GLOBAL SMALL CAP

Portfolio Comments
December 31, 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

Despite the start of central bank monetary easing earlier this year, global 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. The Federal Reserve tempering expectations for rate cuts had global implications. The unprecedented narrowness of the stock market tied to large cap tech and specific themes such as AI is not a US phenomenon. While the industries may differ, we are experiencing this dynamic in other regions such as Europe and Japan, although technology (e.g., AI) seems to be a common thread across all markets. This high market concentration has raised concerns regarding the health of the remaining companies outside of the handful of dominant ones.

Investors are weighing the unpredictability of the incoming Trump administration. The United Kingdom is in a similar situation with its new government as it relates to taxes, fiscal spending, and lingering Brexit issues (e.g., trade deficits with the Eurozone). Elsewhere, in countries such as Germany, Canada, France and South Korea, the political landscape has become incrementally less stable. And the geopolitical turmoil in Ukraine, Gaza, and, most recently, Syria remains on the list of market risks.

Despite these challenges, the economies of many developed countries remain solid. Europe, excluding the UK and Nordics, continues to struggle as it deals with a myriad of issues, not the least of which is access to affordable energy. The UK and Nordics are exceptions in Europe as positive economic growth and industrial activity are increasing, albeit at still depressed levels. The US has distanced itself from other regions, posting strong GDP growth and resilient consumer spending. Japan, while not as strong, is demonstrating solid underlying economic strength. While the fluctuating narratives regarding rates, inflation and economic growth continue to swing sentiment, the market dynamic is clearly more constructive heading into 2025 than it has been the last several years, particularly for small cap companies.

Performance Discussion

In the fourth quarter, the Granahan Global Small Cap strategy returned -3.4% underperforming the Core Index return of -2.6%. Stock selection drove 134bps of detraction, partially offset by a positive allocation effect of 83bps. Poor stock selection was primarily in Consumer Discretionary (-147bps), a function of idiosyncratic factors, some of which are discussed below. The positive allocation from meaningfully overweighting Technology (+91bps) explained most of the benefit while sectors the portfolio consistently owns less of offset each other; Financials (-51bps), Energy (-11bps), Real Estate (+39bps), Materials (+29bps).

Japan, a standout last quarter, gave back some of the alpha as investors took profits. Japan ended the quarter as the region with the greatest negative impact on performance (-54bps). The United States (-48bps), due to Consumer Discretionary, and the UK (-46bps) were close behind. From a LifeCycle standpoint, Pioneers were clearly the worst

performing group at (-9.5%) while Core Growth and Special Situations finished down just shy of 2%, both slightly positive relative contributors to performance this quarter.

Top Contributors:

- **Cellebrite (CLBT US)** is an Israeli provider of digital investigative solutions for law enforcement agencies. Product innovation has been driving meaningful growth in the business, including converting customers to a more robust software platform with a meaningfully higher price. This dynamic combined with healthy agency budgets and increasing importance of digital evidence in law cases is driving better-than-expected growth. We continue to own the company at a higher-than-average weighting.

- **Pure Storage (PSTG US)** provides flash-based data storage. During the quarter, the company announced a design win with a top 4 hyperscaler that we expect will be a material contributor to financial results over the next several years. Pure Storage is well-positioned for the expected ramp in spending related to AI. As such, we maintain our position in the company.

- **Ciena (CIEN US)** is a leading provider of network infrastructure solutions. During 4Q, the company's financial outlook confirmed the opportunity for CIEN as AI-workloads require significantly more investment in networks. We own an average sized position in Ciena.

- **Chef's Warehouse (CHEF US)** is a distributor of specialty food products for independent restaurants that is well positioned to leverage recent investments with stronger revenue growth and profitability. Despite a challenged macro environment and lower inflation benefits, the company continues to grow market share and is increasingly benefitting from cross-selling opportunities related to a recent acquisition. While Chef's Warehouse is not immune from macroeconomic conditions, the company is outperforming due to company-specific factors. We continue to own the stock.

- **Texas Capital Bancshares (TCBI US)** is a regional bank serving mid-sized businesses in Texas. The company's ongoing restructuring is showing signs of improved profitability. The stock, along with many regional bank stocks, reacted positively to the election outcome given the implications for tax and regulatory reforms many expect with the new administration. TCBI continues to be a Top 10 position.

Top Detractors:

- **JMDC (4483 JP)** is a Japanese provider of big data for the healthcare industry. JMDC was the second largest contributor to performance last quarter. Despite continued positive revenue and earnings revisions, driven in part by a strong earnings report in November, the stock has underperformed due to profit taking and concern regarding higher rates in Japan. We continue to own the stock given its attractive long-term growth profile and ability to compound strong earnings over time.

- **Fox Factory (FOXF US)**, is a niche provider of specialty equipment primarily for mountain bikes and off-terrain vehicles. The company has an excellent long-term track record of growth and high returns on capital. Elevated interest rates have weighed on big ticket purchases and post-covid inventory challenges have negatively impacted short-term financial results. Despite the near-term sluggishness, we maintain our position given our expectations for improved results as the year progresses.

- **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. Post the TopGolf acquisition, the combined company has struggled to appeal to investors given the volatility in financial results from TopGolf. Unfortunately, the company reported disappointing financial results primarily at its TopGolf entertainment venue. We believe it will take time to implement necessary changes to drive improved results and, therefore, eliminated the position.

- **Portillo's (PTLO US)** is a Chicago-based restaurant that has struggled to generate same store revenue growth. Investors have been wary that the concept could travel outside of its core Midwest region. The restaurant industry has become increasingly promotional as consumers seek value because of high inflation. While we like the long-term outlook for the company, we believe near term results will be under pressure. As such, we sold our position in the company.

