

Market Scout

OCTOBER 9, 2019

Staying Humble, Focused on the Long Term

“It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.”

— Often attributed to Mark Twain

DEAR INVESTORS:

Although the relative performance of the Wasatch investment strategies was mixed during the third quarter—some strategies were a bit ahead of their benchmarks and some were a bit behind—the 2019 year-to-date and longer-term results (i.e., five years) have been exceptional across most of our strategies. As always, you can access the up-to-date Wasatch performance for all the standard time periods on our website at wasatchglobal.com.

Our performance results over five years and beyond have been gratifying to us because the long term has consistently been our focus. Nevertheless, we know that the markets don’t always reward good investment decisions within the timespan we deem appropriate. This is why we think it’s so important for us to stay humble and realize that the wind won’t always be at our backs.

Moreover, we think it’s critical for us to continually question our analyses and investment decisions because we understand that “what you know for *sure*” isn’t always so. The discussion below reflects the results of



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YEARS OF EXPERIENCE / YEARS AT WASATCH

hard questions to ensure that we stay positioned most appropriately in our U.S. small-cap strategies.

MARKETS

In our Market Scout commentaries, we often highlight the relative consistency of performance across financial markets by referring to the indexes available on *Morningstar.com*. For the year-to-date through September 30, 2019, of the 144 stock, bond, target and commodity indexes, over 95% of them were positive.

For the third quarter alone, however, consistency declined to the point where 75% of the indexes were positive. Moreover, many stocks took a breather from prior gains, and the losses that did occur were concentrated in smaller caps and in growth-oriented names.

In the U.S., the large-cap S&P 500[®] Index rose 1.70% during the third quarter. The technology-heavy Nasdaq Composite Index was up a marginal 0.18%. The Russell 2000[®] Index of small caps fell -2.40%. Growth-oriented small caps fell even more, with the Russell 2000 Growth Index down -4.17%.

Value-oriented small caps in the Russell 2000 Value Index were down a lesser -0.57% during the third quarter, as value stocks—including those across larger market capitalizations—generally outperformed their growth counterparts. Investors' preference for value stocks over growth names was the first major "value reversal" since the 2016 post-election market performance. We discuss growth versus value in greater detail below.

Generally speaking, international stocks had uninspiring performance during the third quarter. The MSCI World ex USA Index was down slightly at -0.93%. The MSCI AC World ex USA Small Cap Index lost -1.19%. And the MSCI Emerging Markets Index fell a more-substantial -4.25%.

Similar to events during the previous quarter, intermediate- and long-term bond yields fell, which may have had something to do with disinflationary forces and extremely low interest rates overseas. In addition, there was probably a flight to safety as angst intensified over politics and trade-war tensions. Because bond prices move in the opposite direction of yields, bond indexes posted positive returns for the third quarter. The Bloomberg Barclays US Aggregate Bond Index increased 2.27%. And the Bloomberg Barclays US 20+ Year Treasury Bond Index was up an impressive 8.15%.

For the most part, we believe the equity markets' ups and downs during the third quarter were driven by day-to-day events—rather than by meaningful changes in company fundamentals. And since the short term isn't the main focus of our investment research, in this Market Scout we'd like to discuss broader, longer-term themes—some of which we're summarizing from our strategy-specific commentaries. These themes center on U.S. small caps, as our website includes recent white papers on China, India, Japan and the biotech industry. You can read further at wasatchglobal.com.

U.S. SMALL CAPS, PRE- AND POST-GFC

As we consider the U.S. small-cap market, let's review some statistics for the Russell 2000 Index—which roughly represents the target universe for our strategies that invest in U.S. small caps. We'd like to discuss growth, valuations and quality in the 10 years prior to the global financial crisis (GFC) and in the almost 10 years after the GFC.

In terms of growth, the median sales growth was 9.2% pre-GFC and 6.6% post-GFC. In terms of valuations, the median market value to sales ratio was 1.6 pre-GFC and 1.8 post-GFC. In terms of quality, the median return on assets was 2.6% pre-GFC and 1.6% post-GFC. What all this means is that post-GFC for the Russell 2000 Index, growth has come down, valuations have risen and quality has deteriorated.

