WASATCH GLOBAL INVESTORS

Quarterly Commentary

Wasatch Micro Cap Value Strategy

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A "Balanced" Approach Was Advantageous in 2020, and We're Implementing Some Modest Changes for 2021

PORTFOLIO MANAGER

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17 YEARS ON STRATEGY / 17 YEARS AT WASATCH

OVERVIEW

During the fourth quarter of 2020, the Wasatch Micro Cap Value strategy produced a double-digit gain but underperformed the benchmark Russell Microcap® Index, which leapt 31.39%. For the entire year, however, the strategy's gain was about double the benchmark's 20.96% increase.

A "balanced" investment approach served us well in 2020. The strategy's underperformance during the fourth quarter was more than offset by its outperformance in the first, second and third quarters. By "balanced," we mean the strategy was invested in a combination of (1) higher-priced growth-oriented companies that were positioned to have strong operations during most economic environments, and (2) lower-priced companies that were somewhat more economically sensitive.

Stocks of companies in the first group tended to perform relatively well during the March, June and September quarters. And stocks of companies in the second group tended to perform relatively well during the December quarter as investors became increasingly optimist regarding accelerated economic reopenings that are likely to coincide with more coronavirus vaccinations. An interesting point in this regard was that stocks of lower-priced, economically sensitive companies experienced their relative outperformance later than had been typical in previous market cycles.

Given the level of volatility in 2020, we're often asked what lessons we learned during the year. Our response is that while there were certainly some new lessons in 2020, the year for us was mainly a period of applying lessons from previous market cycles. For example, we successfully stayed heavily invested in our highest-quality growth companies during the first-quarter downturn and during the initial phase of the rebound. Then, we gradually added more companies that were still of high quality but whose stocks had been punished particularly hard based on the companies' greater sensitivity to economic cycles.

In hindsight, some might argue that a new lesson for us in 2020 was we could have pushed more aggressively into companies that are especially sensitive to the economy. Such a move probably would have improved the strategy's fourth-quarter performance. Having said that, we believe acting more aggressively may have been a short-term "trading" decision rather than a long-term "investment" decision because trends that hold for one or two quarters are sometimes prone to reverse very quickly.

During the fourth quarter, the main sectors responsible for the strategy's underperformance relative to the benchmark were consumer discretionary, information technology, financials and communication services. In each of these sectors, our stock picks lagged the benchmark constituents. On the other hand, our stock picks were especially strong in health care—which contributed positively to relative performance.

In terms of regional exposure, our U.S. stocks performed slightly better than our international names. Still, returns were strong across most countries even as the strategy's overall performance lagged the benchmark. We remain optimistic regarding our international names because we think they're priced somewhat more attractively than our U.S. stocks. And international holdings give the strategy another source of balance.

DETAILS OF THE QUARTER

The top contributor to strategy performance for the fourth quarter was **Green Thumb Industries, Inc. (GTBIF)**, a pharmaceutical company that manufactures and distributes medical marijuana and cannabis products. Unlike many other companies in the marijuana business, Green Thumb isn't just a grower of the plant. Green Thumb is viewed by customers as a high-quality retail brand and is vertically integrated, which means the company also controls marketing and sales. Currently, Green Thumb is required to pay taxes based on gross profits (revenues minus "costs of goods sold"). This could change if regulations are revised to allow marijuana companies to pay taxes based on operating profits—which are lower than gross profits because "operating expenses" (such as selling, general and administrative expenses) are also subtracted. Beyond potential improvement to Green Thumb's tax burden, we've been very impressed with the management team. Moreover, Green Thumb and many of its competitors got a boost during November as voters approved a series of statewide ballot proposals to legalize the expanded use of marijuana.

TPI Composites, Inc. (TPIC) was also a large contributor. Occasionally, we're asked how our holdings measure up to the priorities of the Democratic Party. In general, we believe a strong company will thrive regardless of which political party is in power. But it's possible some of our holdings will align particularly well with the incoming Democratic agenda. TPI Composites is a good example of a company that's well-positioned for green-energy initiatives. The company designs and manufactures composite wind blades for wind energy. The stock was up strongly after TPI announced third-quarter net sales had increased 23.5% compared to the year-ago period. We believe some of this increase was due to the resumption of business that had been postponed during the height of the Covid anxiety. We'd like to find more alternative-energy companies to invest in, but it's often difficult to uncover companies in this segment that meet our valuation and business-quality standards.

Another significant contributor was **Systemax, Inc. (SYX)**, an extremely well-managed company that offers industrial equipment, material-handling services, technology products and accessories. The company's marketing and distribution platform includes e-commerce websites, catalogs, social media and direct-sales representatives. Well before the start of 2020, Systemax had invested heavily to improve its offerings—and we believe that investment has been paying off with increased revenues and profits. Moreover, the stock has benefited from optimism surrounding vaccinations. While we still hold Systemax, we recently trimmed our position at levels much higher than our initial purchase price.

