

An Active Approach to Quality-Oriented Investing

We Pursue Long-Term Success By Attempting to Capture High-Quality Characteristics Going Forward

OCTOBER 9, 2020

At Wasatch Global Investors, we consider ourselves first and foremost to be quality-oriented investors. If we look at quality investing in a simplistic way, we can describe two very basic approaches. The first approach is relatively passive: buy companies that have exhibited high-quality characteristics in the past. The second approach is very active: seek to invest in high-quality companies that our bottom-up, fundamental research indicates will continue to exhibit high-quality characteristics into the future, say over the next five or even 10 years.

PASSIVE MANAGEMENT ("SMART BETA") VERSUS ACTIVE MANAGEMENT AND "PURCHASED QUALITY" VERSUS "CAPTURED QUALITY"

We call the first approach "purchased quality" because it simply entails "purchasing" companies that have **already** shown strong operating results. We call the second approach—which is much more difficult—"captured quality." This approach entails identifying and investing in high-quality companies where **we attempt**



Key Takeaways

- Actively capturing future quality has led to better performance than passively purchasing past quality.
- Quality metrics such as ROA, sales growth and EPS growth are important considerations when constructing a portfolio.
- We look to the future. We want to invest in high-quality companies that we determine have the potential to rank ahead of their benchmarks based on our quality metrics going forward.
- We are quality-oriented investors first and growth-oriented investors second.
- In addition to screening for quality factors, bottom-up research helps us assess less tangible factors such as management expertise and business-model viability that are likely to be important reasons for the persistence of company quality into the future.
- Over 45 years of experience aids Wasatch's efforts to identify companies with the potential to be strong operators into the future.

to “capture” **future** strong operating results by trying to be correct in our research assessments of a company’s prospects going forward. For our more aggressive growth strategies, we often try to predict which companies will be the high-quality growers of the future. For our less aggressive growth strategies, our focus is often on trying to assess whether the quality of our stable-growth companies is likely to persist into the future.

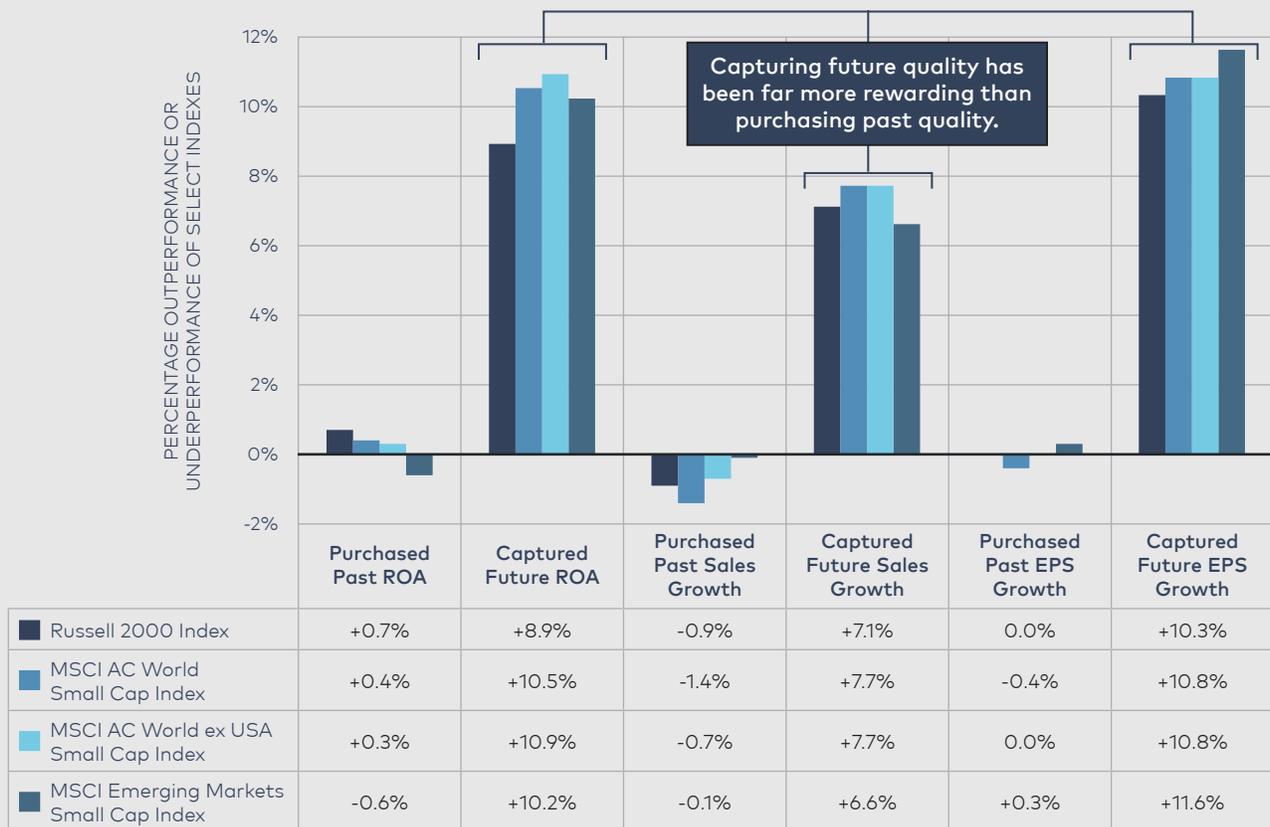
As you may have surmised, taking a passive “smart beta” approach to purchased quality could lead a strategy to outperform an index—but it likely depends on the extent to which quality **persists**. In other words, it may be beneficial to buy the strong operating companies **of the past** because these companies could continue to do well. But the stock prices at that point would have probably already rewarded the strong operating companies at least to some extent. So any stock-performance benefit from purchased quality may be modest or even nonexistent.

