WASATCH INTERNATIONAL STRATEGIES

Quick Take: Japan From Wasatch's Bottom-Up View

Confronting Crisis with Resilience Is a Hallmark of Japan

JUNE 25, 2020

Tokyo at night, emblematic of Japan's thriving business environment.

FINDING QUALITY AMONG JAPAN'S DIVERSE SMALL CAPS

In 2002, Wasatch Global Investors launched its first international strategy. Leading up to that time, from our founding in 1975, we had found considerable success with our investment philosophy, but had primarily limited our focus to small- and micro-cap companies in the United States. Although we maintained our small-cap focus, we increasingly realized that the same proven investment philosophy applied just as well beyond the realm of U.S. small caps.

One country where we have historically had significant success is Japan. Within the Wasatch International Small Cap Growth strategy, which recently reopened, Japan is the most heavily weighted country, accounting for more than a quarter of the strategy's assets and contributing the most to the strategy's return for the five years ended May 31, 2020. Japan is also the largest weighting within the Wasatch International Select strategy, which opened to investors in December 2016.

Japan was one of the first countries to be impacted by the coronavirus pandemic that has driven market activity in 2020. But whereas early headlines threatened a dire situation—among other causes for concern: Japan has the oldest population in the world, on average—the reality as of late May appeared to be that, in characteristic fashion, Japan has responded to the crisis in a calm, efficient and effective manner.

Calm resilience and persistence in the face of crises seems to be the rule rather than the exception in Japan. In 2011, a 9.0+ magnitude earthquake and tsunami destroyed more than 45,000 buildings, 250,000 vehicles and claimed more than 15,000 lives. The natural disaster released such force that it permanently moved Japan's main island of Honshu an estimated eight feet closer to the United States and lowered a 250-mile stretch of the country's coastline by about two feet.

Seven years after the devastating event, which caused an estimated US$210 billion in damages, Japan had already rebuilt 99% of the affected roads in the hardest-hit regions, among other impressive milestones. Incredibly, in Iwanuma, a coastal city in the heavily impacted Miyagi Prefecture, which saw thousands of homes destroyed and residents displaced, the population has already grown beyond where it stood prior to the disaster.

PREPAREDNESS AS A CULTURAL VALUE

Developing such an ability to prepare, innovate, adapt and grow was seemingly necessary in light of Japan's history and geography. In the context of the current crisis, we believe this means Japan, as a country and society, is likely to bounce back much quicker than many other countries. In the context of analyzing Japanese companies as investors, it has led us to view these qualities as deeply embedded cultural values.

These deeply embedded themes of adaptability and preparedness also appear within the operations of many Japanese companies. From our perspective, the recent panic surrounding the coronavirus pandemic has only strengthened our long-established affinity for Japanese markets. Perhaps just as importantly, many of the fundamental reasons Japan's small-cap market has held up better than most is the result of the very same core themes that guide Wasatch's investments: a deep pool of small-cap companies disrupting and innovating, high-quality company leadership and a convincing long-term growth opportunity.

