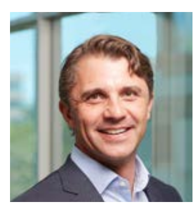
Market Scout

APRIL 2, 2020

Trusting Our Instruments

Like a pilot relying on a plane's flight-control instruments during an unfamiliar route with poor visibility, we are depending more than ever on our fact-based, unemotional investment methods.



JB Taylor
CEO, Portfolio Manager

23 YEARS OF EXPERIENCE / 23 YEARS AT WASATCH

Ajay Krishnan, CFA
Portfolio Manager

25 YEARS OF EXPERIENCE / 25 YEARS AT WASATCH

DEAR INVESTORS:

If you Google "trust your...," some of the most-frequent entries you will see are "trust your gut," "trust your instincts" and "trust your intuition." While these are important considerations during the current health and economic crisis, we think they must be balanced with the equally important "trust your instruments"—a fundamental principle in the field of aviation.

A pilot initially learns to navigate using visual reference points on the ground. But at higher altitude, especially under stormy conditions, reference points outside the cockpit mostly disappear. For these circumstances, a pilot is taught to override the body's physical senses—and instead pay close attention to the instrument display panel. In fact, a pilot flying when visibility is poor must rely almost exclusively on the display indicators.

In our investment process, we benefit from both subjective analysis and our version of "trusting our instruments." As we steer through the current environment characterized by extreme stock-market volatility and a particularly uncertain future, the objectivity of our instruments has become increasingly valuable. Indeed, our instruments indicate that our portfolios are on course—invested in what we believe are strong companies at appropriate position sizes.

A BATTLE OF EXPONENTIAL FORCES

For stocks, the first quarter of 2020 included one of the worst periods on record. Stocks of companies—large and small, around the world and across all sectors—fell in a synchronous fashion. What was staggering, beyond the magnitude of the declines, was the speed at which stocks fell. Nearly all equity indexes declined between -30% and -40% over the four-week period between February 20 and March 20.

For a pilot, this would be the equivalent of flying through sunny, cloudless skies in one moment and through a Category 5 hurricane in the next. With unthinkable speed, we dove from record employment numbers in the U.S. to a probable global recession.

While we continue to follow the statistics regarding the spread of the novel coronavirus, we do not have a unique view on the pandemic's duration or magnitude. With the sad reality being that the remedy to slow the spread is a massive coordinated global slowdown in human interaction and commerce, virtually every business in every sector is taking punishment in the storm.

This unprecedented uncertainty is due to the speed at which the coronavirus has infected the population. Infections are exponential. And just as we understand exponential growth in a positive way—for example, Moore's Law regarding the doubling of computing power every two years or so—exponential growth can be a powerful negative force as well.

However, we remain hopeful based on the simultaneous global responses. Medical responses include the fast-track development of potential vaccines and antiviral drugs. Economic responses consist of monetary and fiscal measures around the world that are simply unprecedented in their size and scope, and for good reason. To paraphrase *New York Times* columnist Thomas Friedman, we are in a battle of exponential forces. The only way to counter a negative exponential force is with an overwhelmingly positive exponential force.

A distinction we see between the current crisis and the 2008-2009 global financial crisis (GFC) is that the current crisis is the equivalent of a massive slowdown in the global "income statement," figuratively speaking, whereas the GFC saw a sudden evaporation of the global "balance sheet" due to enormous levels of bad credit. A struggling income statement can recover, provided the balance sheet is strong. It's encouraging that the monetary and fiscal measures enacted—cash payments for workers, accessible low-interest loans for small businesses and massive influxes of banking liquidity—seem properly focused on preventing our current "income statement" problem from becoming a larger "balance sheet" issue.

Once the crisis has abated, we expect Wasatch clients will be well-positioned with investments in companies benefiting from the renewed economic upturn—and not only in the U.S. Other countries have been just as diligent, or even more so, with their own medical and economic responses to the virus. And because world-wide economies had been relatively strong before the outbreak, we believe our companies will pick up not too far from where they had left off—even if there are hiccups along the way.

THE WASATCH RESPONSE

So, what's the best course of action for us as an investment-research team? Our response during a typical market correction is generally to hold steady. After all, if we liked our companies going into the selloff, we should still like them afterwards—especially at the resulting less-expensive prices.

Therefore, even though this has not been a typical market correction, we are making very few changes with respect to large portions of our growth-oriented portfolios. We generally invest in companies that we consider high quality. We have found that during market downturns, investors tend to prefer high-quality names—even those considered somewhat expensive.

Many of Wasatch's long-term, alpha-producing track records have been generated by outperforming in down markets, and true to form, our portfolios have generally outperformed in the current downturn. During the past few years, it has been especially gratifying to see our growth-oriented portfolios generate benchmark-beating returns on both the downside and the upside.

Looking forward, it's impossible to predict short-term performance, especially under the current "anything-but-normal" conditions. But we think our portfolios are well-positioned compared to their benchmarks. Generally speaking, our companies have long records of stronger sales and earnings growth, higher returns on capital, better cash flows and, importantly, much healthier balance sheets.

Sometimes the hardest thing to do in investing is to not do anything. Because we have navigated severe market volatility many times before, we know what tends to work and we understand the value of keeping our emotions in check. These experiences, in turn, have given us the courage to trust the research we have already done. The overwhelming majority of our investments are in companies that we believe are built to withstand harsh economic shocks.