- **Money Forward (3994 JP)** provides cloud-based accounting solutions to businesses (like Quickbooks in the US) and a personal financial management app to consumers. The company experienced a slowdown in revenue growth this past quarter prompting analysts to revise estimates down slightly. In addition, targets to reach positive EPS has been delayed as management continues to invest in marketing and R&D to drive further growth. At Granahan, we encourage management teams to invest in their businesses if they have high return growth initiatives. As such, we added to our position based on continued confidence in the long-term growth and eventual operating leverage of the business.

A few themes worth discussing:

1. **Narrow Market Across the Board** – 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. A similar trend can be found in other international markets. As our small cap companies overcome the lackluster earnings growth over the last several years, we expect the market to broaden out, which will be beneficial for a diversified investment portfolio. Encouragingly, since the peak in this dynamic on July 10, the market has started to broaden with US small caps outperforming large caps for the six months ending 12/31/2024 (Russell 2000 +9.6% vs S&P 500 +4.4%).

2. **No Help From Healthcare** – The last few years have been particularly difficult for the healthcare sector. Less than 20% of US 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. While the strategy was slightly positive in Q4, despite pharma/biotech being down meaningfully, the performance of healthcare

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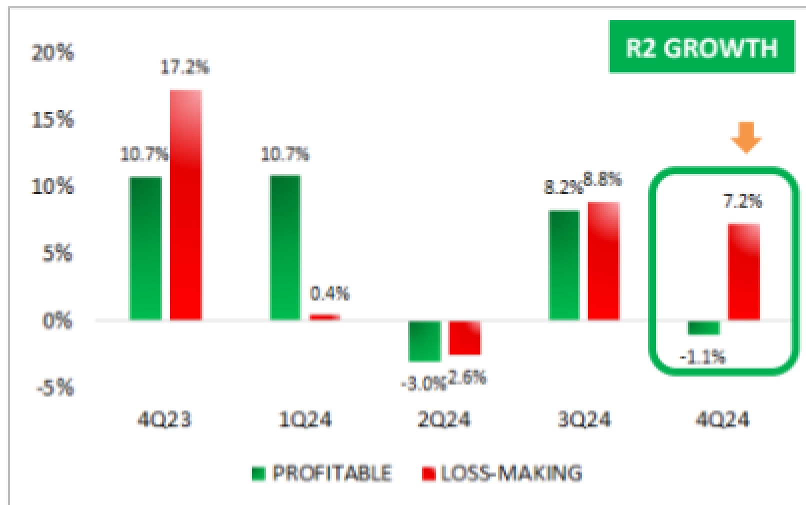
for the year was our largest detractor (-212bps). Interestingly, while loss-making companies outperformed in Q4 (+7.2%; see graph below), biopharma declined by 9%.



Source: Furey Research Partners and FactSet. Data as of 12/31/24; Based upon LTM net Income as known at the start of each quarter.

Commentary

We transacted more than usual this quarter as we reduced names and increased weighting in higher conviction stocks. We added 10 companies and sold 15. Almost two-thirds of the eliminations related to companies in which earnings revisions were negative and where we have limited visibility or less confidence in that dynamic changing. **Autostore** (warehouse robotics manufacturer), **Converge Technology** (Canadian value-added reseller and IT services provider), **908 Devices** (medical device manufacturer), **S4 Capital** (digital ad agency), **TopGolf Callaway** (golf equipment and entertainment), **Portillo's** (restaurant operator), **Power Integrations** (semiconductors), **Quanterix** (in-vitro diagnostics), and **Zealand Pharma** (biotechnology) fall into this category. We sold certain names upon reaching fair value such as **Kinsale Capital Group** (specialty insurance), **Bright Horizons** (childcare centers), **Castle Biosciences** (biotechnology), **Chart Industries** (natural gas infrastructure) and **Marketaxess** (electronic trading platform). Finally, we eliminated **Stoke Therapeutics** (biotechnology), a small holding in which we lacked the conviction to increase our position.

In terms of additions to the portfolio, we added companies that demonstrate solid secular growth attributes. We detail a few of those new positions. **Japan Elevator Service** is a highly differentiated provider of elevator maintenance, repair and refurbishment with a compelling value proposition. The company is well positioned competitively as it offers significant cost savings compared to the original equipment manufacturers while providing better technical capabilities than other independent operator competitors. We estimate that this defensive growth name can compound earnings growth at near 25% over the next few years with the potential for even higher growth tied to an impending elevator upgrade cycle in Japan. **Elf Beauty** (US) is leading provider of affordable beauty products. The company has perfected the art of duplicating products by prestige brands and offering them at highly discounted prices, particularly targeted at younger consumers. Innovation in cosmetics and skincare combined with a superior marketing strategy have led to increased shelf space at Target, Walmart,

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etc., while the international opportunity remains largely untapped. **Diploma PLC** is a UK-listed value-added industrial distributor focused on technically complex products. We believe the company can be a long-term compounder, a function of an entrepreneurial decentralized structure, a well-established culture, and an ability to consolidate a fragmented industry with accretive tuck-in acquisitions. Finally, **FirstService Corp.** is a Canadian domiciled, dual-listed provider of property services in N.A. focused on residential property management and essential services. Homeowner Associations (HOAs) outsource the management, maintenance and repair functions for high-rise condo buildings, apartment complexes, etc. to FirstService. The company is attractive to us due to its repeatable business model, a history of consistent execution (25-year compound average revenue growth rate of 19%), and a high percentage of recurring revenue.

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 central banks globally cuts rates by two times or three in 2025 is much less important than the revenue and earnings growth that our portfolio companies deliver this year 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.

Disclosure:

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