Market Scout

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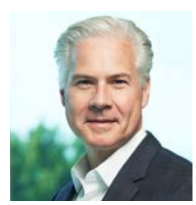
Our Thoughts on Stock Valuations

If we do a good job of investing in high-quality companies with the potential for strong, long-duration earnings growth, we think starting valuations will matter less in generating attractive long-term performance.



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25 YEARS OF EXPERIENCE / 5 YEARS AT WASATCH

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DEAR INVESTORS:

Because stocks have rebounded so strongly despite the ongoing effects of the coronavirus, we're frequently asked about the level of valuations in the market generally and in the growth-oriented Wasatch strategies more specifically.

In response, we acknowledge the higher prices but we emphasize that many of our companies—tech-related companies, in particular—have actually benefited from the pandemic because they facilitate activities like working remotely, seeing a doctor online, renovating household spaces and enjoying home-based recreation. Moreover, we think these activities will continue at elevated levels even after the pandemic ends because people have become accustomed to new routines—both professionally and personally.

STOCK PRICES ARE FORWARD-LOOKING

Another consideration, which also applies to companies that are negatively impacted by the pandemic, has to do with the forward-looking nature of stock prices. In this regard, think about the discussion from a recent CNBC interview with Wharton School professor Dr. Jeremy Siegel. During the interview, he was asked to assess the effects of potentially lost earnings on stock valuations. Dr. Siegel responded that stocks represent claims on long-term company performance.

More specifically, he said that over 90% of a stock's worth is generally based on earnings beyond one year into the future. In other words, if a company loses all of its earnings in the current year, the stock price should be down less than 10%. This is a very broad generalization, of course, and from our perspective it assumes the company can stay in business without impairment to its long-term competitive position, without dilution to its ownership structure and without a major increase in debt.

Because so much of a stock's worth is forward-looking based on earnings well into the future, it can therefore be perfectly rational for a stock to experience a V-shaped recovery in the short term even if it takes the business and the broad economy much longer to get back on track. Additionally, for fast-growing small-cap companies such as those targeted by Wasatch, it's likely that an even greater percentage of a stock's worth is based on earnings more than one year into the future.

This is because especially fast growth puts extra emphasis on the future. For example, with the benefit of 20/20 hindsight, we all would have paid what would have seemed like very expensive share prices in the early years of Amazon.com and Netflix if we had known how fast the companies would grow and how long the duration of the growth would be.

THE WASATCH PERSPECTIVE ON GROWTH-ORIENTED INVESTING: PLAN FOR P/E RATIO CONTRACTION AND FOCUS ON DURATION

When considering the stock valuations of the companies held by the growth-oriented Wasatch strategies—especially in the current environment of generally elevated prices—we think there are two main points to keep in mind. But before we describe these two points, let's start with a discussion of a standard valuation measure: the price/earnings (P/E) ratio.

While we generally prefer metrics like enterprise value to sales (EV/S), the more common expression of the perceived expensiveness of a company is the P/E ratio, which is the stock price divided by the earnings per share (EPS). The P/E ratio can be calculated in several ways—for example, based on trailing earnings or based on projected future earnings. We think most investors would agree that a high-quality company deserves to sell at a greater P/E ratio than a lower-quality company. The question is: How much greater?

At Wasatch Global Investors, we often invest in companies with significantly larger P/E ratios than the ratios for companies in the benchmark indexes. Our reason for this is we believe the high-quality characteristics we emphasize will allow our companies to grow sales and earnings much faster than the average index constituent. In other words, we're not afraid to "pay up" for growth if, for example, we think a company can double in size within the next five years or so. Moreover, we believe high-quality companies are often better able to maintain operations during periodic downturns (like the current pandemic) and emerge stronger and well-positioned for the long term—even if their stocks are priced somewhat more richly in the short term.

This brings us to our first point. When we invest in a company with a high P/E ratio today, we don't do so with the expectation the ratio will stay high indefinitely. If we did, that would require us to depend on the irrational behavior of other investors. Instead, we plan for ***P/E ratio contraction*** (a.k.a., valuation multiple contraction).

We try to estimate the company's earnings about five years into the future. Then we calculate an expected future stock price based on the estimated earnings and based on a lower, less expensive P/E ratio valuation metric. If the stock price at today's higher P/E ratio is significantly below the expected future stock price at the less expensive P/E ratio, we think we can make an adequate return. Our target percentage return is generally in the double digits or in the high single digits annually, which requires enough earnings growth to support both the stock-price increase and the P/E ratio contraction.

Our second point is we try to assess the likely ***duration*** of a company's growth at various rates. For example, consider hypothetical investments in two different companies at the same valuation today. One company grows 25% annually for 10 years. The other company grows 25% annually for five years and then 10% annually for the next five years.

