

# Wasatch Global Small Cap Strategy

DECEMBER 31, 2019

## Maintaining A Long-Term Global Growth Perspective

### OVERVIEW

The Wasatch Global Small Cap strategy finished the fourth quarter with a double-digit gain and outperformed the benchmark MSCI AC (All Country) World Small Cap Index, which finished the period up 9.74%. For the 12 months ended December 31, 2019, the strategy significantly outperformed the benchmark's return of 24.65%.

During the quarter, global markets broadly rose as investors responded favorably to macro developments, including an agreement on a "phase one" deal expected to resolve portions of the U.S.-China trade dispute. Both developed- and emerging-market holdings contributed during the quarter, although developed markets experienced a larger boost and added the most to the strategy's return.

On a country basis, the United States was the largest contributor to strategy performance followed by India and the United Kingdom. In all three countries, our holdings outperformed their benchmark counterparts.

Decisive election results had a positive effect on the U.K. market. While many analysts still worry about the potential outcome of Brexit, the election nonetheless provided a measure of clarity that has been rare in recent years, and investors seemingly felt optimistic about the prospect of market-friendly policies in the U.K. Returns were also aided by the British pound's recovery.

Japan had a good quarter, adding to the strategy's return and performing in line with the benchmark's position in Japan. We believe our Japanese holdings have outstanding long-term growth potential and are well-positioned to achieve their business goals even in more

### PORTFOLIO MANAGERS



**JB Taylor**  
Lead Portfolio Manager

8 / 23  
YEARS ON STRATEGY / YEARS AT WASATCH



**Ajay Krishnan, CFA**  
Lead Portfolio Manager

7 / 25  
YEARS ON STRATEGY / YEARS AT WASATCH



**Ken Applegate, CFA, CMT**  
Portfolio Manager

<1 / 5  
YEAR ON STRATEGY / YEARS AT WASATCH



**Paul Lambert**  
Portfolio Manager

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YEAR ON STRATEGY / YEARS AT WASATCH

uncertain macro environments. There was good news in early December as Japan's upper legislative house approved a U.S.-Japan trade deal introduced in September and passed by the lower legislative house in November. The deal, expected to go into effect in January 2020, will see more than \$7 billion in tariffs on U.S. goods reduced or removed in exchange for lower tariffs on Japanese industrial goods imported by the U.S.

Our lone holdings in China and Korea, which we mention below, both saw their share prices dip during the quarter, but the impact on the strategy's return was minor.

Four sectors collectively contained more than 80% of the strategy's assets—information technology, health care, industrials and financials. These four sectors contributed the most to the strategy's return for the fourth quarter and, with the exception of industrials, each sector outperformed its benchmark counterpart. The materials, consumer-discretionary and consumer-staples sectors were the main detractors from performance relative to the benchmark.

## DETAILS OF THE QUARTER

**Intra-Cellular Therapies, Inc. (ITCI)** was the most significant individual contributor. Shares of the company soared in December on news that its first product, CAPLYTA® (lumateperone), had received approval from the Food and Drug Administration (FDA) for the treatment of schizophrenia in adults. The drug is currently in development for the treatment of bipolar depression, Alzheimer's disease and other neurological conditions. With readouts from these trials expected to begin soon, we think the additional upside potential for CAPLYTA remains considerable.

**AU Small Finance Bank Ltd.** was the second-largest individual contributor during the quarter. The bank is based in India, which was the second-largest contributor on a country basis, and primarily serves unbanked and underbanked low-

and middle-income individuals and small businesses. Conversion from a non-bank vehicle-finance company to a small finance bank in 2017 has provided access to deposit-based funding that has improved profitability. Profit after tax at AU Small Finance Bank jumped 89% in its most-recent quarter compared to the same quarter a year ago. Management cited improved operational efficiency at the bank's branches.

Another top contributor to strategy performance for the quarter was **Pennant Group, Inc. (PNTG)**, a provider of home health care and nursing services. Pennant is the second successful spin-off of **Ensign Group, Inc. (ENSG)** in the past five years. (Incidentally, Ensign is another of the strategy's current holdings.) Pennant's stock was up on news that total revenue for the most-recently reported quarter rose 21.2% versus the same period a year ago. Revenue for the home health and hospice services segment increased 25.9%, and revenue for the senior living services segment grew 14.1%.

The largest individual detractor for the fourth quarter was **LGI Homes, Inc. (LGIH)**, which designs and builds homes with "great value and great prices in excellent locations" throughout Texas, Arizona, New Mexico, Colorado, Georgia, North Carolina, Florida and Washington. We think LGI's stock was down because mortgage interest rates have risen somewhat from their recent lows. But we still like LGI because the company remains focused on providing affordable homes—which show high demand without adequate supply in LGI's target markets—and because signs point to accommodative monetary conditions for a long time going forward.

As mentioned above, our only Chinese holding, **Vitasoy International Holdings Ltd.**, was the second-largest detractor for the quarter. A multinational based in Hong Kong, Vitasoy offers soy milk, tofu, rice milk, tea, juices and related food-and-beverage products in China and other

countries. Investors reacted negatively to Vitasoy's plans to invest more heavily in its soy-milk business to stave off competitive pressures and pave the way for future growth. We think the company's strategy makes sense, however—especially in view of the large untapped potential for packaged soy milk and Vitasoy's strong brand presence in the markets it serves.