Captured quality, on the other hand, may provide significant potential for a strategy to outperform an index because it entails investing in a company that exhibits

quality characteristics today **and** being reasonably correct about the company’s potential to produce strong operating results going forward **into the future**. Obviously, it’s much harder to know which companies will be the strong operators in the future than to simply screen for which companies were the strong operators of the past. In this regard, Wasatch takes an active, hands-on approach and can draw from over 45 years of bottom-up research into the quality of individual companies.

Based on rolling five-year periods updated annually from March 31, 2003 through March 31, 2020 (the most recently available data as of the publication date), **Figure 1** covers three measures of quality: return on assets (ROA), five-year annualized sales growth and five-year annualized earnings per share (EPS) growth. ROA is an indication of a company’s efficiency in using its assets, including debt, to generate profits. Sales growth is a good representation of a company’s ability to take market share and/or participate in a growing industry. And EPS growth is an indication of a company’s ability to increase earnings—whether through

Figure 1: Five-Year Annualized Outperformance or Underperformance Of Select Indexes Based on Top-Quintile (Top 20%) Factors



Sources: FactSet/MSCI/Russell/Wasatch models. Rolling five-year periods with annual observations from March 31, 2003 through March 31, 2020. Past performance is not indicative of future results. You cannot invest directly in an index.

better sales, good control of expenses or a combination thereof.

Figure 1 shows purchased and captured quality across four indexes: the Russell 2000® Index (U.S. small caps), the MSCI AC World Small Cap Index (global small caps), the MSCI AC World ex USA Small Cap Index (international small caps) and the MSCI Emerging Markets Small Cap Index (emerging markets small caps). Each percentage shown in the columns of the key below the bar graph indicates the level of five-year annualized stock-market out-performance (+) or underperformance (-) of the index if a strategy had purchased a top-quintile (top 20%) characteristic of the past or had captured a top-quintile characteristic into the future.

As you can see from **Figure 1**, purchasing a past top-quintile characteristic showed relatively unimpressive results. In general, there seemed to be a mild performance benefit from purchasing top-quintile ROA. But purchasing past top-quintile sales growth or EPS growth was frequently harmful to performance.

On the other hand, capturing a future top-quintile characteristic showed exceptional results across the board—among all high-quality characteristics and among all the indexes listed. So, what's the point of this data? After all, it seems rather intuitive that investing for the future based on the past would probably be nowhere near as successful as correctly forecasting the future.