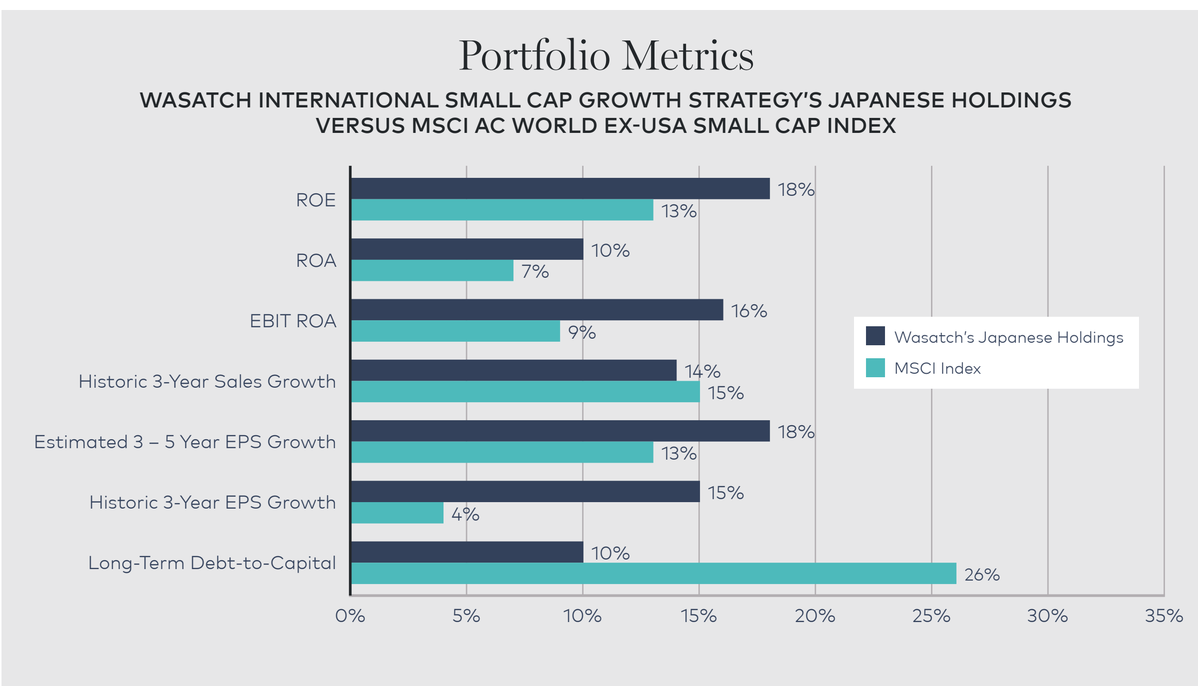
JAPAN'S MARKET OF CHANGE

In recent years, Japan's markets have also provided many great examples of the country's hallmark adaptability and efficiency. As primarily small-cap investors, our excitement about Japan is specific to the country's rich diversity of small-cap offerings. Within the MSCI Japan Small Cap Index, more than 85% of the companies are below a market capitalization of US$3 billion. This compares to the MSCI USA Small Cap Index, where just 42% are below a market capitalization of US$3 billion.

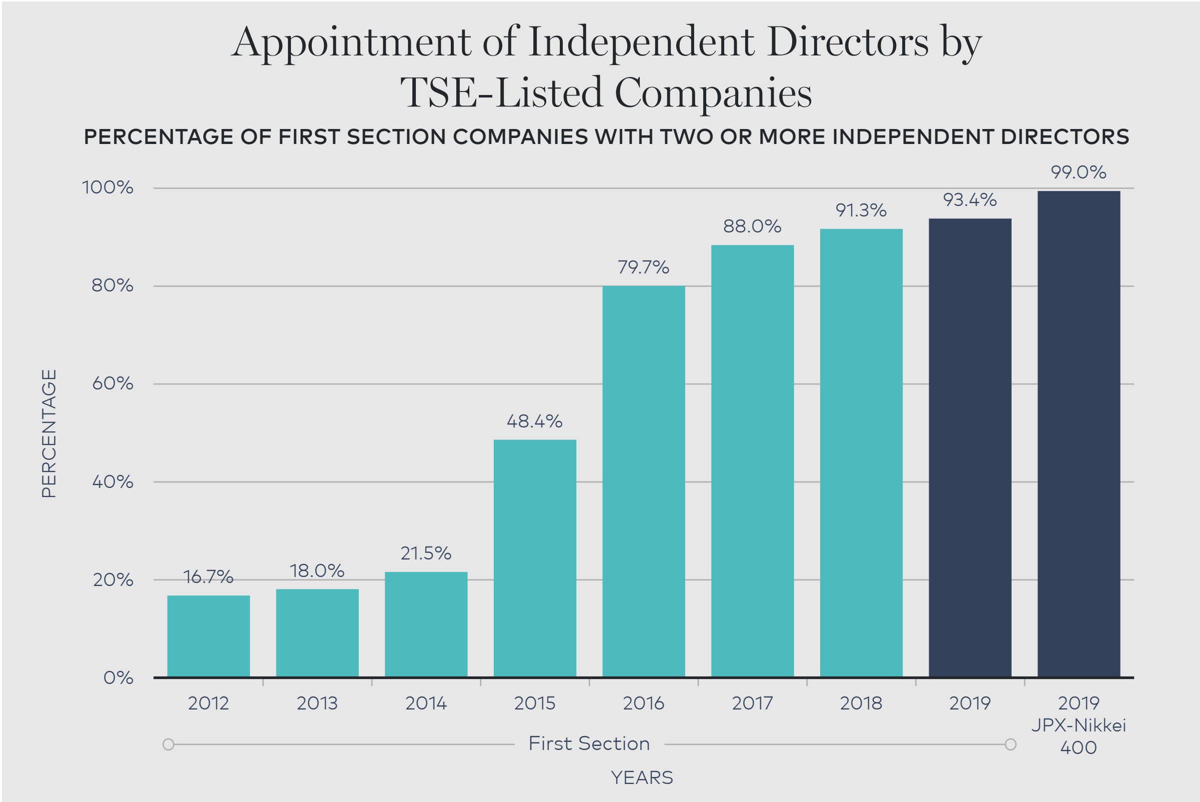
Following the re-election of Shinzo Abe as Japan's prime minister in 2012, we believe many of the structural reforms implemented under "Abenomics" have been positive. One outcome of these reforms has been more shareholder-friendly companies with better corporate governance, higher growth rates and improved returns on equity (ROE). One telling example: In 2012, when screening Japanese small-cap companies based on our quality metrics, the screens would return about 200 companies. Today, less than a decade later, that number is more than 500.