After the full 10 years, the company that maintained its 25% annual growth would be almost twice as large as the company that faltered in its growth. As you can see from this example, an investor who made good assessments of the differing growth rates and durations would have been well-rewarded for choosing the company with consistent 25% growth—even if the investor had been willing to pay a somewhat higher starting valuation.

Moreover, a result that's often surprising to our clients and shareholders is that "paying up" for growth doesn't necessarily mean that a portfolio's performance will be more volatile. Beta is a measure of volatility compared to a benchmark index, and the Wasatch strategies and funds (collectively referred to as the strategies) generally have had lower betas than their benchmarks—as you can see at ***wasatchglobal.com***.

LOOKING BEYOND P/E RATIOS: THE IMPORTANCE OF RISING TRENDS IN GROSS PROFIT

For companies that are very early in their development and/or that are growing sales especially quickly, P/E ratios can be totally irrelevant. This is because innovative companies—particularly tech companies—often operate for a period of time with de minimis earnings. In other words, these companies temporarily use essentially all of their cash from operations to fuel further sales growth.

So how do we know if such a company is a good investment? One indication is the trend in gross profit. The calculation for gross profit is total sales minus the cost of goods sold. What we mean by the "trend" is the nature of the change in gross profit as sales and marketing expenses are increased. For example, suppose a company increases sales and marketing expenses by $100,000 and this leads to a $200,000 gain in gross profit above and beyond the $100,000. Then suppose the company increases sales and marketing expenses by another $100,000 and this leads to a $250,000 further gain in gross profit above and beyond the second $100,000.

This example shows a ***rising trend in gross profit*** ($200,000 then $250,000), which can be a good indication that the company is making the right economic decisions for the long term. Even a steady trend in gross profit can be a good sign. But a rising trend usually gives us more confidence, especially when the company is moving into new business segments and the total addressable market for the company's products or services is expanding.

If we're pleased with the trend in gross profit, we try to forecast the levels of gross margins and net margins that are likely once the company arrives at a relatively steady state—often several years into the future. And for all of our long-term investments, our analysis must show the likelihood of a path to sustainable free cash flows.

GROWTH-ORIENTED INVESTING VERSUS VALUE-ORIENTED INVESTING

In addition to receiving questions about the expensiveness of stocks, we're also asked about cycles favoring growth-oriented investing versus cycles favoring value-oriented investing. While it's certainly true that growth investing has had the upper hand for several years, we don't believe there's a reliable way to successfully move back and forth between growth and value. For our part, we consider ourselves to be quality-oriented investors first and growth-oriented investors second.

In contrast, we think some other growth investors that are less focused on quality get into trouble 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 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. Beyond this boom-and-bust period around the turn of the millennium, the growth-oriented Wasatch strategies have often underperformed when stock prices are on the way up and outperformed when they're on the way down—which is another characteristic that sets us apart from many growth investors.

Today, we don't see a situation that's analogous to the dot-com mania. Software-as-a-Service (SaaS) companies, for example, really are changing productivity, commerce and entertainment for the better. As mentioned earlier, many of these companies have actually benefited from the pandemic. Moreover, we continue to see headroom for ongoing growth based on new ways of living and conducting business.

Another important point related to this topic is that many value investors concentrate on basic industries in which assets are largely tangible and products are often physical. As growth investors, we focus more on higher-tech companies that operate in areas like services, software, information delivery and health care. When we do venture outside these areas, our companies usually have a unique operating model that's not overly capital-intensive. Moreover, in the current environment of higher stock prices overall, we think in-depth insights into management teams, business models, competitive advantages and the scope for market expansion are particularly important. These insights have always been prime areas of focus for us.

An attractive feature of many higher-tech and other non-capital-intensive businesses is they can grow sales very quickly without the risk of having to take on large amounts of debt or the risk of having to dilute their equity ownership excessively or repeatedly. Although these businesses may have stocks that seem to sell at relatively high P/E ratios, many of the businesses could reduce their sales growth and immediately become much more profitable if necessary. For example, Amazon and Netflix continue to operate with low earnings compared to their sales volumes because it still makes sense to plow cash back into expanding their businesses.

WASATCH OUTLOOK AND POSITIONING

Despite the lingering effects of the pandemic, stock markets around the world remained relatively strong during the third quarter of 2020. To a large extent, markets were supported with government-sponsored fiscal measures and very accommodative central-bank monetary policies (including securities purchases and lending backstops) led by the U.S. Federal Reserve. In fact, the Fed recently announced its intention to keep interest rates extremely low for at least the next few years—and to take extra measures promoting higher employment and inflation. Moreover, the

Fed stepped outside its monetary mandate by calling on Congress to spend more money to shore up parts of the economy that continue to struggle.

A close analysis of stock-price movements during September, however, showed the U.S. generally lagged many international developed markets and emerging markets. In addition, the information-technology sector trailed several other sectors. This underperformance wasn't surprising to us because the U.S. and the information-technology sector were previously the leading areas of the markets, and it's often the case that stocks take a breather after strong upward surges.