The point is that the data give us a sense of where to focus our research efforts when looking for high-quality growth companies. In the case of past ROA, there seemed to be some persistence of high-level ROA. So we keep this in mind when we invest. But the bigger finding is the magnitude of the performance advantage if an investor can capture future top-quintile characteristics. And while we don't think any investor can successfully capture all or even a majority of a future characteristic, we do think there's

the possibility of capturing a portion—which might be enough to create a meaningful performance advantage. So identifying quality companies with the potential to sustain or strengthen that quality well into the future is largely where we devote our research efforts as active portfolio managers.

In contrast, a so-called “smart beta” approach, which is a form of passive management, might concentrate on purchasing past high-quality characteristics. Although we think this could produce a fair share of single-base hits, our preference is to focus on areas where doubles, triples and home runs are possible—even if our batting average is far from 100%.

WASATCH'S CASE FOR ACTIVE MANAGEMENT: WE BELIEVE CAPTURING HIGH QUALITY IS THE KEY

Although generating attractive investment performance is our ultimate goal, there's no way to pursue this goal in and of itself. Instead, we have to first determine which company characteristics are associated with strong stock-market performance and then structure our investment research around these characteristics. As explained above, purchased quality is often relatively ineffective—while captured quality can be extremely rewarding.

To reiterate, striving to invest in quality companies is our starting point. From there, our research focuses on determining which companies have the potential to maintain their quality characteristics into the future. In addition to looking at ROA, sales growth, EPS growth and other quality metrics, our research is aimed at trying to answer questions such as: Does the company have an experienced management team? How viable is its business model? Is its competitive advantage sustainable? What is the size of its addressable market? As mentioned above, for our more

Figure 2: Percentage of Wasatch Strategy Holdings in Top Quintile (Top 20%) for ROA, Sales Growth and EPS Growth After Five Years

	ROA	Sales Growth	EPS Growth
Wasatch Small Cap Growth Strategy*	44%	36%	28%
Wasatch Global Small Cap Strategy*	47%	33%	24%
Wasatch International Small Cap Growth Strategy*	37%	35%	23%
Wasatch Emerging Markets Small Cap Strategy*	35%	25%	19%

*These strategies are represented by the Wasatch Small Cap Growth Fund, the Wasatch Global Opportunities Fund, the Wasatch International Growth Fund and the Wasatch Emerging Markets Small Cap Fund, respectively. Standardized performance is available at wasatchglobal.com.

Sources: FactSet/MSCI/Russell/Wasatch models. Rolling five-year periods with annual observations from March 31, 2003 through March 31, 2020. Past performance is not indicative of future results.

aggressive growth strategies, we often try to predict which companies will be the high-quality growers of the future. For our less aggressive growth strategies, our focus is often on trying to assess whether the quality of our stable growers is likely to persist into the future, perhaps over the next five or 10 years.

So how has Wasatch done in terms of capturing quality? Based on rolling five-year periods updated annually from March 31, 2003 through March 31, 2020 (the date of the most recently available data), **Figure 2** shows the success we've had across four growth-oriented Wasatch strategies that correspond to the indexes presented previously.

For each index, we determined the number range required for a company to be in the top quintile after five years for ROA, sales growth and EPS growth. Then we determined the percentage of each Wasatch strategy's holdings that made it into that top-quintile range.

By definition, the top quintile for an index is 20%. So for a Wasatch strategy, we consider any number above 20% to be favorable. As you can see, each Wasatch strategy shown in **Figure 2** generated numbers significantly above 20% for ROA and sales growth. For EPS growth, the Wasatch percentages are generally good but don't look quite as impressive as for ROA and sales growth because the top EPS growers are concentrated in companies that had low or negative earnings to start. Wasatch tends to invest in much more profitable companies.

As stated above, generating attractive investment performance is our ultimate goal—and you can see the standardized performance for all the Wasatch funds at wasatchglobal.com. But investment performance doesn't usually occur smoothly or within the time frame we'd prefer. So we make a habit of monitoring how well we capture quality in our various strategies. And we believe if we capture a reasonable degree of quality on a relatively consistent basis, that quality will be reflected in our strategies' long-term performance relative to their benchmarks.

We hope the numbers presented above help you understand why we structure our research process the way we do and why we consider ourselves first and foremost to be quality-oriented investors. When you think about the numbers, also keep in mind that we don't focus on ROA, sales growth and EPS growth in isolation. These quality measures are presented separately for analysis purposes only. In practice, we take a holistic approach to quality-oriented investing. Additionally, we analyze many other quality factors beyond ROA, sales growth and EPS growth. Some of these factors—such as management expertise and business-model viability—cannot be presented numerically but they're vitally important nevertheless.

