# GLOBAL SMALL CAP

**Portfolio Comments**
**September 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, Consumer Discretionary and Industrials 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 most significant macroeconomic development during the quarter was the Federal Reserve's decision to cut interest rates by 50 basis points, a move that followed earlier easing actions by central banks in Europe, Canada and Australia.  While much anticipated, the action was meaningful, nonetheless, as the shift in monetary policy marks an important pivot to a more normalized environment for growth investing.  While a reduction in rates is certainly welcome, a mere stabilization of rates is enough to allow our high-growth, long-duration growth companies to be more recognized and rewarded by the market.

Inflation trends remain top of mind for investors, but with the first easing action in the books, the market has shifted its attention (and concern) to the potential for a recession in the near term.  Those concerns are more acute in Continental Europe given heavier reliance on China trade (and its economic issues) and Russian oil and gas.  The ISM has yet to bottom, global PMIs remain in contractionary territory (22 of last 23 months), the pressure points on consumer spending appear to be worsening, namely higher rates and inflation, and the high cost of capital is impacting companies' willingness to invest in projects.  As a result, consensus earnings estimates have recently been revised downward (see graph) and sentiment has shifted to favoring defensive sectors such as Real Estate, Insurance (Financials), and Utilities (see graph).  Factors including yen volatility, an escalating Middle East conflict, various labor strikes, reduction in guidance by blue chip retailers, and uncertainty related to upcoming US elections, and potential policy such as tariffs, have added to cautious sentiment.


| | MSCI The World Index Small Cap | | |
|---|---|---|---|
| | Bench. Average Weight | Bench. Total Return | Bench. Contrib. To Return |
| Total | 100.00 | 9.50 | 9.50 |
| Real Estate | 8.26 | 17.77 | 1.41 |
| Financials | 15.55 | 13.21 | 1.99 |
| Utilities | 2.56 | 12.58 | 0.31 |
| Communication Services | 2.97 | 12.54 | 0.37 |
| Materials | 7.45 | 10.85 | 0.80 |
| Consumer Discretionary | 13.34 | 10.26 | 1.36 |
| Consumer Staples | 4.80 | 10.15 | 0.48 |
| Industrials | 19.54 | 9.76 | 1.88 |
| Health Care | 9.69 | 8.60 | 0.85 |
| [Unassigned] | 0.48 | 6.62 | 0.04 |
| Information Technology | 10.85 | 2.51 | 0.31 |
| [Cash] | -- | -- | -- |
| Energy | 4.53 | -6.44 | -0.31 |

Source: Factset

While there is no shortage of market concerns, the environment is not all dour. A 'soft landing' from the aggressive monetary policy over the last few years remains a real possibility, and we are seeing green shoots in certain areas of the market. US GDP likely grew at or above 3% this quarter. Inflation is showing continued signs of moderation globally with Europe (at <2% year over year) more advanced than the US, in this respect. The labor market has clearly cooled in the US, but the economy is still adding jobs at a decent clip and unemployment remains in the Fed's target range. The consumer, while increasingly feeling pressure, remains resilient, for the most part. Lower interest rates are raising expectations for a recovery in the housing market as well as for large ticket consumer items and capital spending. And infrastructure spending remains solid due to government initiatives such as the Inflation Reduction Act (IRA) and similar programs globally. While our portfolio companies are less cyclical than the average benchmark company, they are not immune to slowdowns. However, with secular demand drivers, pricing power, and low financial leverage, our companies will navigate macroeconomic weakness better than most.

**Performance Discussion**

In the third quarter, the Granahan Global Small Cap strategy returned 11.5%, outperforming the Core Index return of 9.4%. Stock selection drove 366bps of performance, more than offsetting the negative allocation effect of 122bps. Real Estate, Financials and Utilities, sectors in which the strategy is meaningfully underweight, were in the top 4 performing sectors while Technology trailed the index by 700bps. In that type of quarter, the portfolio typically underperforms. However, strong stock selection, particularly in Industrials (+200bps) and Technology (+140bps), more than offset these sector allocation headwinds. Japan was the standout this quarter, as our earlier decision to increase positions in two of the portfolio's top secular growth companies, following an inflection point in fundamentals, proved successful; our weighting to Japan increased to 10.5% at the end of Q3 compared to 5.3% at the end of Q1.

