WASATCH GLOBAL INVESTORS

Quarterly Commentary

Investor

WMICX

# Wasatch Micro Cap Fund

DECEMBER 31, 2019

## A Positive Fourth Quarter Topped a Very Strong Year

FUND MANAGERS

**Ken Korngiebel, CFA**
Lead Portfolio Manager

2 YEARS ON FUND / 4 YEARS AT WASATCH

**Dan Chace, CFA**
Portfolio Manager

15 YEARS ON FUND / 17 YEARS AT WASATCH

### OVERVIEW

The final three months of 2019 capped a robust year for the Wasatch Micro Cap Fund. In what was a positive fourth quarter for U.S. micro caps, the Fund gained 14.36% and surpassed the 13.45% gain in the benchmark Russell Microcap Index. For the year, the Fund gained 42.23% and significantly exceeded the benchmark's return of 22.43%. We're also pleased to report the Fund significantly outperformed the benchmark over the last three-, five- and 10-year periods ended December 31, 2019. We believe these long-term results were driven by our bottom-up investment process, which identifies micro-cap companies with the potential to grow faster than the typical Index company over time.

Information technology (IT) was the largest source of outperformance relative to the benchmark during the quarter. Our IT stocks substantially outgained the IT stocks in the Index, and so the Fund benefited from our overweight position in the sector. Along with health care, IT has been an abundant source of companies possessing the investment characteristics we seek. In pursuit of the Fund's growth objective, we look for innovative businesses that we believe have the potential to take market share and go on to become much larger companies.

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*Data show past performance and is not indicative of future performance. Current performance may be lower or higher than the data quoted. For the most recent month-end performance data, visit wasatchglobal.com. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. The Advisor may absorb certain expenses, leading to higher total shareholder returns. Wasatch Funds will deduct a 2% redemption fee on Fund shares held 60 days or less. Performance data does not reflect this redemption fee or taxes.* ***Total Expense Ratio: 1.65%. The Advisor has contractually agreed to limit certain expenses to 1.95% through at least 1/31/2020.***

These types of consistent-growth stocks did particularly well during the first half of 2019 as the U.S. economy appeared to be losing steam. In a bid to ward off recession, the Federal Reserve (Fed) cut its key lending rate in July, September and October. This shift in Fed policy posed a modest headwind for us, especially during the early part of the quarter, as stocks in more-cyclical areas such as energy saw renewed interest from investors.

Energy stocks received an additional boost from higher oil prices. U.S. crude rallied 13% during the fourth quarter amid reports that the Organization of Petroleum Exporting Countries (OPEC) and its allies agreed to deeper-than-expected cuts in production. Our energy stocks underperformed, representing the greatest source of weakness relative to the benchmark. Although our underweight position in energy was a minor negative for the quarter, the underexposure is largely structural. Simply put, the cyclical, capital-intensive nature of the energy business doesn't fit well with our preference for fast-growing companies.

Broader participation by cyclicals helped the Fund's holdings in industrials. Our machinery, distribution and industrial-services stocks posted an aggregate gain well ahead of the industrials in the benchmark.

Health care was the top-performing sector of the Index, as improved risk appetite propelled biotechnology and pharmaceutical stocks to lofty gains. Our own biotech and pharma holdings performed even better. Despite significant underexposure to these areas, the Fund's health-care stocks nearly kept pace with the health-care component of the Index. While we do own a number of biotech companies in the Fund, their small weightings relative to their weights in the benchmark—both individually and as a group—reflect our desire to maintain what we consider reasonable levels of risk.

## DETAILS OF THE QUARTER

The two strongest contributors to Fund performance for the quarter were a pair of biopharmaceutical companies—**Intra-Cellular Therapies, Inc. (ITCI)** and **ChemoCentryx, Inc. (CCXI)**. Intra-Cellular develops therapeutics for disorders of the central nervous system. 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.

ChemoCentryx develops orally administered therapeutics for autoimmune diseases, inflammatory disorders and cancer. The company's stock price rose sharply in November after ChemoCentryx announced positive top-line results from the Phase 3 clinical trial of its lead drug candidate, Avacopan, for the treatment of ANCA vasculitis. ANCA vasculitis is a systemic disease leading to the inflammation and destruction of small blood vessels. This can result in damage to organs, especially the kidney, and is fatal if not treated. The trial demonstrated Avacopan's disease-modifying efficacy and superiority over the current standard of care.

**Transcat, Inc. (TRNS)**, an industrial holding, was also a significant contributor. The company provides calibration and laboratory-instrument services in the U.S. and other countries. Transcat has been benefiting from the need for accurate instrumentation in regulated industries. Rather than maintain their own instrumentation capabilities, a number of companies have chosen to outsource these services to providers such as

Transcat. Service-segment revenue at Transcat grew 18% in the company's most-recent quarter as consolidated operating income jumped 40% versus the same quarter a year ago. Management credited Transcat's ongoing technology and productivity initiatives with driving the company's improved profitability.

One of the greatest detractors from Fund performance for the quarter was **Superior Group of Cos., Inc. (SGC)**. The company provides workplace uniforms and related accessories to businesses in the United States. It also offers promotional products and remote-staffing solutions. Superior has struggled as competitive pressure has caused the growth of its uniform segment to stagnate. Increased capital investment in systems and facilities also have weighed on the company's stock price. Although we expect some additional capital expenditures next year, we anticipate stabilization—followed by improvement—in the uniform segment, combined with margin expansion across all three segments. We remain optimistic but are maintaining a small weight in recognition of potential downside risks.