**Medytox, Inc.**, our lone Korean holding, was the third-largest detractor. Medytox manufactures neurotoxins for cosmetic applications. Concerns about the pending approval of the company's products for sale in China continued to weigh on shares of Medytox. Meanwhile, the company's lawsuit against a pair of competitors—which seeks to block U.S. imports of a rival product—have created an additional layer of uncertainty around the stock. On the plus side, a recent inspection of the company's manufacturing facilities by Korea's Ministry of Food and Drug Safety failed to uncover any serious problems, thus removing a potential obstacle to Chinese approval.

## OUTLOOK

The fourth quarter provided a solid end to what was a strong year for the strategy. Internationally, markets generally rose, but signs of slowing global growth still persisted.

During December, most developed markets posted solid returns to close out a strong year. In the U.S., the S&P 500® Index rose 31.49% for the 12 months ended December 31, 2019, its best return since 2013. Meanwhile, the U.K. showed early signs of casting off the shadow of uncertainty created by Brexit that has loomed for nearly four years.

As was the case during the fourth quarter, a falling U.S. dollar is generally helpful to emerging markets. Weakness in the greenback can become self-reinforcing, as outsized equity gains and stronger economic growth in emerging markets pull investment away from the U.S., further impacting the dollar. Conversely, a strong U.S.

dollar can pose headwinds to emerging-market investments. Countries with structurally weak currencies are especially vulnerable to dollar strength, which may compel them to adopt overly restrictive monetary and fiscal policies in order to attract and retain foreign capital.

Although U.S. stocks generally notched significant gains during the fourth quarter, we don't necessarily view this as a sign of overexuberance. For one, after a large downturn toward the end of 2018, stocks started 2019 well off their highs. For another, price/earnings multiples for profitable companies are lower today than two years ago.

On the topic of growth-oriented investment strategies, one of the most interesting articles we've read recently is entitled "A Mysterious Force Took Over Investing. I Know What It Is." The article appeared in *Institutional Investor* and was written by Christopher Schelling of Texas Municipal Retirement System.

In contrasting growth versus value, Mr. Schelling explains, "On the other hand, growth is perhaps harder to spot. It's not just that doing so involves making simple forecasts about the future—computers generally beat humans at that, too, by the way—but it requires something more than that. In my experience, successful growth investors have an ability to synthesize unstructured data across multiple, often seemingly unrelated, domains."

Mr. Schelling goes on to point out, "In a world of information asymmetry and fairly high average economic growth—as existed 40 years ago, when the ability and effort needed to dig through physical copies of opaque financial statements resulted in a clear informational edge for those who did it—value looked like alpha. But perhaps today, in a low-growth world of data ubiquity, with a Bloomberg on every desk, where computers have eaten all the value, growth looks more like alpha."



As growth-oriented investors ourselves, we agree with Mr. Schelling that the way we create alpha is to go beyond the numbers. While the numbers may help show us where we need to dig further, on-the-ground research is what gives us the perspective to decide which management teams, products, services and marketplace dynamics have the potential to enable a company to double in size many times over.

Although we don't know for sure which of our current holdings will be the next success stories, the search for such dynamic growth-oriented

companies is what energizes us every day that we come to work. And we believe that employing our patient, bottom-up approach is the best way we can serve our clients.

Thank you for the opportunity to manage your assets.

Sincerely,

JB Taylor, Ajay Krishnan, Ken Applegate and Paul Lambert

*The MSCI AC World Small Cap Index is an unmanaged index and includes reinvestment of all dividends of issuers located in countries throughout the world representing developed and emerging markets. This index is a free float-adjusted market capitalization index designed to measure the performance of small capitalization securities. You cannot invest directly in this or any index.*

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*Alpha is a risk-adjusted measure of the so-called "excess return" on an investment. It is a common measure of assessing an active manager's performance as it is the return in excess of a benchmark index or "risk-free" investment. The difference between the fair and actually expected rates of return on a stock is called the stock's alpha.*

*Brexit is an abbreviation for "British exit," which refers to the June 23, 2016 referendum whereby British citizens voted to exit the European Union. The referendum roiled global markets, including currencies, causing the British pound to fall to its lowest level in decades.*

*The price/earnings (P/E) ratio, also known as the P/E multiple, is the price of a stock divided by its earnings per share.*

*The S&P 500 Index includes 500 of the United States' largest stocks from a broad variety of industries. The Index is unmanaged and is a commonly used measure of common stock total return performance.*

*This commentary is intended to provide you with information about factors affecting the performance of the Wasatch Global Small Cap strategy during the period. References to individual companies should not be construed as recommendations to buy or sell shares in those companies. Wasatch analysts closely monitor the companies held in the Global Small Cap strategy. If a company's underlying fundamentals or valuation measures change, Wasatch will reevaluate its position and may sell part or all of its holdings.*

*Past performance is not indicative of future results.*