SMALL CAP CORE GROWTH

Portfolio Comments
September 30, 2024

Commentary

The most significant macroeconomic development during the quarter was the Federal Reserve's decision to cut interest rates by 50 basis points in September. While a reduction in rates is certainly welcome, macroeconomic and geopolitical concerns continue to weigh on investor sentiment, and small cap stock returns continue to lag behind those of large caps. The Granahan [Small Cap Core Growth] composite was up 5.4% in the quarter ending September 30, 2024, lagging the Russell 2000 Growth benchmark which was up 8.4%. For the year-to-date, the portfolio is up 3.3% versus the benchmark's return of 13.2%.

Four information technology companies detracted from performance this quarter; two Pioneers**:** **indie Semiconductor** and **Confluent** and two Core Growth**: PROS Holdings** and **Five9**. Communications Services company and Special Situation **Vivid Seats** rounds out the bottom five detractors.

- **indie Semiconductor** reduced guidance on its Q2 call, reflecting a continuation of an automotive inventory correction that has been underway for several quarters. This in turn is pushing out shipments of indie's new semiconductor design wins. Importantly, the company has not lost design wins--i.e., shipments/sales of their chips will occur, just later than expected. We have maintained our investment in INDI shares.
- **Confluent** is a leader in data streaming infrastructure software. The company saw consumption spending headwinds in Q2 as customers tightened budgets. We increased our position, taking advantage of the more attractive valuation.
- **Vivid Seats** operates an online ticket marketplace that is experiencing a return to normalcy with slower growth after 2 years of post-pandemic concert exuberance. However, the stadium concert line-up for 2025 is very strong. The stock is selling at 12X earnings; we are holding.
- **Five9** is a leading provider of cloud-based contact center software to enterprises. A company leadership change and a lowering of annual guidance pressured the stock. We have trimmed some of the stock, but with new AI modules to aid live agents and an attractive valuation, we are holding the rest of the position.
- **PROS Holdings** provides pricing and sales optimization software to customers, particularly in the airline industry. The company saw weaker travel bookings in the quarter, as airline struggled with cybersecurity disruptions and lower travel volumes, both transient factors. We have maintained our position.

Positives for the quarter include three Health Care companies, one from each lifecycle: **Exact Sciences** in Core Growth, **Evolent Health** in Special Situation, and **Edgewise Therapeutics** in Pioneer. Core Growth companies **Axon Enterprises** (Industrial) and **Zeta Global Holdings** (Information Technology) round out the top five.

- **Exact Sciences** is a molecular diagnostic company specializing in early cancer detection and prevention. Cologuard, the first FDA approved non-invasive stool DNA test for colorectal cancer, has successfully gained market share over the past several years. During the quarter, the company reported a very strong earnings report with a meaningful improvement in profitability on the continued strength in Cologuard adoption. We expect this trend to continue. Additionally, the company also reported early data on an emerging blood-based colon cancer screening test that was received positively by investors. We initiated a position in Exact during the quarter and have continued to increase our weighting given our expectation that the stock is meaningfully undervalued given its growth opportunity.
- **Evolent** reported a good Q2 and importantly, reassured investors regarding two important items: 1) that the company is indeed going to be both retroactively paid and have contracts adjusted for changes in Medicaid prevalence, and 2) reaffirmed its $300M EBITDA run rate target at the end of 2024. These factors enabled the stock to rebound in Q3 from its fall in Q2. We added to the position on the pullback and are maintaining the current position.
- **Edgewise Therapeutics**, a biopharmaceutical company that develops treatments for rare muscle disorders, was a strong contributor for the quarter and year-to-date, after announcing promising data for their hypertrophic cardiomyopathy (HCM) drug EDG-7500. While we've trimmed a bit on strength, we remain highly encouraged by the company's long-term growth potential.
- **Axon Enterprise** develops advanced electronic devices for law enforcement. The company reported strong Q2 results and H2 guidance. We have maintained our position in AXON shares believing the company's prospects both domestically and internationally are strong, and the stock's expected return and risk/reward remain attractive.
- **Zeta Global Holdings** operates a cloud platform that provides enterprises with consumer intelligence. The company beat earnings in Q2 and has pre-announced strong earnings for Q3. We believe the company remains well positioned as business momentum is strong. That said, while we still own a sizable position, the stock's strong appreciation led us to reduce it meaningfully in Q3.