PORTFOLIO MANAGER / QUANTITATIVE ANALYST BIOS



Mike Valentine

Portfolio Manager

15 / 4
Years of Experience / Years at Wasatch

Mr. Valentine is a Portfolio Manager on the U.S. small cap and global research teams. He joined Wasatch Global Investors in 2016.

Since entering the asset-management business in 2005, Mr. Valentine has covered various sectors including health care, information technology and basic materials across all market capitalizations and geographies.

Prior to joining Wasatch, Mr. Valentine was a portfolio manager at Point72 in Boston where he led a team of analysts and managed a long/short fund focused on the technology and telecom sectors. Before Point72, he worked from 2005 to 2012 as an analyst and a portfolio manager at Fidelity Investments in Boston where he developed a technology-sector strategy for a group of diversified funds in addition to managing long-only sector portfolios.

Mr. Valentine holds a Bachelor of Arts degree in Computer Science from Amherst College in Amherst, Massachusetts.



Mick Rasmussen, CFA

Quantitative Analyst

6 / 6
Years of Experience / Years at Wasatch

Mr. Rasmussen, who conducted the analysis presented in this document, joined Wasatch Global Investors in 2014 as a Quantitative Analyst on the U.S. small cap and global research teams.

Prior to joining Wasatch, Mr. Rasmussen studied at the University of Southern California, earning a Bachelor of Science in Finance. While in college, he held various internships with companies including eBay, Cincinnati Financial Corporation and Moreton & Company. Along with studying business, he earned a degree in Music Production and worked as a DJ in the Los Angeles area. He is also a CFA charterholder. CFA® is a trademark owned by the CFA Institute.

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.

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 Small Cap Growth Fund is long-term growth of capital. Income is a secondary objective, but only when consistent with long-term growth of capital. The investment objective of the Wasatch Global Opportunities Fund, the Wasatch International Growth Fund and the Wasatch Emerging Markets Small Cap Fund is long-term growth of capital.

Wasatch Advisors, Inc., doing business as 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.

DEFINITIONS

Beta is a quantitative measure of the volatility of a given stock relative to the overall market. A beta above one is more volatile than the overall market, while a beta below one is less volatile.

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.

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.

Smart beta describes investment strategies that use rules-based systems for selecting investments to be included in a portfolio. Smart beta strategies choose holdings based on predetermined financial metrics.

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. You cannot invest directly in this or any index.

The Wasatch strategies and funds have been developed solely by Wasatch Global Investors. The Wasatch strategies and funds are not in any way connected to or sponsored, endorsed, sold or promoted by the London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). FTSE Russell is a trading name of certain of the LSE Group companies.

All rights in the Russell 2000 Index vest in the relevant LSE Group company, which owns this index. Russell® is a trademark of the relevant LSE Group company and is used by any other LSE Group company under license.

The index is calculated by or on behalf of FTSE International Limited or its affiliate, agent or partner. The LSE Group does not accept any liability whatsoever to any person arising out of (a) the use of, reliance on or any error in this index or (b) investment in or operation of the Wasatch strategies and funds or the suitability of this index for the purpose to which it is being put by Wasatch Global Investors.

The **MSCI AC (All Country) World 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. This index is a free float-adjusted market capitalization index designed to measure the performance of small capitalization securities. You cannot invest directly in this or any index.

The **MSCI AC (All Country) 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. You cannot invest directly in this or any index.

The **MSCI Emerging Markets Small Cap Index** is a free float-adjusted market capitalization index designed to measure the equity market performance of small-company stocks in emerging markets. You cannot invest directly in this or any index.

Source: MSCI. The MSCI information may only be used for your internal use, may not be reproduced or disseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties or originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com)

Wasatch Global Investors

505 Wakara Way, 3rd Floor
Salt Lake City, UT 84108

Financial Advisors

p: 800.381.1065
advisorservices@wasatchglobal.com

Institutional Investors

p: 800.381.1065
institutionalinfo@wasatchglobal.com

Individual Investors

p: 800.551.1700
shareholderservice@wasatchfunds.com