**Top Contributors:**

- **Baycurrent Consulting (6532 JP)** is a Japanese consulting firm focused on helping clients with digital transformation. The company is experiencing such a robust demand environment for its services that management decided to aggressively hire, temporarily reducing consultant utilization and rates. We encourage management teams to invest in their businesses if returns are strong, even if it impacts growth or profitability in the short term. Given our long-term conviction on the growth potential of the business, we took advantage of the compelling opportunity to add to our position prior to the company reporting a solid quarter.
- **JMDC (4483 JP)** is the leading provider of big data for the Japanese healthcare industry. The regulations are different in Japan regarding data which creates significant barriers to entry for JMDC. After a couple of large projects related to COVID ended, the growth rate temporarily decelerated. We have a high degree of confidence in the long-term secular growth of the company and took the opportunity to increase the weighting earlier this year ahead of a strong earnings report in August.
- **Cogent Communications (CCOI US)** is a tier 1 facilities-based Internet Services Provider providing high-speed Internet access, Ethernet transport, and colocation services. About 25% of the world's internet traffic travels across Cogent's network. The company has been repurposing legacy assets acquired from T-Mobile to capitalize on demand for optical wavelengths tied to Data center buildouts and AI. We believe there are several catalysts over the next year that will highlight the attractiveness of the company's assets and a return to strong revenue growth and margin expansion.
- **Goosehead Insurance (GSHD US)** is a highly differentiated insurance agency with a technology and business model advantage relative to legacy incumbents. Goosehead is a disruptor of the status quo in

the personal lines insurance market and is gaining market share. The dynamic post-COVID has created a mismatch of insurance claims and rates which are highly regulated at the state level. As a result, underwriters have completely exited certain markets due to challenged profitability. Insurance policy choice is a key value proposition, and the lack of availability of products in certain markets combined with a challenging housing market has weighed on the agency industry. The company reported strong earnings in July that increased market confidence that we have reached an inflecting point of moving past these headwinds.

- **Portillo's (PTLO US)** is a casual restaurant chain known for its iconic Chicago-style street food. There are now over 70 locations across 10 states as the company expands into new locations specifically targeting high growth states like Florida, Arizona, and Texas. The restaurant serves a menu featuring Italian beef sandwiches, Chicago-style hot dogs, char-broiled burgers, and salads. During the quarter, the stock responded favorably to a better-than-expected earnings report and management's expectations for a stronger second half of the year driven by revamped marketing efforts. The stock remains very attractive given its valuation that heavily discounts the long-term growth opportunity.

**Top Detractors:**

- **TopGolf Callaway Brands (MODG US)** is a leading company in the golf and active lifestyle sectors participating in a range of products from golf equipment, apparel and TopGolf entertainment venues. The combined company has struggled to appeal to investors given the volatility in financial results from TopGolf and the stock was weak in response to the latest earnings report. Subsequently, the company announced it would separate into two companies to address the recent stock weakness. We trimmed our weighting but maintain a position given the current valuation that is meaningfully discounting the value we expect to be recognized due to the split.
- **Pros Holdings (PRO US)** provides a software platform that provides businesses with predictive AI insights in the form of product suggestions, personalized offerings, and real-time pricing across sales channels. The products have a demonstrated ROI in the form of revenue uplift and margin improvement. The stock was weak in the quarter given the company's exposure to the airline industry. Some of the carriers' operational challenges have led to softer bookings that will moderate growth over the next year. We continue to own the stock.
- **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. The stock was weak in the quarter as some customer purchase decisions have been elongated given the current macro environment; however, we believe there will be improved results over the next year.
- **Power Integrations (POWI US)** manufactures high-voltage analog integrated circuits (ICs) for the power conversion market. The company's products are used in many products like cell phone chargers, cellular base stations, consumer appliances and numerous industrial applications. Customers choose POWI's highly integrated solutions to simplify supply chains and gain energy efficiency to meet stringent mandates. The overall industry has experienced short-term weakness given the macro environment; however, we believe trends are improving while the stock does not reflect the long-term value creation we expect given the strong secular tailwinds.

- **OrthoPediatrics (KIDS US)** is a medical device company that develops and markets anatomically appropriate implants and devices for the treatment of children with orthopedic conditions. Over the last several years, the company has done an excellent job in building out its portfolio of products through organic investment and attractive M&A. KIDS can now meet most of a children's hospital's surgery needs that we believe will lead to meaningful market share gains over the next several years. The recent multiple compression has been tied to higher interest rates and investors skepticism towards healthcare companies investing in future growth initiatives. As KIDS meets its financial expectations, we expect the company to be recognized by investors given its market leadership position and attractive financial profile of growth and profitability.

