SMALL CAP CORE GROWTH

Portfolio Comments
December 31, 2024

Commentary

The fourth quarter ended on a down note, as the Fed signaled a slower pace of rate cuts in 2025 at their December meeting. Though the economy shows many signs of strength, such as a solid labor market and healthy consumer spending, the lack of clarity regarding potential tariffs, tax cuts, global conflicts and immigration policy has led to volatility in the markets. The Fed's more hawkish stance has also created uncertainty over interest rate levels. We believe earnings ultimately drive stocks long term, but as we all know, rising yields can exert pressure on equities, as we have seen over the last several years. The Granahan Small Cap Core Growth composite was down -0.7% versus the Russell 2000 Growth Index which was up +1.7%. For the year, the portfolio lagged at +2.5% versus the Index return of +15.2%.

The last few years have been particularly difficult for the healthcare sector. 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 investor 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. This quarter continued with negative healthcare trends as our 5 largest detractors were from this sector; three Pioneers, one Core Growth and one Special Situation. **Evolent Health** (Special Situation) rebounded significantly in Q2 with news that the company was going to be retroactively paid by Medicaid, but this quarter the number of oncology cases at their partners increased by 50%, causing them to cut their financial expectations. The company is working on many options to cut costs and lower risk; we are holding the stock. In Pioneers, **Viking Therapeutics** was hit when obesity stocks fell out of favor over concern about the new administration. We've added to the position as it is the most attractive small cap asset in the largest and most disruptive pharmaceutical market ever. **Keros Therapeutics**, whose CEO has been very successful in the world of biotech drug production, reported unexpected safety issues for the company's lead drug which caused a dramatic stock selloff. We have eliminated the position as our thesis has been negated. **Syndax Pharmaceuticals** was weak during the quarter given investor debate around the market size and competitive environment for its recently approved cancer drug, Revuforj. We increased our position as we expect commercial uptake to exceed street expectations. Lastly, Core Growth company **Exact Sciences**, a molecular diagnostic company specializing in early cancer detection and prevention. Cologuard, the first FDA approved non-invasive stool DNA test for colorectal cancer, has successfully gained market share over the past several years. During the quarter, the company reported disappointing financial results due to one-time impacts and a slower ramp in new sales hires. Despite the short headwind we have a high degree of confidence in strong growth in 2025 and beyond. We increased our position during the quarter, and this represents one of our largest healthcare positions.

Winners for the quarter included three Pioneers and two Core Growth companies. In Pioneers, **Porch Group**, **Confluent** and **Reddit** were strong, with Porch contributing 3X more than the other names. **Porch** provides homeowners' insurance, software, and other services for the residential housing market.

The company announced that its long-awaited transition to a reciprocal structure had been approved which should significantly smooth the company's earnings going forward. The company also issued initial 2025 EBITDA guidance which was roughly 100% higher than Street consensus and held its first ever analyst day. We continue to believe that the company's prospects are good, and the stock's risk/reward is attractive. **Confluent** is the leader in data streaming infrastructure software. In Q2, the company faced consumption spending headwinds, which turned to tailwinds from digital native customers in Q3. We trimmed our position in the quarter on the higher valuation. **Reddit** is a social media platform that connects users to communities to discuss topics and share information. The company reported very strong Q3 results and raised forward guidance substantially. We reduced our holding but maintain a mid-sized position. **Axon**, maker of the taser non-lethal weapon, is a mission-driven company which sells products, platforms, and services designed to improve law-enforcement efficiency and efficacy. The stock rose in the wake of very strong Q3 results and forward guidance. We have eliminated Axon as it crossed over the $30 billion market cap demarcation for the portfolio.

Detractors for the year included three Healthcare companies: **Evolent**, as well as two Pioneers, **908 Devices**, which we have trimmed, and **10X Genomics** which we have eliminated. Detractors in Information Technology included **indie Semiconductor** and **SuperMicro**. Indie remains a large position because of their superior position in ADAS chips, and we sold SuperMicro.

Winners for the year were concentrated in Core Growth with **Magnite**, **Pure Storage** and **Axon**. We are trimming both **Magnite** and **Pure Storage**. **Natera**, a Healthcare Pioneer, was strong with its test for cancer surveillance. We maintain a solid position. **Carpenter Technology** (Materials, Special Situation), has benefitted from a resumption of aerospace spending. We have been trimming into strength.

Attribution

During the fourth quarter of 2024, Granahan's Small Cap Core Growth composite underperformed relative to the Russell 2000 Growth Index, with a total return of -0.7% compared to the benchmark's return of +1.7%. This underperformance was primarily driven by a stock selection effect of -1.3% and a sector allocation effect of -0.8% basis points. Within the sectors, Consumer Discretionary and Health Care were the largest detractors. Within the Healthcare sector, Biotechnology and Healthcare Technology were the largest detractors to underperformance. Pioneers were the weakest performers, followed by Special Situations and then Core Growth.

In 2024, the Small Cap Core Growth composite underperformed the Russell 2000 Growth, delivering a total return of +2.5% compared to the benchmark's +15.2%. This underperformance was primarily driven by a significant stock selection shortfall and to a much lesser extent allocation. Within the sectors, Information Technology and Healthcare were the largest detractors. The Semiconductors & Semiconductor Equipment industry within Information Technology and the Biotechnology industry within Healthcare were the most significant industry detractors. Pioneers were the weakest performers followed by Special Situations and then Core Growth.

Weightings

The Healthcare weighting is flat year-over-year and is overweight the Index. However, quarterly changes to the Healthcare sector weighting were adjusted to lower our portfolio holdings in the sector by 500 bps. We added to Communication Services, Consumer Staples, Materials and Financials. We are still overweight Healthcare as the opportunities for both earnings growth and valuation are myriad. We have simply consolidated holdings.

On a year-over-year basis the Index weightings have changed quite a bit with gains in Financials (+2.5%), Healthcare (+2.4) and Industrials (+3.0). Utilities, Energy and Consumer Staples were reduced in the Index. The significant change in the Granahan Small Cap Growth portfolio on a year-over-year basis is a reduction in Information Technology by 375 bps and Industrials by 168 bps. We have added to Communication Services, Consumer Staples and Healthcare.

Quarterly change in Lifecycles are minor with a reduction of 100 bps to Special Situations and an increase by the same to Pioneers. Core Growth has been reduced by 500 bps year-over-year while Pioneers have increased by 400 bps and Special Situations by 200 bps.

Themes

Thankfully, the 2024 US presidential election is in the rear-view mirror.   The new administration is expected to focus on deregulation, tax cuts, and protectionist trade policies, much of which could spur US economic growth. This, coupled with artificial intelligence productivity gains, and a reduction in costs from advancements in Healthcare, could provide a new era for growth and lessen inflation.   The hope from this incoming administration is that any inflationary impulses will be more than offset by the disinflationary forces of deregulation (particularly energy), DOGE, and a peace dividend from ending all major global conflicts helping to lower commodity prices. The reality is that we will have to wait to see the extent to which these policies are actually implemented.

The narrowness of the stock market, where a limited number of stocks drove most of the market gains, 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.

Macro

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.

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.