SMALL CAP ADVANTAGE

Portfolio Comments
December 31, 2024

Distinguishing Features

GIM builds the Small Cap Advantage portfolio from the bottom-up; sector weightings are secondary to stock selection. As of December 31, 2024, the Small Cap Advantage portfolio was overweight its Russell 2000 Growth benchmark in Technology, Fianancials, and Utilities. We are underweight the benchmark in Industrials and Heathcare and equal weight all other sectors. The portfolio has no exposure to Energy or Consumer Staples.

Commentary

Market Environment

Following a promising shift in policy last quarter, the Federal Reserve tempered expectations for rate cuts, given stronger economic data, and its potential inflationary effects. Yields climbed meaningfully during Q4 2024 due to better economic data, particularly job growth, and continued rising government debt levels, which fueled concerns about resurgent inflation. While the fluctuating narratives regarding rates, inflation and economic growth continue to swing sentiment, the market dynamic is more constructive heading into the new year than it has been in the last few years, particularly for small caps because of the return of strong projected revenue and earnings growth.

Performance

For the fourth quarter, the Granahan Small Cap Advantage strategy returned +1.9%, slightly outperforming the +1.7% return of its Russell 2000 Growth benchmark. Strength in the portfolio came from stock selection in Industrials despite being penalized for the relative underweighting in the sector. Stock selection in the Health Care sector was a detractor. For the full year, the strategy returned +6.9% compared to the index return of +15.2%.

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

TOP CONTRIBUTORS	
4Q – 2024	**2024**
1. **Axon Enterprise** (Industrial, Core Growth)	1. **Zeta Global** (Financials, Core Growth)
2. **Porch Group** (Financials, Pioneer)	2. **Axon Enterprise** (Industrials, Core Growth)
3. **Reddit, Inc.** (Technology, Pioneer)	3. **Toast, Inc.** (Technology, Pioneer)
4. **Toast, Inc.** (Technology, Pioneer)	4. **Victory Capital** (Financials, Core Growth)
5. **Marex Group** (Financials, Core Growth)	5. **Edgewise Therapeutics** (Health Care, Pioneer)

TOP DETRACTORS	
4Q – 2024	**2024**
1. **Evolent Health** (Health Care, Special Situation)	1. **Sprout Social** (Technology, Core Growth)
2. **Zeta Global Holdings** (Financials, Core Growth)	2. **Evolent Health** (Health Care, Special Situation)
3. **KinderCare Learning** (Consumer Disc., Core Growth)	3. **indie Semiconductor** (Technology, Pioneer)
4. **Keros Therapeutics** (Health Care, Pioneer)	4. **Quanterix Corp.** (Health Care, Pioneer)
5. **Exact Sciences** (Health Care, Core Growth)	5. **PROS holdings** (Technology, Core Growth)

Positioning

It was a challenging year for the strategy, as our healthcare sector was under siege. For healthcare investors, the last few years have been particularly difficult to navigate. Less than 20% of healthcare stocks have beaten the market over the last two years, the lowest percentage of winners in two decades. This, combined with concerns about the potentially negative effects of policies discussed by the incoming political administration, has been a painful dynamic for a sector that has historically helped with downside protection. The negative healthcare trend continued in the quarter as 5 of our largest 10 detractors were from this sector.

Also contributing to the challenging year was the narrowness of the stock market, where a limited number of stocks drove most of the market gains, and has masked underlying weakness in the broader market. This lack of breadth can signal fragility, as it suggests that investors have been worried about inflation, higher interest rates, geopolitical tensions and/or recession—even as excitement about AI innovation has supported the largest cap players. The small cap market has been experiencing something similar, as almost 50% of the return of the Russell 2000 Growth Index for the year came from just 10 names, and in Q4, 150% of the Index return was from 10 stocks. As our small cap companies overcome the lack of earnings growth over the last several years, we expect the market to broaden out, which will be beneficial for a diversified investment portfolio.

Outlook

Concerns over a potential recession have been replaced by expectations related to the degree to which revenue and earnings growth will accelerate in 2025 and 2026. In that respect, small cap companies are well positioned, with revenue and earnings growth anticipated to be better than large cap for the first time in the last several years. “Higher for longer” in terms of rates is not necessarily a significant negative if it happens in the context of stronger economic growth, as valuation compression over the last three years has been substantial. Stronger economic growth is fueling greater small cap revenue and earnings growth estimates for 2025 and beyond. The severe narrowness of the market seen over the course of 2024 is gradually giving way to more breadth, a positive dynamic for active investing.

It is worth mentioning that today’s environment is quite different than 2022 and 2023 when inflation and rates were spiking, and an altered supply/demand cycle (i.e., COVID hangover) caused massive dislocation across industries. The risks today are less extraordinary and resemble factors that are more normal course and ones that we have assessed for decades. Whether the Fed cuts rates by two times or three in 2025 is much less important than the revenue and earnings growth that our portfolio companies deliver in 2025 and beyond. As such, we continue to be focused on the fundamentals of the underlying businesses in which we invest. The shortsightedness we see in the current market creates opportunities for us to leverage short-term volatility to a long-term advantage.