**Health Insurance Innovations, Inc. (HIIQ)** was sold on deteriorating fundamentals. The company operates a cloud-based technology platform and distributes individual and family health-insurance products. Skepticism surrounding the transition of Health Insurance Innovations from traditional short-term medical insurance to Medicare Advantage policies impacted the company's stock price for most of 2019. With the recent departure of the Chief Financial Officer adding to what was an already-elevated level of uncertainty, we decided to move on.

**Tabula Rasa HealthCare, Inc. (TRHC)** was another large detractor. The company develops cloud-based software solutions that enable health-care organizations to optimize medication regimens, improve patient outcomes and reduce costs. Despite Tabula Rasa's innovative technology, its stock has languished for much of the past year as investors have become impatient with the company's transition from small-scale pilot programs to broader commercialization. Having taken profits in late-2018 and early-2019, we used recent weakness in the stock as an opportunity to increase the Fund's position ahead of what we expect to be a better year for Tabula Rasa in 2020. *(Current and future holdings are subject to risk.)*

## OUTLOOK

The market's shift away from risk aversion during the fourth quarter was a welcome development in our view. Although the increase in risk appetite brought some short-lived rotation toward structurally underweighted areas of the Fund—such as biotechnology, energy and financials—small- and micro-cap stocks benefited overall, as the perceived safety of large-cap issues lost some of its appeal. Because the stocks of smaller companies tend to be more cyclical than those of their larger peers, their relative underperformance can sometimes be a harbinger of recession. In that sense, the solid performance of micro caps during the fourth quarter appears to bode well for the economy in the New Year.

Although modest improvement in economic indicators and the Fed's adoption of a more-accommodative monetary stance have reduced the near-term likelihood of recession, we don't anticipate a rapid upturn in the U.S. economy. We believe these conditions are conducive to the Fund's growth-oriented investment style. Identifying companies that will benefit from the green shoots of growth in a slow-growth economy plays to our strengths.

Thank you for the opportunity to manage your assets.

Sincerely,

Ken Korngiebel and Dan Chace

## AVERAGE ANNUAL TOTAL RETURNS

FOR PERIODS ENDED DECEMBER 31, 2019

| | Quarter* | 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|
| Micro Cap Fund | 14.36% | 42.23% | 25.68% | 16.17% | 15.34% |
| Russell Microcap® Index** | 13.45% | 22.43% | 6.39% | 6.57% | 11.26% |

**Returns less than one year are not annualized.*

*Data show past performance, which is not indicative of future performance. Current performance may be lower or higher than the data quoted. To obtain the most recent month-end performance data available, please visit wasatchglobal.com. The Advisor may absorb certain Fund expenses, without which total return would have been lower. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost.* **Total Expense Ratio: 1.65%**

Total Annual Fund Operating Expenses include operating expenses, including the management fee, before any expense reimbursements by the Advisor. **The Advisor has contractually agreed to limit certain expenses to 1.95% through at least 1/31/2020.** See the prospectus for additional information regarding Fund expenses.

*Wasatch Funds will deduct a 2.00% redemption fee on Fund shares held 60 days or less. Performance data does not reflect the deduction of fees or taxes, which if reflected, would reduce the performance quoted. For more complete information including charges, risks and expenses, read the prospectus carefully.*

**Investing in micro cap funds will be more volatile and loss of principal could be greater than investing in large cap or more diversified funds. Investing in foreign securities, especially in emerging markets, entails special risks, such as currency fluctuations and political uncertainties, which are described in more detail in the prospectus.**

***An investor should consider investment objectives, risks, charges and expenses carefully before investing. To obtain a prospectus, containing this and other information, visit wasatchglobal.com or call 800.551.1700. Please read the prospectus carefully before investing.***

**The Russell Microcap Index is an unmanaged total return index of the smallest 1,000 securities in the small-cap Russell 2000 Index along with the next smallest 1,000 companies, based on a ranking of all U.S. equities by market capitalization. The Russell 2000 Index is an unmanaged total return index of the smallest 2,000 companies in the Russell 3000 Index. The Russell 2000 is widely used in the industry to measure the performance of small company stocks.

*You cannot invest directly in these or any indexes.*

*The Wasatch Micro Cap Fund has been developed solely by Wasatch Global Investors. The Wasatch Micro Cap Fund is not in any way connected to or sponsored, endorsed, sold or promoted by the London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). FTSE Russell is a trading name of certain of the LSE Group companies.*



*The Index is calculated by or on behalf of FTSE International Limited or its affiliate, agent or partner. The LSE Group does not accept any liability whatsoever to any person arising out of (a) the use of, reliance on or any error in the Index or (b) investment in or operation of the Wasatch Micro Cap Fund or the suitability of the Index for the purpose to which it is being put by Wasatch Global Investors.*



*The Wasatch Micro Cap Fund's investment objective is long-term growth of capital. Income is an objective only when consistent with long-term growth of capital.*

*The "cloud" is the internet. Cloud-computing is a model for delivering information-technology services in which resources are retrieved from the internet through web-based tools and applications, rather than from a direct connection to a server.*

## MICRO CAP FUND — TOP 10 HOLDINGS

AS OF SEPTEMBER 30, 2019

| Security Name | Percent of Net Assets |
|---|---|
| Kornit Digital Ltd. (Israel) | 3.8% |
| Medallia, Inc. | 3.1% |
| ICF International, Inc. | 2.8% |
| Construction Partners, Inc., Class A | 2.5% |
| Boot Barn Holdings, Inc. | 2.4% |
| Freshpet, Inc. | 2.4% |
| Kadant, Inc. | 2.2% |
| Transcat, Inc. | 2.1% |
| Alamo Group, Inc. | 2.1% |
| Fabrinet | 2.1% |
| Total | 25.4% |

*Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Fund or its Advisor. Current and future holdings are subject to risk.*