WASATCH GLOBAL INVESTORS

Quarterly Commentary

Wasatch Micro Cap Growth—U.S. Strategy

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A Positive Fourth Quarter Topped a Very Strong Year

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OVERVIEW

The final three months of 2019 capped a robust year for the Wasatch Micro Cap Growth strategy. In what was a positive fourth quarter for U.S. micro caps, the strategy surpassed the 13.45% gain in the benchmark Russell Microcap® Index. For the year, the strategy significantly exceeded the benchmark's return of 22.43%. We're also pleased to report the strategy 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 strategy 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 strategy'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.

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 strategy'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—often referred to as health-technology stocks—to lofty gains. Our own health-technology holdings performed even better. Despite significant underexposure to this area, the strategy's health-care stocks outperformed the health-care component of the Index. While we do own a number of biotechnology companies in the strategy, their small weightings—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 strategy 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.

The greatest detractor from strategy 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 strategy's position ahead of what we expect to be a better year for Tabula Rasa in 2020.

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 strategy—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 strategy'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

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.

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