GRANAHAN INVESTMENT MANAGEMENT LLC

Future Pathways

Portfolio Comments
December 31, 2024

Distinguishing Features

The GIM Future Pathways portfolio focuses on US companies that promote sustainability, in addition to meeting traditional financial benchmarks for investment. As such, GIM builds the Future Pathways portfolio from the bottom-up, and sector weightings are secondary to stock selection. During the period, the Future Pathways portfolio remained overweight Industrials, Consumer Staples, Health Care. We are underweight the Russell 2500 Growth benchmark in all other sectors. The portfolio has no exposure to Utilities, Communication Services, Real Estate, or Materials.

Market Environment

Following a promising shift in policy last quarter, the Federal Reserve tempered expectations for rate cuts considering 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, fueling concerns about resurgent inflation. While the fluctuating narratives regarding rates, inflation and economic growth continue to swing sentiment, the market dynamic is clearly 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 & Attribution

The Granahan Future Pathways strategy returned -9.4% in the quarter, lagging the +2.4% return of its Russell 2500 Growth benchmark. For the full year, the strategy returned -9.5%, underperforming the index return of +13.9%.

Challenges in the quarter were largely tied to selection in Information Technology, Health Care, and Industrials. Selection and allocation in Consumer Staples was positive but not enough to offset the detractors. With respect to sustainable objectives, Social Justice & Opportunity and Water & Food holdings nicely outperformed the return of the benchmark but it wasn’t enough to offset the negative returns from Health Care Outcomes & Cost, Clean Energy and Energy Efficiency holdings.

TOP CONTRIBUTORS	
4Q – 2024	**2024**
1. **Axon Enterprise** (Social Justice & Opportunity)	1. **Axon Enterprise** (Social Justice & Opportunity)
2. **SunOpta, Inc.** (Water & Food)	2. **Pure Storage** (Energy Efficiency)
3. **Vita Coco Company** (Water & Food)	3. **SunOpta, Inc.** (Water & Food)
4. **Universal Technical Inst.** (Social Justic & Opportunity)	4. **Veracyte, Inc.** (Health Care Outcomes & Cost)
5. **iRhythm Technologies** (Technology, Pioneer)	5. **SPX Technologies** (Energy Efficiency)

TOP DETRACTORS	
4Q – 2024	**2024**
1. **Evolent Health** (Health Care Outcomes & Cost)	1. **Evolent Health** (Health Care Outcomes & Cost)
2. **First Solar** (Clean Energy)	2. **Array Technologies** (Clean Energy)
3. **Ameresco, Inc.** (Clean Energy)	3. **Viking Therapeutics** (Health Care Outcomes & Cost)
4. **Viking Therapeutics** (Health Care Outcomes & Cost)	4. **Montrose Environmental Group** (Pollution Reduction)
5. **Exact Sciences** (Health Care Outcomes & Cost)	5. **SoundThinking** (Social Justice & Opportunity)

Positioning

It was a challenging year for Future Pathways against our broad benchmark with our two biggest objectives, Clean Energy and Health Care, each having major negative contributions to the strategy.

The "Red" sweep in the November elections made an already challenging year even more difficult, as it became a foregone conclusion that the Inflation Reduction Act would likely be scaled back significantly. While the changes are unlikely to have the greatest impact on the companies we are invested in, the uncertainty this has caused has driven many investors in the sector to the sidelines, at least until greater clarity emerges. We have maintained a lower weighting in Clean Energy stocks relative to our stated ranges, but even this natural overweight has been a significant headwind and is likely to remain so in the early part of the year.

That said, there was one clear positive contributor in this area: **Chart Industries**, which stands to benefit from the resurgence in LNG infrastructure award activity. The company also delivered its first strong quarter for cash flow with its third-quarter results. As we move through 2025, we plan to opportunistically add to our Clean Energy positions when we can identify businesses that are clearly beginning to reaccelerate their growth.

Our healthcare sector was under siege for both the quarter and the year. 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.

In the healthcare space, we unfortunately found ourselves whipsawed by **Evolent Health (EVH)** after strong performance in Q3 as it was an outsized detractor in the strategy in Q4. As a long-term holding, the stock has been more like a roller coaster than a steady performer, but we believe better days lie ahead. Evolent's core value proposition is helping managed care companies lower the cost of treatment while maintaining – and often improving—quality of care. However, currently the company shares in the financial risk of its customers and this exposure became overwhelming in Q3. A higher-than-expected number of patients requiring cancer treatment, coupled with escalating treatment costs, led to a significant earnings downgrade. While Evolent is responsible for reducing costs, it cannot control the prevalence of cancer or the pricing of expensive cancer drugs, Nonetheless, we remain confident in the company's ability to adjust its risk-sharing contracts, potentially accepting lower margins in exchange for reduced risk exposure. Evolent's role in lowering costs becomes even more critical when expenses are rising and its customers are under financial strain. We believe this dynamic will either result in a material expansion of earnings or an increase in valuation as the company's risk profile improves. Following the significant Q4 drawdown, we are optimistic about a positive update in the coming weeks.

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 the stronger 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.

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