



GLOBAL SMALL CAP

Portfolio Comments

June 30, 2024

Distinguishing Features

GIM builds the [Global Small Cap](#) portfolio from the bottom-up; sector and geographic weightings are secondary to stock selection. The Global Small Cap strategy is overweight Information Technology, Health Care, Communication Services, and Consumer Discretionary versus the MSCI World Index Small Cap benchmark. The strategy is underweight in all other sectors. The portfolio has no exposure to Utilities or Energy.

Market Environment

The second quarter of 2024 proved to be a challenging period for small cap growth companies. While broader market indices such as the S&P 500 continued to show resilience, the performance of the small cap growth segment was notably more subdued. For small cap growth stocks, concerns related to earnings sustainability, inflation and higher interest rates have exacerbated negative sentiment, leading to multiple compression across the sector. The market has become incredibly short-sighted with investors seeking more immediate returns, in many cases chasing stocks that are exposed to topical trends despite increasingly unreasonable valuations. The market has become very narrow with gains primarily driven by mega-cap technology stocks, especially those with exposure to AI.

From a macro standpoint, the market remains hyper focused on the words and potential actions of the Federal Reserve, political developments across the world, and, increasingly, slowing growth due to higher interest rates and inflation. Fed Chair Powell recently said that the Fed will be “seeking greater confidence” that inflation is moving sustainably toward their 2% target before loosening. The ISM has trended lower over the last six months, below the 50-expansion mark. These weaker numbers came through in the reported inflation rate of 2.6%, the lowest since March of 2021, and down from 2.8% in April. Inflation is trending in the right direction for eventually lowering rates.

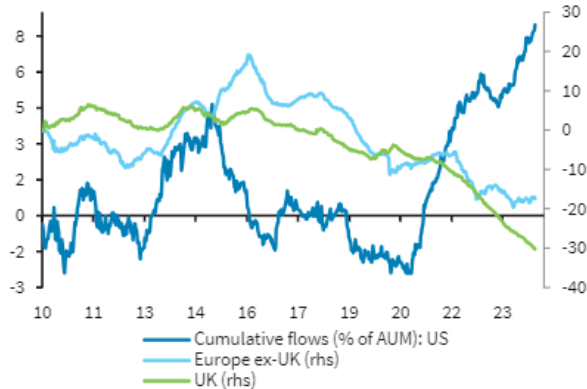
Growth remains lackluster overseas as well. Tail risk associated with policy and political developments across several regions dominated the narrative. While second half growth deceleration concerns have become top of mind for US investors, developed markets such as Europe and Japan appear to be in relatively better shape, but not significantly so. Disinflation is proceeding at a quicker pace in the Eurozone leading to expectations for earlier central bank easing by the ECB which already cut rates once.



Source: Goldman Sachs Global Investment Research

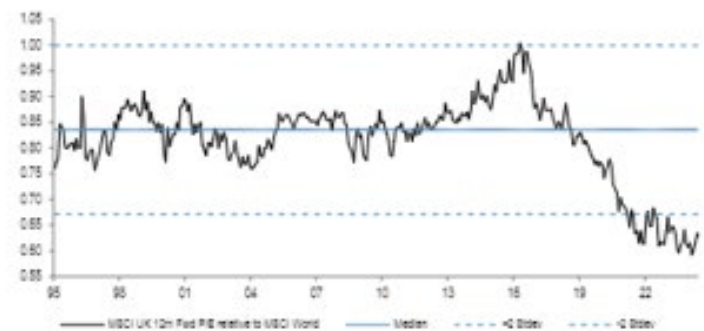
After years of meaningful UK fund outflows (AUM -20% compared to 2016), the political win by the Labour Party, the impending monetary easing and signs of improving economic growth (e.g., PMIs in expansionary territory,

leading indicators to consumer growth are getting better) are driving outperformance in the UK market for the first time in years. This setup typically favors small cap stocks which, like the US, have meaningfully underperformed large caps over the last few years. As shown below, UK equities currently trade at a 38% discount versus the MSCI World Index. We are currently equal weight to the UK but will certainly be evaluating new names for the portfolio.



Source: EPFR, Barclays Research

Figure 4: MSCI UK 12m Fwd P/E relative to MSCI World



Source: Datastream

As usual, Japan is a very different animal. The Japanese economy emerged from a multi-decade long disinflation cycle and is finally rejoining other developed nations in terms of a more normal functioning monetary policy. The COVID shock was quite a positive for the Japanese economy. The post-pandemic spike in inflation, meaningfully less than the US and Europe, has normalized at a more rapid pace. The Bank of Japan has recently raised interest rates, partly to combat the extreme weakness in the Yen relative to the US Dollar. This tightening weighed on our Japanese holdings (-53bps) as investors rotated to value-oriented companies and manufacturers whose exports benefit from the weaker currency. Japan Small Cap Value (+16.5%) significantly outperformed vs Japan Small Cap Growth (+9.7%) during the first half of 2024.