Only on the margin have we slightly increased our trading activity. To be prepared for scenarios in which the current crisis becomes longer and deeper than we expect, the Wasatch research team has re-analyzed and stress-tested every company we own for balance-sheet strength and the ability to endure relatively long-term hits to sales and earnings.

We have adjusted weightings in companies for which we see increased or decreased potential, and we have sold a few names where our outlook for their long-term growth prospects has changed (which may not necessarily be due to recent events). As always, we continue to assess new opportunities—especially since many companies on our wish lists have fallen to once-in-a-decade valuations.

Beyond the adjustments that have already been made, we are contemplating more moves for our growth-oriented portfolios. Again, these potential moves are based on our research and on what we saw firsthand during—and after—previous market downturns.

For context, it's important to emphasize that market cycles consist of two phases. One phase is the downturn, during which Wasatch has performed admirably in the current cycle. The other is the ensuing recovery, the start of which can only be determined in hindsight.

Because the stocks that hold up better during a significant downturn are sometimes the same ones that performed relatively well before the downturn, portfolio adjustments may not be necessary. But a recovery rally off the market bottom can be trickier to navigate. That's not to say a static portfolio will necessarily perform poorly during a recovery rally. It's just that moderate alterations to the portfolio can often improve performance.

For example, our historical research and firsthand insights—which are our versions of "flight-control instruments"—indicate that some of our biggest decliners during the downturn may also be some of our largest winners during the recovery. So, rather than selling these positions based on what might look like deteriorating fundamentals, we may prudently add to current weights at lower prices.

The idea is that, unlike run-of-the-mill market corrections, crisis-induced precipitous declines often warrant increasing weights in what seem like "higher-risk" holdings. To be prepared, we have re-analyzed all our portfolio holdings and watch-list names. This has given us, and will continue to give us, the conviction to increase position sizes and make incremental investments in companies whose stocks get punished particularly unfairly in our view.

We also recognize that the world may be operating under a new paradigm once we get past the current crisis. Consider, for example, how emerging virtual applications are likely to transform health care, office work and education. With many stocks trading at discounted prices, we may be able to invest in some of the companies best positioned for a paradigm shift.

MAINTAINING OUR LONG-TERM PERSPECTIVE

Currently, we think patience is our most-important asset. While it's true that the current crisis is different from what we have seen in the past, crises are always different. What is not different is our conviction that the long-run earnings trajectories of the vast majority of the companies we own remain intact. In daily discussions with management teams, we have been impressed with the way they are handling a very uncertain environment.

We remain steadfast in our bottom-up research process. We will continue to reconfirm our thesis for every holding, and we will continue to scan the respective investment universes for opportunities to improve our portfolios. Above all, we are long-term investors focused on paying reasonable prices for high-quality companies. We value great corporate cultures and world-class management teams that have the skill to generate substantial earnings growth in markets with substantial headroom.

We think quality is especially important during a crisis because exceptional companies often increase their competitive advantages in times of stress, even when short-term sales and earnings decline on an absolute basis. After the crisis, these companies are particularly well-positioned to grow and take even more market share over the long term.

In closing, we would like to note that we as a firm believe it's important to support public-health officials in containing the novel coronavirus. As such, Wasatch has temporarily halted business travel. And members of our team have redoubled their efforts to minimize the impact on our operations.

For example, many of our scheduled in-person research meetings have been converted into technology-enabled "virtual visits." Moreover, we have been impressed that the companies we own and those that we are considering for investment have been universally accommodative, so we have been able to get the information we need to do our jobs with remarkably few impediments.

Finally, out of an abundance of caution for the safety of our staff and the broader community, most of our employees are working from home. Please note that all business functions are fully operational and all lines of communication with Wasatch remain open and unchanged.

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

JB Taylor | Ajay Krishnan

PORTFOLIO MANAGER BIOS

JB Taylor
Chief Executive Officer, Portfolio Manager

Mr. Taylor is Chief Executive Officer of Wasatch Global Investors and serves on the Board of Directors. He is also a Portfolio Manager, the head of U.S. small cap investing and a member of the global research team. He joined Wasatch as an Analyst in 1996.

Mr. Taylor graduated from Stanford University, earning a Bachelor of Science in Industrial Engineering.

JB is a California native who speaks Hungarian. He enjoys cycling and coaching youth lacrosse.

Ajay Krishnan, CFA
Portfolio Manager

Mr. Krishnan joined Wasatch Global Investors in 1994 and serves on the Board of Directors. He is also a Portfolio Manager, the head of emerging markets investing and a member of the global research team.

Mr. Krishnan earned a Master of Business Administration from Utah State University, where he also worked as a graduate assistant. He completed his undergraduate degree at Bombay University, earning a Bachelor of Science in Physics with a minor in Mathematics.

Mr. Krishnan is a CFA charterholder and a member of the Salt Lake City Society of Financial Analysts.

Ajay is a native of Mumbai, India and speaks Hindi and Malayalam. He enjoys traveling and cycling. He is also a budding vintage-car enthusiast and an amateur horologist.

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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.**

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DEFINITIONS

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.*

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

The **global financial crisis***, also known as the financial crisis of 2008 to 2009, is considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s.*

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

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.*

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