In the context of the recent market volatility, there are several other attributes of Japan's small-cap market that we believe bode well for investors. The same Japanese large-cap companies that have struggled in recent years are also more interconnected with globalization than their smaller counterparts. Consider, for example, Japanese automakers or prominent consumer electronics brands. These large companies are sure to be impacted by disruptions to the global manufacturing and supply chain. Japanese small caps, by contrast, tend to be more connected to the domestic economy. And we believe domestic economies will be among the first to bounce back when the current uncertainty is concluded.

Moreover, Japanese consumers have shown a secular tendency to prefer home-grown companies. As a result,



Sources: FactSet and Wasatch Global Investors, as of May 31, 2020 for a representative account. Past performance is not indicative of future results. Portfolio metrics are subject to change.



Source: Japan Exchange Group. The figures for years prior to 2019 are based on corporate governance reports. The figures for 2019 are based on corporate governance reports submitted by listed companies as of July 12, 2019.

multinationals have struggled to get a foothold in Japan and their smaller, more efficient Japanese competitors have been able to capitalize on an understanding of the region and take market share.

Japan also boasts a robust initial public offering (IPO) market and was a global leader in the total number of IPOs for the five-year period ended December 31, 2018. These are the sorts of companies that we believe might disproportionately benefit from prospective increased investments into a broad range of products, technologies and services that are responsive to needs arising from the pandemic. Such a trend would likely benefit agile, forward-thinking small-cap companies that are not hindered by legacy systems or infrastructures.

The JPX-Nikkei400 is another telling example of Japan's "market of change." Introduced in 2014, the Index highlights the country's best-run firms and was formally endorsed by the Japanese government. The reform caught on quickly and inclusion in the Index has now become an aspiration for many Japanese firms.

The Japanese government also supported work style reform legislation in 2018, which limits overtime work, establishes equal pay and benefits for equal work and strengthens health protections for workers. We expect these reforms will lead to increased inclusion of women and seniors in the workforce. Other positive trends include improved public/private cooperation and more widespread adoption of independent directors. As shown in the bar chart above, and as we noted in a previous white paper on Japan, "In 2014, 21.5% of the companies in the TOPIX—which tracks the First Section of the Tokyo Stock Exchange—had two or more independent directors. Today, more than 93% do."

This "arms race" for good governance, which is rightly driven by the understanding that well-run firms tend to be more-successful firms, has led to higher ROEs and growth rates for companies. On average, Japanese companies (and households) tend to have strong balance sheets, including large cash reserves, which better enable them to weather uncertain environments.

LONG-TERM OUTLOOK

The favorable reforms implemented under Abenomics, combined with the strong themes of preparedness and adaptation within Japan have created a situation that we believe is promising for long-term investors. We also believe it is possible that the coronavirus pandemic is accelerating many of the trends that we already expected to drive the potential for strong performance in Japanese small caps for the next 20 years. Many recent, broad societal changes have forced companies to accelerate modernization in key areas.

For example, the current pandemic has starkly highlighted the necessity and value of information-technology (IT) investments, including remote-working and other similar online services that suddenly find themselves far more essential. In Japan, the adoption of Software-as-a-Service and other cloud applications is still relatively early when compared to the U.S. However, we believe the continuation of this trend is an all-but-foregone conclusion, thus representing considerable growth potential over the long-term for well-positioned Japanese companies. Implementation of the aforementioned workforce reform legislation is among the developments we believe may support such a trend.

Likewise, Japan's aging population will increasingly lean on the offerings of companies in the health-care space, another sector poised for sustained growth, in our view. Beyond the continued growth in the IT and health-care sectors—and the related growth of telemedicine offerings which represent a promising intersection of the two spaces—we also expect to benefit from ongoing consolidation within the many fragmented industries in Japan. In much of the developed world, a few large companies generally come to dominate upward of two-thirds of a given industry. That figure is closer to one-third in Japan, on average, but it is moving toward the global average with factors like wage and cost inflation acting as catalysts for change.