A few themes worth discussing:

1. **AI Cart Before The Horse** – The potential of artificial intelligence to improve business efficiencies, provide deeper insights and enhance decision-making is undeniable. But AI models are nothing without the data that feeds them. The success of AI hinges on effective data management, data governance and data security practices. Data is the foundational layer that must be cleaned and structured before AI models can be employed and scaled. Traceability, understanding where data is sourced, how it is used and how it changes over time, and security, focused on access controls and authentication, are essential components of deploying AI. The amount of upfront work around data will create growth opportunities for technology companies that have experience in this space. **Converge Technology**, a recent addition to the portfolio, is benefiting from this upfront work by helping customers create robust data management frameworks to ensure AI models are built on accurate, reliable and well-structured data. **Baycurrent**, a Japanese consulting company with a focus on digital transformation, offers similar services to its customers.

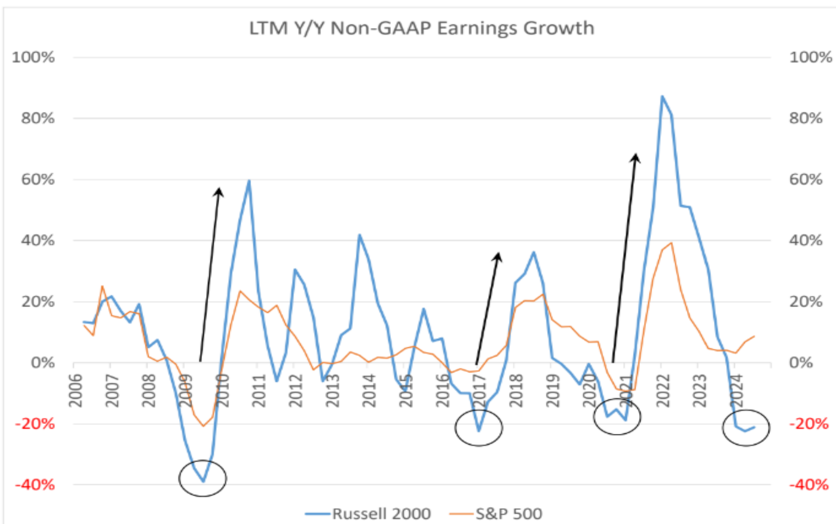
2. **USD/JPY Carry Trade** – The portfolio experienced volatility intra-quarter due to an unwind of the USD/JPY carry trade. In this financial maneuver, investors borrow funds in Yen at low interest rates and invest those funds in assets denominated in US dollars. The trade is attractive when there is a substantial interest rate differential between the two currencies which has been the case between the US and Japan, particularly over the last few years with the Fed aggressively tightening monetary policy. The weak economic data in the US in early-August essentially confirmed that the Fed would lower interest rates in September, leading to a sharp unwind of the carry trade. Investors sold assets, including stocks, to pay back Yen borrowings causing volatility in our Japanese holdings. Our companies declined 12-16% in a matter of a week, but mostly bounced back in the subsequent few weeks.

3. **Encouraging Signs in the Battle of Small vs Large** – We have discussed in prior commentaries the historically high underperformance of small cap relative to large cap over the decade or so. In 1H 2024, small caps lagged large by 12.5%, the widest spread since 1973. But what does the potential trend reversal mean for the GSC portfolio, specifically? Small caps have outperformed large caps in only 2 of the last 8 quarters (Q4 2023 and Q3 2024). In both quarters, the GSC portfolio outperformed the benchmark:

- Q4 2023: +127bps alpha (Russell 2000 Growth 12.5% vs S&P 500 Growth 9.8%)

- Q3 2024: +244bps alpha (Russell 2000 Growth 8.3% vs S&P 500 Growth 3.6%)

Relative valuation is at a historically low level and relative performance is more than 2 standard deviations below the mean. In addition, concerns relating to a record level of profitability for large caps is starting to be discussed more. Small caps, in contrast, have plenty of room for profitability improvement as well as positive earnings estimates revisions (see graph). When these cycles occur, they typically last for prolonged periods of time (see graph). When the market has experienced significant concentration in the top 5 S&P 500 stocks, as is the case today, the relative performance of small caps tends to be significantly positive (see graph).