Another important point is that prior to the GFC, stock prices were largely driven by sales and earnings growth—rather than by price/earnings (P/E) multiple expansion. After the GFC, stock prices were again driven by sales and earnings growth, but there were also significant expansions in P/E multiples (i.e., investors were willing to pay more for a stream of earnings).

Does this mean that U.S. small caps, and growth-oriented small caps in particular, are priced "irrationally"? We don't think so for two main reasons. First, the healthy gains in stock prices since the GFC started from a low base, and since then the U.S. economy and U.S. corporations have performed reasonably well—and ahead of most counterparts around the world. Second, it makes sense to us that extremely low interest rates have favored stocks, particularly those of small-cap companies with the potential to grow by double-digit percentages in an economy that's expanding quite slowly by comparison.

Moreover, although P/E multiples expanded for several years after the GFC, in the past two years, P/E multiples overall for profitable companies have actually contracted. In our analysis of the majority of our U.S. small-cap holdings and of Russell 2000 positions, we found that stock returns were influenced mainly by sales growth, and to a lesser extent by profit-margin improvement that led to even better earnings growth—not by P/E multiple expansion. For Wasatch holdings, sales growth was especially strong.

RETAIL, TECHNOLOGY AND HEALTH CARE

Moving on from general conditions, we'd like to discuss a few of the specific types of U.S. small-cap companies in which we invest. For this discussion, we focus on retail, technology and health care.

While Wasatch has a long history of success in retail stocks, the investing playbook has changed dramatically. In the U.S. alone, retail generates about \$5.3 trillion in annual sales. But a remarkable percentage of this figure runs through Amazon.com.* And in terms of market capitalization, Amazon makes up over 40% of the total value in retail. Beyond that, since the end of 2002, Amazon has been growing almost eight times faster than other retailers.

Because we're small-cap specialists and we don't invest in Amazon, we have to find other ways to succeed in retail—which include the following investment themes: specialty e-commerce companies, Amazon-proof/resistant companies, business-tailwind beneficiaries and unique opportunities.

Specialty e-commerce companies are those that can succeed in the face of Amazon because they've developed such a strong consumer brand, user interface and distribution network. Amazon-proof/resistant companies are mostly discount retailers that sell damaged goods, factory closeouts and very inexpensive items that aren't conducive to free delivery. Business-tailwind beneficiaries have an internet component but they combine that with service at a physical location. Similarly, unique opportunities also require a physical presence and often profit from an extremely loyal customer following.

As for technology, major transformations are occurring as Software-as-a-Service (SaaS) and cloud computing disrupt legacy IT systems. If you think about it, today's consumer entertainment tends to exemplify

these transformations. When you listen to music or watch a movie, you're often doing so through an app connected to the internet. The app is SaaS because the provider keeps the app updated and working properly without much effort on your part. And the music or movie is probably stored in the cloud.

In business, SaaS and the cloud are just as important and for several years have been helping to turn services into ongoing subscriptions. To a large extent, firms pay periodic fees to have their software and data managed and stored in the cloud, accessible securely through the internet. Corporate customers benefit because the software is always current—with quicker implementation of new features—and data are always backed up.

At the same time, SaaS developers benefit because they receive recurring, long-term revenue—provided, of course, that they continue to offer productivity-enhancing software at a fair price. SaaS developers also tend to have high customer-retention rates and the ability to enhance their software and raise prices over time. These are just some of the reasons why we find certain well-researched SaaS companies to be such high-quality, long-duration growth investments.

Next we turn to health care, which is a huge market where some of the largest businesses operate. But most of the true innovation occurs in small companies—exactly where we focus our investment research. Other attractive features of the health-care market are that it's a significant source of initial public offerings and it provides long runways for company growth.

At Wasatch, we invest both in early-stage and in well-established health-care companies. In early-stage companies, we generally look for better outcomes than the prior medical standard, faster recoveries, and economics favorable to the patient, hospital and insurance company. In well-established companies, we're willing to accept lower growth for less risk but we still want to see great management teams and economics that support usage.