SILVER LININGS FOLLOWING A LOST DECADE (OR TWO)

Despite the many advantages we believe are present in Japan for investors, inevitably some investors will remain cautious about investing in Japan. We believe this is partly due to investors constantly looking in the rear-view mirror, given that Japan's market was an underperformer for most of the 1990s and 2000s, and partly due to an infatuation with focusing on "top down" indicators. Wasatch invests from the "bottom up" and we believe that Japan has one of the most dynamic and exciting small-cap markets on the planet. We have witnessed considerable change in Japan during the last decade. This has led to Japan becoming one of the best-performing small-cap markets in the world over the past five years (based on several MSCI indexes). Not only did the MSCI Japan Small Cap Index outperform the MSCI World Small Cap Index for the five years ended May 31, 2020, but it also outperformed the MSCI USA Small Cap Index. This is calculated in U.S. dollars, given that another perceived concern amongst investors appears to be currency.

Over long periods of time, developed-market currencies have tended to be mean-reverting. Case in point: The Japanese yen is the same level as it was 20 years ago. Just as Japan has admirably and effectively adapted to natural disasters, we believe it has similarly responded to the coronavirus pandemic economic and health disaster. Lessons learned from managing through challenging times have been most readily applied by—and are most apparent in—Japan's nimble small-cap companies. Year-to-date through May 31, 2020, the MSCI World Small Cap Index was down -15.05%, while the MSCI Japan Small Cap Index was down -8.90%.

While we make no attempt to prognosticate regarding how short-term macro events might play out, we believe the pandemic crisis has further demonstrated the unique characteristics we see in Japan. Much like the Japanese people and the Japanese businesses in which we invest, we have sought to create international strategies that can both "survive and thrive."

Japan remains one of our favorite markets and we believe the stocks of many strong Japanese companies have been unfairly punished during the recent market panic. In the midst of this current downturn, we have been seeking to capitalize on opportunities to add to many of our most-exciting Japanese holdings, often at what we consider attractive prices.

As promising as we find Japan's small-cap offerings, most of the companies that interest us remain under-followed by other investment analysts. While this can represent a boon for us as investors it also requires tireless, ongoing research. We believe our strategies benefit immensely from the institutional knowledge and cross-collaboration of our world-class and time-tested research team, which have been keys to Wasatch's long and proven historical track record.

RISKS AND DISCLOSURES

Investing in small 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 unstable currencies, highly volatile securities markets and political and social instability, 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.

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

Abenomics *refers to the economic policies advocated by Japanese Prime Minister Shinzo Abe after his December 2012 re-election to the post he last held in 2007. His aim was to revive the sluggish economy with "three arrows"—a massive fiscal stimulus, more aggressive monetary easing from the Bank of Japan, and structural reforms to boost Japan's competitiveness.*

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-per-share *or* **EPS** *is the portion of a company's profit allocated to each outstanding share of common stock. EPS growth rates help investors identify companies that are increasing or decreasing in profitability.*

EBIT (earnings before interest and taxes) *is a measure of a firm's profit that includes all expenses except interest and income tax expenses. It is the difference between operating revenues and operating expenses. EBIT is also called "operating earnings," "operating profit," or "operating income."* **EBIT ROA** *is the ratio of EBIT to the total capital invested in operating assets.*

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

The **JPX-Nikkei Index 400** *is a capitalization-weighted index of 400 companies from the First Section, Second Section, JASDAQ and Mothers of the Tokyo Stock Exchange (TSE).*

Long-Term Debt-to-Capital *is a company's debt as a percentage of its total capital. Debt includes all short-term and long-term obligations. Total capital includes the company's debt and shareholders' equity, which includes common stock, preferred stock, minority interest and net debt.*

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.*

Return on Equity (ROE) *measures a company's efficiency at generating profits from shareholders' equity.*

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

The **Tokyo Stock Price Index**, *commonly known as* **TOPIX**, *is a free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange (TSE) First Section. It is calculated and published by the TSE.*

The **MSCI Japan Small Cap Index** *is designed to measure the performance of the small-cap segment of the Japanese market. With 982 constituents, the index represents approximately 14% of the free float-adjusted market capitalization of the Japan equity universe.*

The **MSCI USA Small Cap Index** *is designed to measure the performance of the small-cap segment of the U.S. equity market. With 1,740 constituents, the index represents approximately 14% of the free float-adjusted market capitalization in the U.S.*

The **MSCI World Small Cap Index** *captures small-cap representation across 23 developed-market countries. With 4,269 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.*

You cannot invest in these or any indexes.

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