*Source: FRP, FactSet; as of 9/30/24*

FUREY RESEARCH PARTNERS
INTEGRATED SMALL-CAP STRATEGY

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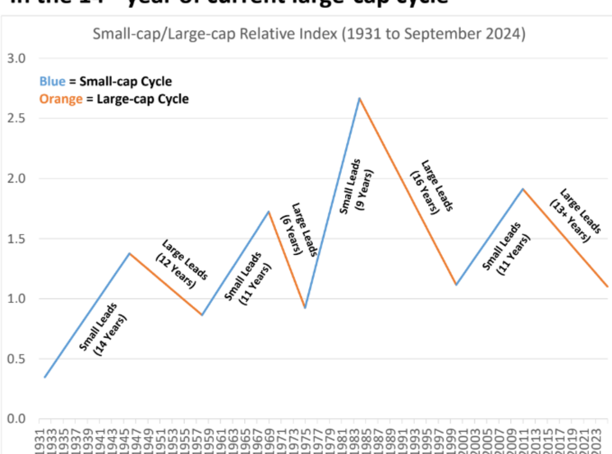
**In the 14th year of current large-cap cycle**




*Source: FRP, FactSet; as of 9/30/24*

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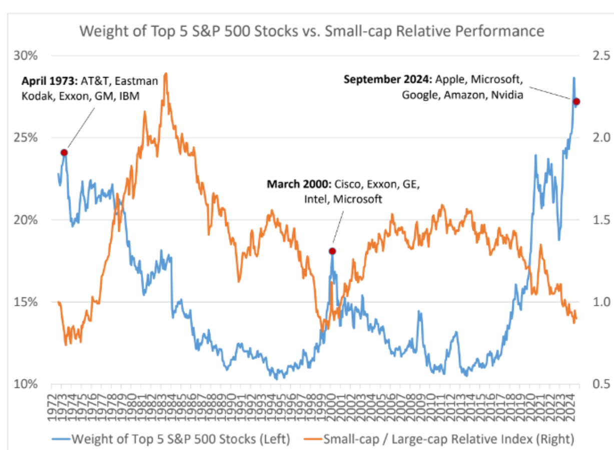


*Source: FRP, FactSet; as of 9/30/24*

**Commentary**

In terms of actions taken this quarter, we added 6 companies and sold 5. **Converge Technology**, a Canadian value-added reseller and IT services provider, is well-positioned to benefit from secular growth drivers such as AI, cloud migration, data analytics and cybersecurity. After a period of M&A, the company has created a scale and capability advantage relative to smaller competitors, raising their importance with the top vendors in the space such as AWS, Microsoft and Crowdstrike. At a free cash flow yield of ~18%+, the company is mispriced compared to its growth profile. **Chart Industries** manufactures highly engineered equipment used in the production, storage and end-use of hydrocarbons and industrial gases. The company has been expanding into high-growth areas such as hydrogen and liquefied natural gas driven by strong secular trends. **MarketAxess** provides electronic trading of US and European corporate bonds to broker-dealers and institutional clients. The adoption of electronic trading solutions is still early days with plenty of long-term growth as clients increasingly look for pools of liquidity and trading efficiency. **Docebo**, is a highly differentiated provider of SaaS learning management software with a competitive advantage tied to a better tech stack (e.g., more customization, user friendly) and an unparalleled capability in the external training market (e.g., powers the AWS certification program). **Merus N.V.** is a Netherland-based biotechnology company with expertise in biospecific antibody therapeutics to treat cancer. Finally, **Organo**, a Japanese water treatment engineering company, has a favorable market position, particularly with TSMC, and is benefitting from the buildout of semiconductor capacity globally. The high barriers to entry in this space have created an oligopoly in Japan.

**Outlook**

A shift to a more accommodative monetary policy on a global basis clearly makes the outlook for our investment style incrementally more favorable. While the crosscurrents in the market continue to warrant caution, we are intently focused on determining the long-term earnings growth of our secular growth companies and how it compares with market expectations. With stabilization in the rate dynamic, the investing environment feels more normal and a far cry from 2022 and 2023 when interest rates were rising at historic levels. With that headwind behind us for the time being, a return to a focus on fundamentals, something we have never lost, and a broadening of what has been an incredibly narrow market would certainly be a welcome change.

*Disclosure:*

*The information provided in this commentary should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and, in the aggregate, may represent only a small percentage of an account's portfolio holdings.*

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