GRANAHAN INVESTMENT MANAGEMENT INC

SMID SELECT

Portfolio Comments
June 30, 2024

Distinguishing Features

GIM builds the SMID Select portfolio from the bottom-up; sector weightings are secondary to stock selection. At quarter-end, the SMID Select was overweight in Communication Services, Consumer Staples, and Information Technology versus the Russell 2500 Growth benchmark. The strategy is underweight Consumer Discretionary, Industrials, and Energy, and equal weight in all remaining sectors. The strategy continues to have no exposure to Utilities.

Market Environment

The current market environment continues to be dominated by macro related factors, especially a hyper focus on U.S. inflation data. The year started out with higher-than-expected inflation data that supported a far more cautious approach to start of the rate cuts. Late in 2023, Federal Reserve Chair, Jerome Powell postulated that three rate cuts would occur in 2024, and the market was convinced even a higher number which could be implied from market data. With the negative surprise to inflation in the early part of the year, we are only now seeing the start of lower inflation. The Fed needed to have more of these data points in the first half of the year to feel confident in a rate cut at all in 2024. Now the debate with investors is the path of rate cuts going forward. While this is clearly still an unknown, we do feel that the pressure on inflation is likely to continue to subside as the economy grows at a more subdued pace than it did in 2023. We are seeing this clearly in the consumer space where bellwether companies like Nike and Levis's announced lackluster results late in June. McDonald's has seen consumer pushback on prices and as a result introduced a new lower priced $5 value menu. While these are just anecdotes, it shouldn't surprise anyone that when our debt takes a bigger piece of our budgets, there is less money to buy things, especially at these higher prices. As we approach the back half of the year, the inflation data will continue to be in focus and be a key determining factor in sentiment, particularly in small cap stocks and Pioneer companies.

Performance & Attribution

The Granahan SMID Select strategy returned -4.25% in the second quarter, in line with the -4.22% return of its Russell 2500 Growth benchmark.

Top Contributors	Top Detractors
1. Magnite (Comm Svcs, Core Growth)	1. Porch Group (Tech, Pioneer)
2. Carpenter Technology (Materials, Special Sit.)	2. Evolent Health (Health Care, Special Sit.)
3. First Solar (Tech, Core Growth)	3. Array Technologies (Technology, Core Growth)
4. Shift4 Payments (Financials, Core Growth)	4. Viking Therapeutics (Health Care, Pioneer)
5. Pure Storage (Tech, Core Growth)	5. Indie Semiconductor (Tech, Pioneer)

With respect to LifeCycle categories for the quarter, Core Growth and Special Situation names outperformed the benchmark while Pioneers lagged.

Positioning

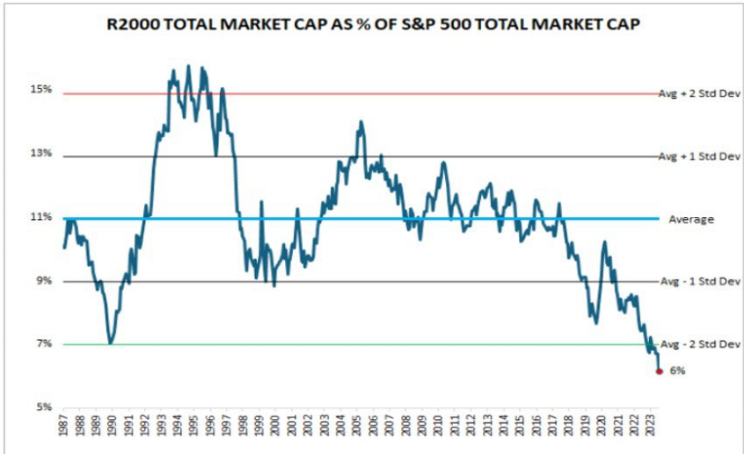
In the second quarter we trailed our benchmark. However, there was meaningful outperformance in the month of May which importantly coincided with Q1 earnings season. This is different; it feels like we are at the beginning stages of having a broader range of companies getting credit for strong growth reflected in positive stock price movements. This, however, is still not universal, particularly with our Pioneer companies which were down for the quarter and accounted for 90% of the negative contribution in the quarter. While this is a difficult result, the good news is that many of our Pioneers are poised for continued growth and are positioned to become profitable. What we have observed in some of our holdings is that there is an unusually large penalty being placed on small losses. A company growing 20% with $10 MM of EBITDA losses might trade at 2-3X EV/Sales and a similar company that is in the same industry growing 20% with positive EBITDA of $20MM might trade at 7X EV/Sales.

We believe Pioneer names like **indie Semiconductor, SI Bone, Porch** and **Quanterix** all have the makings of becoming profitable companies because of their strong growth characteristics. .If we continue to see inflation slowing and interest rates decrease, these stocks could do very well imminently. Importantly, we are not counting on this; our patience should be rewarded over time.

Our newest Major Leage position in the strategy is **Parsons Corporation**, a Core Growth Company that provides software cybersecurity solutions and a myriad of services largely to the US intelligence community. Parsons had very strong organic growth in the most recent quarter. Additionally, bookings were strong across the board with a 1.4X Book to Bill and several large $100MM awards. The company is winning across a host of opportunities in Transportation, Defense, Security, Middle East development and Environmental remediation including PFAS. Parsons is emblematic of what we look for in many of our Core Growth companies; strong internal and sustainable growth, improving margins, an excellent management team, all with a very reasonable valuation that should allow the stock trajectory to follow the earnings trajectory.

Outlook

The second quarter of 2024 proved to be a challenging period for small cap growth companies. The headwinds of historic interest rate increases, persistent levels of inflation, political uncertainty, and numerous concerns about macro weakness all have pressured small cap growth stocks. While the broader market indices such as the S&P 500 continued to show advance on the backs of the AI related stocks, the performance of the Russell 2000 Growth index was more subdued. Small cap stocks have lagged large cap by 12.5% in the first half of 2024, the widest spread since 1973. The Russell 2000 total market capitalization is now just 6% of the S&P 500 total market capitalization, well below the historical average of 11%, representing a new low. Small cap valuations compared to large cap valuations are in a territory that we have seldom seen.



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

The market has become extremely narrow with leadership concentrated in the Magnificent 7 and a handful of select stocks leading to a short list of stocks that are "Haves" and a much longer list of "Have Nots". While investors have increasingly become short-sighted, we believe there are a significant number of our companies operating very well with long-term secular drivers that have extremely compelling growth prospects and valuations. Over GIM's 39-year history, we have demonstrated compelling returns buying long-term growth stocks where valuations are meaningfully disconnected from their earnings power.