Recent areas of interest for us in health care include minimally invasive cancer screening, easier management of diabetes, better relief from central nervous system disorders and streamlined treatment of sleep apnea. The specific details of our holdings in health care—as well as in retail, technology and other areas—are beyond the scope of this Market Scout but are addressed in our quarterly commentaries and periodic white papers.

U.S. VERSUS INTERNATIONAL, AND GROWTH VERSUS VALUE

Regarding our investment outlook, we often receive two main questions from clients and shareholders. First, how do U.S. valuations compare to international valuations? And second, what are the implications of the situation in which growth-oriented investing has outperformed value-oriented investing by a substantial margin (the third quarter notwithstanding)?

As for the first question, when we looked at returns for the U.S. small-cap Russell 2000 Index versus the MSCI AC World ex USA Small Cap Index since the end of the GFC in 2009, we found that the two indexes performed similarly through 2012. After 2012, however, the Russell 2000 gained a large performance advantage. At the same time, sales growth and earnings growth have been in the same vicinity for both indexes. So we can conclude that valuations are somewhat higher among the U.S. small caps in the Russell 2000.

Does this mean that now's the time for investors to skew their holdings internationally? While there's always a good case for international diversification, we don't think the U.S./international balance should necessarily change. For one, we aren't investing in an index. Moreover, as mentioned, P/E multiples overall for profitable U.S. small-cap companies held by Wasatch have actually declined during the past two years as our companies have strongly delivered on sales and earnings improvement. Beyond that, the U.S. is home to many of the innovative companies that are able to generate high growth within the context of a slowly expanding world economy.

As for the second question—growth versus value—it's important to understand the circumstances that lead some practitioners of growth-oriented investing to get into trouble. Oftentimes, it's when there's a bubble in stock prices for companies that don't live up to their hype as total game-changers. A prime example was 2000's peak in the dot-com mania—which, by the way, we at Wasatch largely avoided. We don't see a similar situation today. SaaS companies, for example, *really are* changing productivity, commerce and entertainment for the better.

Let's revisit the dot-com mania to help us gain a better understanding of where valuations stand today. The bubble burst in 2000, and the Russell 2000 Growth Index didn't start recovering until 2002. So by 2003, growth stocks had still been major laggards for more

than a decade compared to the value names in the Russell 2000 Value Index. From 2003 to 2013, growth and value stocks performed almost in lockstep.

The period from 2013 to the present has been when growth names have really done well on a relative basis. But rather than seeing this as a sign of significant overpricing in growth stocks, we think this reflects (1) some ongoing catching up from the dot-com crash, (2) the truly spectacular operating performance of certain companies in the Russell 2000 Growth Index, and (3) investors' rational attraction to companies with faster sales and earnings growth within the context of extremely low interest rates and a slowly expanding economy.

We do acknowledge, however, that there are certainly some areas in which stocks are overpriced. We just don't see signs of a widespread bubble. And, as mentioned, we never did get caught up in the dot-com mania because we were grounded in our bottom-up research of company fundamentals. As a result, we were willing to lag index performance until we were eventually vindicated by the market. Moreover, we believe that as active, non-index investors, we can still find some of tomorrow's winners in the competition to grow sales and earnings at double-digit rates.

WASATCH

We announced on September 24 that Wasatch Advisors has rebranded as Wasatch Global Investors. This new branding better reflects our firm's global footprint and our business as investors in individual companies, not as personal financial advisors. But it's also important to note that there are no corresponding changes in Wasatch's ownership, employees, philosophy or process.

Although we got our start in U.S. micro- and small-cap investing, the Wasatch philosophy and process have also proven successful in identifying high-quality companies of all sizes around the world. In fact, almost half of our assets under management are invested in dedicated international (non-U.S.) and global strategies.

All told, Wasatch offers 16 investment strategies that span market caps and geographies. Moreover, having lived in 42 countries and speaking 23 languages, our team members bring truly global perspectives to investment management. Last year alone, we visited 23 countries and performed intensive due diligence to

find high-quality, long-duration growth investments all over the world.

In conjunction with the Wasatch Global Investors name change, we created a new visual design (including a restyled logo)—and we developed a new website, wasatchglobal.com, serving both institutional clients and mutual-fund shareholders.