Going forward, there's a case to be made that international developed markets and emerging markets—supported by strengthening currencies versus the dollar—may continue to outperform the U.S. as they did in September. After all, non-U.S. markets prior to their recent leadership had lagged the U.S. for several years. And they may still have some catching up to do. Moreover, our research indicates the combination of high-quality businesses and reasonable stock prices is especially prevalent beyond U.S. borders.

As for information technology, this sector is at the heart of the discussion of growth-oriented investing versus value-oriented investing. The recent pullback in tech shares prompted talk about the possibility of a rotation into value names within basic industries. If that happens, we think the growth-oriented Wasatch strategies could lag their benchmarks temporarily.

Having said that, information technology holds an important place in our quality-oriented investment strategies. The sector is being propelled by key secular trends such as remote work, telemedicine and streaming entertainment that we think will continue to accelerate. As described above, we believe many tech businesses—including those involved in cloud computing—are still early in their development and don't have overly capital-intensive operations.

More generally, we believe sales growth and earnings growth drive stock prices over the long term. We favor industry-leading companies that are largely able to self-fund their growth without much debt and, if possible, without high fixed costs. Where possible, we also look for sustainable competitive advantages, healthy balance sheets, high returns on capital and strong cash flows.

It often makes sense for these companies to reinvest their cash flows in order to build large customer bases, which are good sources of future revenues. As long as a company has a great product or service, large scope to increase share in an expanding market and strong customer retention, we're not overly worried about a high P/E ratio. We know from experience that in the hands of the right management team, accelerating revenues in the near term can lead to a steady stream of exceptional earnings in the future.

To sum up, we think well-chosen growth companies will benefit from the fact that today's worth of a quickly developing business is especially dependent on future earnings. And this characteristic is likely to be reinforced by the Fed's "lower for longer" interest-rate policy, which also places a premium on the future. So rather than attempting to navigate macro events like vaccine development, political election results and growth versus value cycles, we prefer to stay squarely focused on assessing duration and quality for the long term.

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

Ken Korngiebel and Jagjit Sahota

PORTFOLIO MANAGER BIOS

Ken Korngiebel, CFA
Portfolio Manager

Mr. Korngiebel is a Portfolio Manager on the U.S. micro/small cap and global research teams. He joined Wasatch Global Investors in 2015.

Mr. Korngiebel's investment career has spanned decades, during which he has covered small, mid and large cap growth stocks across all sectors.

Prior to joining Wasatch, Mr. Korngiebel was a founder, partner and lead portfolio manager at Montibus Capital Management—a business backed by Stifel Financial Corp. At Montibus, he led a team of five investment professionals from 2006 to 2015, managing the firm's long-only small and SMID cap growth portfolios totaling $1 billion in assets. Earlier in his career, he was a senior managing director and lead portfolio manager at Columbia Management Company—where he rebuilt a six-person investment team, implemented a new philosophy and process, and managed small, SMID and mid cap growth portfolios totaling $2.6 billion in assets. His tenure at Columbia Management was from 1996 to 2006.

Mr. Korngiebel holds a Master of Business Administration from the Wharton School of the University of Pennsylvania, and a Bachelor of Arts in Economics and Spanish from Stanford University. He is also a CFA charterholder.

Ken has lived in Venezuela, Spain and Switzerland. He speaks Spanish, and his French is passable. He is also an avid skier, wine collector and struggling golfer.

Jagjit Sahota
Portfolio Manager

Mr. Sahota is a Portfolio Manager on the U.S. small cap and international research teams. He joined Wasatch Global Investors in 2014 as a Senior Analyst. During his career, he has held several senior-level research positions, with a particular focus on technology companies.

Prior to joining Wasatch, Mr. Sahota was a partner and technology analyst for a long/short hedge fund. Earlier, he was a vice president and sector head for Crosslink Capital, which focused on investing in disruptive technologies, secular-growth opportunities and early-stage public companies. His other professional experience included positions at hedge-fund and equity-research organizations, as well as a corporate-development role at Agilent Technologies.

Mr. Sahota began his career as an analyst at Kensington Investment Group after earning a Bachelor of Science in Finance from the Walter A. Haas School of Business at the University of California, Berkeley.

Jagjit grew up in the San Francisco Bay Area. He speaks fluent Hindi and Punjabi. He enjoys traveling and playing soccer.

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 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.

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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.*

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.*

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.*

Enterprise value (EV) *is a measure of a company's value calculated as market capitalization plus debt, minority interest and preferred shares, minus total cash and cash equivalents. The* **EV (enterprise value)-to-sales (EV/S) ratio** *is enterprise value, as defined above, divided by annual sales. The EV/S ratio is a measure of a company's expensiveness.*

Free cash flow *is a measure of a company's financial performance, calculated as operating cash flow minus capital expenditures. It is the cash a company generates after spending the money required to maintain or expand its asset base.*

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 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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