index this quarter is simply mind blowing. Without these two stocks, the technology names in the Index would have been down 1% versus the reported 16%. We are overweight in Technology as well as Healthcare. While our stock selection in Technology was strong, we were not as fortunate in Health Care. Underweight sectors, Industrials and Energy, which saw a 22% rise in crude oil prices during the quarter, also had stock selection that detracted. We are underweight all other sectors with the exception of Communication Services, which contributed positively to attribution with additional help from strong stock selection.

Core Growth companies were the strength in the portfolio this quarter followed by Special Situations. Pioneers lagged.

Weightings

Our Information Technology and Materials weightings are up quarter-over-quarter by 1%. Industrials have been reduced by 1.6% and Financials by 0.6%. Special Situations are up 3% and Core Growth is down 3%. Pioneers are flat with last quarter.

Themes

Generative AI is a disruptive force that will significantly alter how we learn, work, and interact. We invest in many small cap companies that are driving the buildout of AI across hardware infrastructure, software infrastructure, and software applications. Currently, AI spending is most pronounced in hardware infrastructure used to train large language models. We hold positions in **Onto Innovation**, **Nova** and **FormFactor**, key enablers of high-bandwidth memories for model training. **PDF solutions** and **Veeco Instruments** serve next generation AI chip manufacturing. We also hold companies **Nutanix** and **Pure**

Storage which provide the infrastructure hardware and storage that will deploy these models. Next, software developers will increasingly move their data and applications to the cloud. We invest in infrastructure software leaders that enable data transfer and application development in the cloud, including **Confluent**, **JFrog**, and **HashiCorp**. Finally, software applications are introducing AI copilots and assist agents. As users find value in these features, software companies like **Smartsheet** in collaboration work management, **PROS Holdings** in pricing analytics, **DoubleVerify** in advertising fraud detection, **Five9** in customer service experience, and **Varonis Systems** in data security will likely see higher contributions from AI.

In the Health Care sector, we remain excited about the underlying fundamentals and secular drivers that make this area very compelling, despite this quarter's performance. There were positive developments from several stocks that delivered robust returns. **Stoke Therapeutics** reported data from its clinical trial that showed meaningful reductions in seizures in patients with Dravet Syndrome. We believe STK-001 could become the first disease modifying therapy for this devastating condition potentially leading to further upside for the stock. With Stoke's stock up nearly 150% year-to-date, we think this underscores our approach to owning biotech stocks that are not fully discounting the value of the company's underlying science. **Shockwave Medical's** stock was very strong in the quarter given a robust earnings report followed by rumors of a pending acquisition. After the quarter, the company announced it had agreed to be acquired by Johnson & Johnson.

In terms of detractors, we did see meaningful pressure on several stocks that we believe was largely attributable to fears of rising interest rates, as the companies have strong underlying fundamentals. **SI-BONE** and **OrthoPediatrics** came under selling pressure despite solid earnings reports and positive guidance for the full year. We have used the weakness as an opportunity to increase our weighting given the compelling valuation, strong competitive positioning, and robust growth outlook for both companies. In addition to interest rate fears, there have been policy shifts that may place additional pressure on drug prices and reimbursement rates for medical procedures in the U.S. Against this backdrop, Granahan will continue to focus on high-quality franchises offering products and services that improve health care delivery in a cost-effective manner.

Macro

Recent economic data highlight that the U.S. economy remains resilient. Commodity prices and yields have increased in response to the underlying strength of the economy. Geopolitical risks have risen as trade tensions with China have increased and the continuation of conflicts in Ukraine and Israel cause trepidation. These dynamics have created volatility within the financial markets especially as investors debate the Federal Reserve's position on inflation, and when and whether they will cut rates. A strong job market and elevated wage inflation could delay the Federal Reserve's first cut in interest rates from current expectations for a June cut. While small caps saw a meaningful recovery off the October lows, we expect continued volatility until there is more clarity from the Federal Reserve.

Outlook

Since 1985, the relative valuation of small cap companies versus large caps has only been lower one other time, at the bottom of the Covid bear market. Earnings growth improved in the portfolio in the last quarter of 2023, which is perhaps the reason for the run up in our stocks since the market low of October 27, 2023.

Valuations are lower on the stronger earnings, the lowest they have been in many years. We are optimistic that a normalizing of interest rates and financial conditions will be a tailwind for smaller quality companies and small cap returns going forward.