Performance Discussion

In the fourth quarter, the Granahan Global Small Cap strategy returned -5.7%, underperforming the Core Index return of -2.6%. Hotter inflation figures that impacted the end of the first quarter spilled over into the second quarter, continuing to weigh on our long duration holdings. Stock selection explained the entire underperformance in the period. Interestingly, the performance across Life Cycle categories was unusually narrow within a range of down 1.57 - 2.27%. Core Growth companies slightly outperformed Special Situations and Pioneers.

Tech was the best performing sector in the benchmark, the only sector in positive territory this period. The portfolio benefited by 138bps, the majority of which was driven by stock selection. Industrials was the largest detractor as concerns regarding decelerating second half growth weighed on the sector. Consumer Discretionary was the worst performing sector due to this same slowing growth fear.

Top Contributors:

- **Keyword Studios (KWS LN)** is a leading provider of outsourced services to the video games industry. The stock has been punished since early-2023 due to a misperception by the market regarding the impact of AI on its business and due to a macro-related slowing in new game releases. Private equity firm EQT recognized the security's mispricing and made a cash offer at a 67% premium. We sold our position.



- **Pure Storage (PSTG US)**, a leading provider of flash memory storage solutions to enterprise customers. The company is a disruptor leading to market share gains as flash memory takes share from hard disk drives commonly used in the large \$65B storage market. The company is seeing strong adoption of its technology with its subscription-based business recently gaining momentum while also securing a large deal with a leading GPU service provider as AI serves as a tailwind for its business. As a result, earnings estimates continue to be revised upwards.
- **Boot Barn (BOOT US)** is a retailer of Western wear and work gear. The company is highly differentiated and dominates its growing niche market. After 6 consecutive quarters of negative same-store sales, the company reported a return to positive comps in June. The inflection in demand combined with a reacceleration of unit growth and broadening of product categories is driving positive earnings revisions.
- **JTC Plc. (JTC LN)**, a provider of fund administration services to the alternative asset management and private client industries, is a defensive growth company that can weather periods of economic weakness. While the earnings report in April was well received, two acquisitions announced in the quarter drove the outperformance. The accretive nature of both deals was attractive, but the long-term benefits, specifically an acceleration to the US expansion strategy and the expansion into a new service category, was the source of investor enthusiasm. We continue to view JTC as a long-term compounder and core holding in the portfolio.
- **Biolife Solutions (BLFS US)**, Biolife Solutions is a leading provider of bioproduction tools to companies developing next generation cell and gene therapies. BLFS' products are critical in maintaining the health of biologic source material and finished therapies during manufacturing, storage, and distribution. While the stock reacted positively to signs of a recovery in the company's business, the main catalyst was due to the sale of a discontinued business that had materially underperformed. We expect BLFS to see a resurgence in revenue growth and a highly attractive profitability profile.

Top Detractors:

- **Portillo's (PTLO US)** is a fast casual restaurant founded in Chicago. The restaurant has incredible brand recognition in the Midwest and has been expanding this concept in several Sunbelt states that we expect to deliver attractive growth over the next several years. The company reported soft results last quarter given difficult weather conditions in its core markets. Additionally, the expansion plans are pressuring near-term profitability. We find the valuation extremely attractive at current levels and expect improved financial results over the course of the year to serve as a catalyst for the stock.
- **Columbus McKinnon (CMCO US)** manufactures material handling equipment. The company recently expanded into new markets focused on automated warehouses and conveyance systems. We expect these new markets to drive stronger overall organic revenue growth and higher levels of profitability for the company. The stock was pressured after management's outlook for the fiscal year included cautionary commentary around the macro environment. We maintain our position as we expect the secular drivers of increased automation to continue to transform the company leading to a higher valuation multiple for the stock.
- **Alfen NV (ALFEN NA)** operates three businesses tied to renewable energy: substations and smart grid solutions, EV charger equipment and energy storage. The company reported disappointing earnings and lowered its full year guidance due to project delays in their energy storage business and weak EV car sales in Europe. The fundamental profile of the company has gotten increasingly volatile and unpredictable as the mix has shifted away from the core smart grid business. We have lost a great deal

of confidence in management’s ability to execute and management investor expectations. We sold the stock shortly after quarter end.