Separate from the new branding, visual design and website, we've also launched two new investment strategies in the form of institutional separate accounts and mutual funds—the Wasatch Global Select Fund and the Wasatch International Select Fund. Each of these funds invests in a select portfolio of 20 to 40 companies, while offering broad diversification among countries and sectors.

The two new mutual funds join the longer-established Wasatch Emerging Markets Select Fund. While the Wasatch Select funds maintain the flexibility to invest in companies of all sizes, they focus on mid caps—with a sweet spot in companies generally below \$20 billion in market capitalization. The Global Select Fund invests in companies within the U.S., other developed markets and emerging markets. The International Select Fund primarily invests in companies within international (non-U.S.) developed markets.

You can read more about "The Wasatch Select Approach" in the *News & Insights* section of our website. This section also contains other recent articles and white papers—including "India's Virtuous Circle of Amazing Progress," which we referenced last quarter.

With sincere thanks for your continuing investment and for your trust,



JB Taylor
CEO and Head of U.S. Small Cap Investing

RISKS AND DISCLOSURES

Mutual-fund investing involves risks, and the loss of principal is possible. Investing in small-cap and micro-cap funds will be more volatile, and the loss of principal could be greater, than investing in large-cap or more diversified funds. Investing in foreign securities, especially in frontier and emerging markets, entails special risks, such as unstable currencies, highly volatile

securities markets, and political and social instability, which are described in more detail in the prospectus.

Diversification does not eliminate the risk of experiencing investment losses.

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.

*Information in this document regarding market or economic trends, or the factors influencing historical or future performance, reflects the opinions of management as of the date of this document. These statements should not be relied upon for any other purpose. **Past performance is no guarantee of future results, and there is no guarantee that the market forecasts discussed will be realized.***

The investment objective of the Wasatch Emerging Markets Select Fund, Wasatch Global Select Fund and Wasatch International Select Fund is long-term growth of capital.

Wasatch Global Investors is the investment advisor to Wasatch Funds.

Wasatch Funds are distributed by ALPS Distributors, Inc. (ADI). ADI is not affiliated with Wasatch Global Investors.

**As of September 30, 2019, none of the Wasatch Funds were invested in Amazon.com, Inc.*

DEFINITIONS

*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.*

***Earnings growth** is a measure of growth in a company's net income over a specific period, often one year.*

*The **global financial crisis (GFC)**, also known as the financial crisis of 2007-09 and 2008 financial crisis, is considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s.*

*An **initial public offering (IPO)** is a company's first sale of stock to the public.*

*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.*

***Return on assets (ROA)** measures a company's profitability by showing how many dollars of earnings a company derives from each dollar of assets it controls.*

***Sales growth** is the increase in sales over a specified period of time, not necessarily one year.*

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

*The **Russell 2000 Index** is an unmanaged total-return index of the smallest 2,000 companies in the Russell 3000 Index, as ranked by total market capitalization. The Russell 2000 is widely used in the industry to measure the performance of small-company stocks.*

The **Russell 2000 Growth Index** measures the performance of Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 2000 Value Index** measures the performance of Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

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The **Nasdaq Composite** is a market-capitalization weighted index of the more than 3,000 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks. The Nasdaq was created by the National Association of Securities Dealers (NASD) to enable investors to trade securities on a computerized, speedy and transparent system, and commenced operations on February 8, 1971.

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.

The **MSCI AC World ex USA 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, excluding securities of U.S. issuers. This index is a free float-adjusted market capitalization index designed to measure the performance of small capitalization securities.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 26 emerging market countries. With 1,202 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI World ex USA Index** captures large and mid cap representation across 22 of 23 developed market countries—excluding the United States. With 2,215 constituents, the index covers approximately 85% of the global equity opportunity set outside of the United States.

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The **Bloomberg Barclays US Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, U.S. dollar denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities (MBS) (agency fixed-rate and hybrid adjustable-rate mortgage [ARM] pass-throughs), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) (agency and non-agency).

The **Bloomberg Barclays US 20+ Year Treasury Bond Index** measures the performance of U.S. Treasury securities that have remaining maturities of 20 or more years.

You cannot invest directly in these or any indexes.

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