The largest detractor from strategy performance for the fourth quarter was **Stride, Inc. (LRN)**, formerly known as K12, Inc. This technology-based education company offers proprietary curriculum, software and services created for online delivery to students in kindergarten through 12th grade. The stock declined despite reasonably strong enrollment. In hindsight, we underestimated investor concerns that there'll be considerably lower demand for the company's services as the economy reopens more fully. Nevertheless, we believe those concerns may be overblown and it's possible the pandemic has changed parents' and students' mindsets toward online education. Therefore, we think annual growth—even after the pandemic ends—could be at double-digit rates. This is because the industry itself and Stride's market share both have plenty of room to expand. Moreover, any reluctance to give Stride a try could be reduced because the company's fees are paid by schools, not by parents. And Stride is expanding by also offering at-home services that are integrated with school-based education.

Paysign, Inc. (PAYS) was also a major detractor. The company develops and manages payment services, prepaid-card programs and customized payment plans. A large portion of Paysign's business comes from blood banks. With many of the usual blood donors receiving government assistance and limiting their personal interactions, activity at blood banks has declined—which was a trend we saw coming. But we misjudged the magnitude of the trend. At the lower share prices recently available, we increased our position in Paysign because we think payment activity will accelerate as the economy continues to reopen and people resume more of their normal routines.

Another significant detractor was **Esperion Therapeutics, Inc. (ESPR)**, a developer of oral therapies for people with elevated low-density lipoprotein cholesterol (LDL-C, or "bad cholesterol"). Esperion's recently approved flagship medications, Nexletol® and Nexlizet,™ are intended to increase the effectiveness of statins and other cholesterol-lowering drugs in high-risk patients. However, sales of these new products have been hampered as patients fearful of contracting Covid-19 postponed routine physicals and other non-urgent appointments during which the medications might have been prescribed. Given the many challenges involved, uptake of the new drugs has been encouraging in our view. We remain optimistic about Esperion's long-term prospects and continue to own it in the strategy. Having said that, we're keeping the position size relatively small because we always take a cautious approach to biotech stocks and we'd ideally like to see the company's balance sheet in somewhat better condition.

OUTLOOK

As referenced above, there's a difference between a "trading" decision and an "investment" decision. From our perspective, a trading decision may need to be reversed in relatively short order—

while an investment decision aligns with a longer-term outlook.

At Wasatch, we consider ourselves to be investors rather than traders. This doesn't mean we refuse to move in and out of stocks if the market suddenly gives us attractive prices. But we don't try to time short-term stock movements that aren't consistent with our secular perspective.

If the economy gets back on track very quickly, it's possible the aforementioned stocks of especially cyclical companies will maintain their market leadership for a prolonged period of time. Currently, however, that's not our outlook. Instead, we think economic growth will be more modest.

At some point within approximately the next year, we believe the Federal Reserve (Fed) will recognize it's time to pull back on monetary stimulus. Similarly, we think fiscal support from the federal government will be tapered so companies and individuals can make rational decisions regarding which business ventures and career endeavors make sense for the long term.

As monetary stimulus and fiscal support start to be withdrawn, or even as such moves are merely discussed by policy makers, it's probable the economy will begin an adjustment period that may involve a slowdown. Likewise, returns in the stock market may be based on a changing set of factors that could include somewhat higher interest rates and inflation.

So what types of companies do we want to own? The short answer is we want to stay balanced. But the way in which we stay balanced is likely to evolve over time. Currently, we hold many names that are somewhat—but not overly—sensitive to economic cycles. For example, we like several travel- and hospitality-related companies but we're avoiding highly cyclical banks and energy companies.

If it looks to us that the economy will start to slow again, our balance will probably shift. We'll want to own fewer economically sensitive names. At the same time, we'll want to own more growth-oriented companies—such as smaller software and fintech names—that can better navigate an economic downturn. But we may also need to be more price-conscious than we were during the initial phase of the pandemic.

At that time, valuations didn't matter as much because investors gravitated to "shelter-in-place" technology businesses and health-care companies considered to be beneficiaries of the pandemic. Going forward, we think valuations will matter more—especially if interest rates rise. And when we analyze companies that so far have benefited from the pandemic, we'll need to consider whether the pandemic caused a one-time boost to performance or actually created a new business paradigm that'll be long-lasting.

An example of a company we like for a changing investment environment is **Aspen Group, Inc. (ASPU)**, a Colorado-based operator of certificate programs and associate's, bachelor's, master's and doctor's degree programs. We're especially impressed with the company's nursing programs, which we consider reasonably priced with excellent job-placement track records. Aspen's organic growth recently came in at about 40% based on accelerating enrollments. Moreover, we don't think Aspen's success is overly dependent on the economy, Fed policies or government spending.

Another gradual change we've been making in the strategy, and that we'll likely continue, is we've been selling some of our bigger companies that have done extremely well—both from an operational perspective and a stock-price perspective—during the past several years. With the proceeds of these sales, we intend to rotate into smaller, less-expensive companies that have greater headroom to grow and take market share from competitors. As always, our emphasis is on companies with outstanding business models, top-notch management teams, high returns on capital and strong balance sheets.

Thank you for the opportunity to manage your assets.

Sincerely,

Brian Bythrow

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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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Return on capital is a measure of how effectively a company uses the money, owned or borrowed, that has been invested in its operations.

Valuation is the process of determining the current worth of an asset or company.

This commentary is intended to provide you with information about factors affecting the performance of the Wasatch Micro Cap Value 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 Micro Cap Value 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.

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