GIM GRANAHAN INVESTMENT MANAGEMENT LLC

SMALL CAP SELECT

Portfolio Comments
December 31, 2024

Distinguishing Features

GIM builds the Small Cap Select portfolio from the bottom-up; sector weightings are secondary to stock selection. At quarter-end, the Small Cap Select portfolio continues to be overweight in Communication Services, Consumer Staples, Consumer Discretionary and Materials versus the Russell 2000 Growth benchmark. The portfolio is underweight the benchmark in all other sectors. We have no exposure to Utilities.

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 & Attribution

For the fourth quarter, the Granahan Small Cap Select strategy returned +3.9%, outperforming the +1.7% return of its Russell 2000 Growth benchmark. Strength in the portfolio came from stock selection in Information Technology 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 +7.5% 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. **Porch Group** (Info. Technology, Pioneer)	1. **Magnite** (Communication Svcs, Core Growth)
2. **Shift4 Payments** (Financials, Core Growth)	2. **Carpenter Technology** (Materials, Special Situation)
3. **Magnite** (Communication Svcs, Core Growth)	3. **Porch Group** (Info. Technology, Pioneer)
4. **Vita Coco** (Consumer Staples, Core Growth)	4. **Shift4 Payments** (Financials, Core Growth)
5. **SunOpta** (Consumer Staples, Core Growth)	5. **Semtech Corp** (Info. Technology, Special Situation)

TOP DETRACTORS	
4Q – 2024	**2024**
1. **Evolent Health** (Health Care, Special Situation)	1. **indie Semiconductor** (Info. Technology, Pioneer)
2. **Viking Therapeutics** (Health Care, Pioneer)	2. **Evolent Health** (Health Care, Special Situation)
3. **Exact Sciences** (Health Care, Core Growth)	3. **Array Technologies** (Info. Technology, Core Growth)
4. **OrthoPediatrics** (Health Care, Core Growth)	4. **Vivid Seats** (Comm. Svcs, Special Situation)
5. **SharkNinja** (Consumer Discretionary, Core Growth)	5. **Viking Therapeutics** (Health Care, Pioneer)

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.

In the fourth quarter, the portfolio outperformed the Russell 2000 Growth Index. The outperformance came in November and December offsetting the challenging October. These quarterly results were dominated by several securities, two of which we will highlight.

- **Porch (PRCH)** The company, a leading provider of software to the home inspection industry, also owned a captive home insurance company. The integration of these two businesses struck us as visionary--leveraging home inspection data to create better-informed home insurance policies seemed like an obvious opportunity. During the fourth quarter, Porch received approval from the Texas Department of Insurance to transition its insurance business into a Reciprocal Exchange, effectively removing insurance risk away from its operations. Under this structure, Porch will now earn a 20% fee on the policies, significantly reducing risk while enhancing potential growth. We believe the company also has an opportunity to monetize its home inspection-based data to other home insurance companies on a recurring basis, which would smooth and enhance the company's earnings going forward. Porch issued initial 2025 EBITDA guidance which was roughly 100% higher than Street consensus and held its first ever analyst day. All of this was very well received by the market leading to its contribution in Q4 and 2024.

- **Evolent Health (EVH)** was a significant 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.

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. We believe the shortsightedness we see in the current market creates opportunities for us to leverage short term volatility to a long-term advantage.