- **10x Genomics (TXG US)** is a life sciences company providing equipment and consumables used to interrogate biology in single-cell resolution and spatial context, enabling the advancement of genomics research. We eliminated our position in the stock as we expect capital buying conditions in the life sciences tools sector to come under additional pressure this year. We were optimistic that we would see a rebound as the year progresses but now expect weakness to continue. While the company is a recognized leader in providing equipment for next generation genomics research, the valuation did not reflect the expected weakness.
- **Kinsale Capital Group (KNSL US)** is a specialty insurance provider focused on the Excess and Surplus markets. Kinsale has delivered some of the best metrics in the P&C insurance industry over the past several years; however, results in 1Q24 were disappointing. The company has recently expanded into some new verticals that has led to more volatility in reported results. We continue to hold the stock as we believe the current valuation is attractive for the expected long-term growth.

A few themes worth discussing:

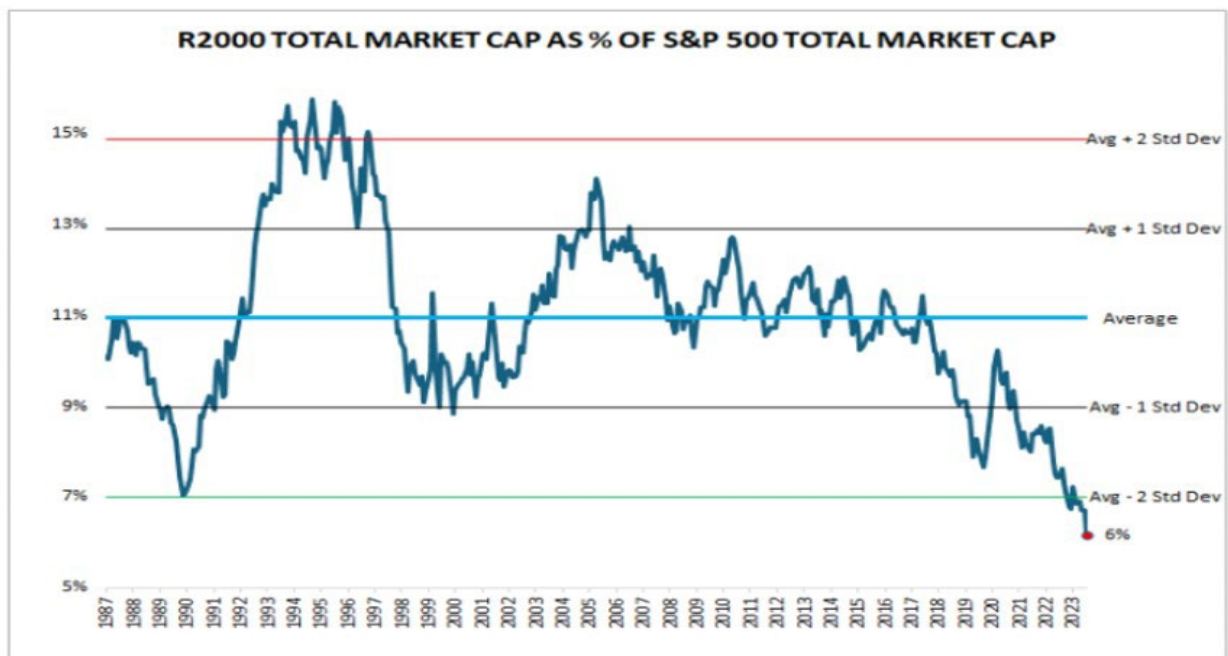
1. **Japan Macro Developments** – The strong market gains in Japanese stocks (~13% year-to-date) domestically were more than offset by the significant weakening of the Yen to a multi-decade low relative to the USD. This dynamic has increased volatility and uncertainty, dampening overseas investor sentiment. The magnitude of the depreciation has stoked fears that the Bank of Japan will adjust monetary policy to counteract Yen weakness, thereby further raising interest rates and impacting valuations of long-duration assets. While we are meaningfully underweight Japan (6.3% vs. benchmark 12.1%) given the inherent lower growth, excessive conservative nature of managements, and less attractive capital allocation policies, we have underperformed in the region due to a focus on secular growth companies, typically the stocks with the highest percentage of foreign ownership. As shown in the graph below, growth stocks have lagged value stocks by ~20 percentage points since the beginning of 2023, leading to dramatic multiple compression for our holdings despite similar long-term growth profiles.