Attribution

The overweight Information Technology sector of the portfolio explains the underperformance this quarter, largely due to the stocks described above. Underweight Industrials, Consumer Staples and Financials also detracted from performance, although stock selection in Industrials contributed negatively as well. We are also underweight in Real Estate, Consumer Discretionary, and Materials, where our stock selection was positive. Overweight Health Care was our largest contribution to positive performance, with stock selection superior to that of the Index. Core Growth companies were strong this quarter with Pioneers and Special Situations equally contributing to performance.

Year-to-date performance versus the Index has been penalized by the stock selection in Information Technology, Health Care and Industrials. Stock Selection in Materials, Financial, Communications Services and Real Estate has been positive. We are overweight in Information Technology, Health Care and Communications Services. All other sectors are underweight. Core Growth performance is the leading the portfolio, with Pioneers lagging.

Weightings

Information technology's weight is down 5% from last quarter, half from performance and the other half from trimming names. Healthcare is up 4% and Industrials are up 1%, both from positive performance. Year-to-date changes are similar. Changes from last quarter for lifecycles are flat, with year-to-date changes more pronounced. Core Growth is down 6%, while Pioneers and Special Situations are up 3% each since the beginning of the year.

Themes

As companies move more of their data to the cloud, particularly for better AI results, the need for robust data protection and digital security has grown commensurately. Given the growth of remote work, the volume and sensitivity of data being transmitted and stored has grown exponentially. Our investments in **Cellebrite, Qualys, Rapid7, Varonis Systems,** and **Okta** represent a strategic focus on companies at the forefront of defending enterprises from evolving cyber threats. **Cellebrite** specializes in digital intelligence and investigative solutions, providing critical tools for law enforcement and corporate investigations. **Qualys Inc.** offers cloud-based security and compliance solutions, helping organizations secure their digital environments through continuous monitoring and vulnerability management. **Rapid7** provides threat detection, incident response, and cybersecurity analytics, playing a crucial role in proactive defense strategies. **Varonis Systems** focuses on protecting sensitive data from insider threats and cyberattacks, leveraging AI-driven analytics to secure organizational data. Lastly, **Okta** is a leader in identity and access management, ensuring that businesses can manage digital identities securely across platforms. We believe these companies will be key beneficiaries as companies look to leverage the benefits of AI while also protecting their data and infrastructure.

Our portfolio includes key holdings in companies that are at the forefront of improving healthcare delivery through innovative medical devices and solutions. **BioLife Solutions** is a leader in the development of biopreservation tools that ensure the safe storage and transport of critical cellular therapies, contributing to the advancement of regenerative medicine. **OrthoPediatrics** focuses on pediatric orthopedic care, developing specialized implants and instruments to improve surgical outcomes for children with musculoskeletal conditions. **SI-BONE** is revolutionizing treatments for patients with lower back pain, offering minimally invasive implants that provide lasting relief for sacroiliac joint dysfunction. Finally, **TransMedics Group** has developed groundbreaking organ preservation technology that enhances the viability of donor organs for transplantation, expanding access to life-saving transplants. Collectively, these companies are transforming how care is delivered, making procedures safer, more effective, and accessible to a broader patient base.

Macro

Part of the reason small caps have lagged since the Fed cut rates may have been doubts about the economy. Inflation looks to be headed in the right direction, and jobs growth suggests an economic 'soft landing.' The outlook is not without risk, however. Tensions in the Middle East are escalating, US elections are weeks away, and wage growth is up some, all concerns for the market. A strong jobs market and re- acceleration in wage growth could mean fewer rate cuts than expected, however, overall the macro picture remains positive.

Outlook

Earnings growth in our small companies has been hampered by slowing top line growth comparisons versus the pandemic era hyper-growth, as well as interest rate hikes that hindered customers' ability to spend.

> *"Small cap three-year returns turned meaningfully negative, something that has happened only four times since 1978. Such periods of stagnation are followed by strong recoveries. One thing we know about the market is that it moves in cycles. Large caps have been leading for over 13 years now, which is relatively long compared to history. Small-cap trailing 10-year relative return versus large-cap is near an 80-year low. These lows have been reached multiple times in the past and each time it looked as if small caps had been left for dead, only for them to recover strongly in the forward years. The question is when will the recovery begin."* -Furey Research, October 7, 2024.

The valuation on our portfolio using EV/Sales is the lowest it has been in quite some time at 5.4X. Sales growth is beginning to recover with the outlook for 2025 strong for both revenue and earnings growth. We believe the companies in the portfolio are operating well with their secular demand drivers, pricing power and low financial leverage.