2. **French Political Environment** – The increased possibility that the French government would shift to one controlled by Marine Le Pen’s far-right party shook the European markets during the period and

led to higher yields. The uptick in volatility was both related to political instability (e.g., French version of BREXIT) as well as financial concerns. The market feared that a shift in power would lead to the adoption of fiscal expansionary measures, resulting in further erosion in government finances (the EU has already been demanding that France take corrective measures to its fiscal deficit) and potentially sustained inflation from further government spending.

3. **Small vs Large Still Making New Lows** – In the US, small cap lagged large caps by 12.5% in the 1H 2024, the widest spread since 1973. The Russell 2000 total market capitalization is now just 6% of the S&P 500 total market capitalization. M&A started the year strong, which bodes well for small caps. The picture is similar in other parts of the world.



Source: Furey Research Partners and FactSet. Data as of 6/28/24.

Commentary

The market has become quite short-sighted and narrowly focused, and incredibly impatient. As investors bid up stocks with any mention of AI, GLP-1 or cryptocurrencies in their businesses, there are multiples of other companies whose valuations underappreciate the long-term growth profiles of their businesses. We believe the pendulum will eventually swing back to recognizing long-term compounders that are now significantly undervalued, in many cases. Drew Beja, Portfolio Manager of our US Focused Growth Fund, has communicated the dynamic in this interesting way.

The investing world has become one of “Haves and Have Nots”. After ideal conditions for long duration growth stocks from 2010 to late 2021, the favorable tailwinds turned into fierce headwinds (e.g., historical rate hikes, slowing growth, spike in inflation, multiple layers of macro uncertainty). The “average” well-positioned secular growth company has seen earnings estimate cuts and valuation multiples slashed to unthinkable levels. Stocks are either blessed to be “Haves” or are on the much longer list of “Have Nots.” The Haves have been well-documented – Mag 7, AI infrastructure winners, and a narrow list of “other” stocks that have captured investor



interest for idiosyncratic reasons (e.g., MicroStrategy, Coinbase, Abercrombie & Fitch, and Sweetgreen). Meanwhile, the "Have Not" bucket is spilling over with a wide range of companies. Among these, we believe, are a significant number of secular growth companies whose valuations are meaningfully disconnected from their earnings power. Many of these companies have some common characteristics which enable us to group them in one of three buckets:

1. Estimates have/will be cut, but long-term earnings power, and stock risk/reward are compelling
2. Special Situations that are too complicated for the market today but should be clearer in 6-9 months
3. Executing well but the market just hasn't cared, but we believe it will.

In each category, investors are broadly shunning companies with these characteristics, leading to some particularly attractive investment opportunities.

In terms of actions taken this quarter, we consolidated the portfolio by selling 6 names, two of which were acquisition takeouts, and increased our weighting in higher conviction holdings. We added 3 new companies to the portfolio this quarter. **Fox Factory**, a manufacturer of high-end suspensions and related products for premium off-road bikes and vehicles as well as high-end baseball bats, is nearing a positive inflection in the business after weakness related to the post-pandemic inventory correction and demand normalization. Fox Factory is an iconic brand in their categories that has consistently outgrown its markets by 10%+ CAGR. We believe the company will return to that growth profile soon. **Knife River** provides aggregates-based construction materials and contracting services in attractive, high-growth markets, in which many the company is the leading provider. The combination of accelerating pricing power and impending strong government spending programs is likely to drive earnings growth above consensus estimates and lead to multiple expansion. **Zealand Pharma**, a Denmark-based biotech, is Europe's strongest player among smaller companies in the obesity space with a long legacy of developing peptide-based drugs. We believe the four early to mid-stage obesity-related development programs, including GLP-1 and GIP, are incredibly promising based on the size of the market, strong category growth and impressive Phase 1B data. After a recent \$1 billion equity raise, the company is well-funded to advance these drug candidates to later-stage development.

Outlook

While we cannot predict what future periods will bring in terms of macro, political and policy developments, we can remain true to the investment philosophy and process that has made Granahan Investment Management so successful over many decades. We are certainly aware of external factors that affect the performance of our portfolios but prefer to focus on finding secularly growing companies with strong competitive advantages, compelling value propositions and superior management teams. The opportunity to continually upgrade the portfolio as valuations of "our type of companies" unreasonable fall is significant. We remain disciplined and are focused on the factors that we can control. That's not to say we have not made mistakes by getting the earnings growth wrong or underestimating idiosyncratic risks; execution can be better. But we remain invested in the types of companies that have always been a staple of the Granahan investment process and are highly confident that patience will lead to outperformance over the long term.



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