Our Take on the U.S. Presidential Election

Political considerations make for interesting discussions but are of dubious value when it comes to investing.

NOVEMBER 9, 2020

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

Ajay Krishnan, CFA
Head of Emerging Markets Investing

Ken Applegate, CFA, CMT
Head of International Developed Markets Investing

DEAR INVESTORS:

With the election of Joe Biden as the 46th president of the United States, we anticipated that clients and shareholders would be interested in our thoughts. While we have no shortage of opinions about the companies we own, we have less to say about what the investment repercussions of the election might be. To understand why, consider whether or not you think the macro predictions of popular media pundits have generally been accurate.

From our perspective, we find that within scientific fields, evidence-based predictions are often quite reliable. But within fields such as economics, sociology and politics, predictions are frequently poor—sometimes with the most knowledgeable and experienced pundits faring the worst. This is because these latter fields involve human behavior, the effects of which cannot easily be discerned. For example, we may have a good understanding of fear and greed. However, that understanding doesn't inform us about the timing or magnitude of economic, societal and political changes.

Key Takeaways

- Forecasts and knowledge of macro events don't necessarily improve investment performance.
- Historically, there hasn't been much difference in stock returns under Republican versus Democratic administrations.
- In our view, "great companies find a way" under most conditions.
- We think capturing high-quality factors in companies is the key to investment success over the long term.

KNOWING WHAT WE DON'T KNOW

In one of our recent commentaries discussing the perils of trying to forecast how the coronavirus pandemic would impact the global economy in the short term, we recalled a famous common-sense quote from the late economist John Kenneth Galbraith, who said, "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." We counted ourselves among the first group, "those who don't know."

We then went on to explain that our inability to accurately forecast the effects of macro events doesn't particularly bother us. How could this be? The simple answer is we believe that even highly accurate forecasts would be of dubious value in generating strong investment performance. If you're skeptical of our conclusion here, ask yourself if you would have predicted that many stock indexes would be hovering near all-time highs amid one of the worst global pandemics in the past century.

POLITICS, TAX RATES AND ECONOMIC GROWTH

The same conclusion applies to politics. Again, if you're skeptical, try doing an internet search of stock-market performance after a presidential election. The results may run counter to what you would have anticipated prior to your search. The truth is that historically there hasn't been much difference in stock returns under Republican versus Democratic administrations. Why is this? After all, don't presidents influence important factors like tax rates and economic growth? Sure, but the repercussions are complicated and take place with unclear lag times. Moreover, there doesn't seem to be any reliable way to predict stock prices based on tax rates or economic growth.

Let's start with tax rates. It's clear that a large increase or decrease in corporate tax rates immediately lowers or raises a company's earnings. But over the longer term, these changes may be offset by modifications to government spending on priorities like infrastructure and unemployment assistance—which are examples of especially important priorities in the current environment.

As for economic growth, it does seem to be true that companies overall tend to grow in line with gross domestic product (GDP). Therefore, stock prices should theoretically be constrained by GDP growth to some extent. But that constraint doesn't take into account that some companies can grow earnings very quickly even while other companies are in decline. And stock prices tend to reflect these company-specific trends regardless of GDP growth. Moreover, many companies operate internationally and aren't limited by domestic markets.

"GREAT COMPANIES FIND A WAY"

Now let's consider two real-world examples from our investment experience. One company was a disappointment, and the other was a success. Both companies are located in the United Kingdom. For context, you need to understand that these investments took place in the environment surrounding Brexit, which is shorthand for the U.K.'s pending exit from the European Union.

In fact, Brexit has caused a significant decline in the U.K.'s GDP growth. Undaunted, we've continued to invest there for the reasons described above. And from the time that Brexit was announced on June 23, 2016 through November 6, 2020, the MSCI UK Small Cap Index was up about 2% while the MSCI AC (All Country) World Small Cap Index was up approximately 41%.

Our disappointing U.K. investment was in a financial-services firm that we thought would replicate the type of success that one of the firm's executives had with a similar entity. Unfortunately, we didn't foresee the firm's challenges operating in a new environment and its need to raise capital on disadvantageous terms.

On the other hand, our successful U.K. investment was in an industrial company that manufactures and distributes building components, scientific equipment and telecommunications products. Based on the accomplishments of the company's domestic and international operations, the stock had significant gains.

Our point here is that "great companies find a way." With hindsight, we now know the financial-services firm wasn't a great company. We don't blame our investment disappointment on Brexit, on sluggish GDP growth or on the U.K.'s lagging stock market. By the same token, we believe our industrial holding is a great company that's been able to grow despite the challenges posed by Brexit. And its stock has handily outperformed not only the MSCI UK Small Cap Index but the MSCI AC World Small Cap Index too.

WHERE DO WE GO FROM HERE?

In assessing where we go from here, let's start with what we think is possible. With the election of Joe Biden, taxes and regulations could increase. But it could also be that higher government spending may improve the prospects for many businesses and individuals who are still struggling. Currently, we don't see anything in a Biden victory that's likely to undermine the case for owning the vast majority of our companies.

Although we don't expend intellectual energy on trying to predict political and other macro events, that doesn't mean we put our heads in the sand. The way we describe our approach is that we're "macro aware" rather than "macro driven." We take the evidence as it comes. If we get the sense that a macro event will meaningfully affect our investments, we adjust. Presently, however, we just don't view the election results as dramatically altering the competitive landscapes for our companies over a full investment horizon—which we consider to be five years or more.

CAPTURING HIGH QUALITY IS THE KEY

Because we're not enamored with macro forecasting, it's important for us to describe what we think does work in investing. Basically, we think it's possible to make reasonable assessments of long-term business quality—which consists of factors like market expansion, competitive advantage, business-model viability, management experience, and likely growth rates and returns on capital. It's in these company-specific factors where we believe we have expertise and where we spend our time and effort.

We recently issued a paper entitled *An Active Approach to Quality-Oriented Investing*, which is available at ***wasatchglobal.com***. In the paper, we describe our approach—which calls for identifying and investing in high-quality companies where we attempt to "capture" future strong operating results by trying to be correct in our research assessments of a company's prospects going forward.

Capturing quality 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 of 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.

THE SMALL-CAP LANDSCAPE: THE UNITED STATES, INTERNATIONAL DEVELOPED MARKETS AND EMERGING MARKETS

Common themes across the United States, international developed markets and emerging markets are that central banks are likely to keep interest rates very low and that economic activity will probably be relatively sluggish for a while. Under such conditions, we'll be especially comfortable owning innovative, growth-oriented companies that have the potential to generate strong returns on capital. Moreover, we see signs that fiscal initiatives around the world are benefiting small companies—which do much of the work on infrastructure and technology solutions to challenges arising from the coronavirus.

Especially in the U.S., there have been many questions about tech-company valuations. An important point here is that the pandemic hasn't just brought to the present the technology spending that otherwise would have occurred later. For example, consider the theoretical purchase of an automobile. If you buy an automobile today, it's likely that you won't need another one for several years.

Accelerated technology spending due to the pandemic is very different. Current spending on business-communications technology, for example, likely *replaces* other forms of business expenditures—such as spending on transportation, lodging and meals. As such, the technology spending hasn't just been brought from the future into the present—it's been *incremental* spending. Additionally, now that businesspeople have been forced to become especially tech-savvy, they're likely to spend even more on technology going forward. This acceleration of tech adoption—and associated revenues and earnings—explains a lot in terms of stock valuations and may make certain technology companies less expensive than some analysts believe.

In international developed markets, we see the same tech trends. But valuations are generally somewhat lower. With the Biden victory, global relations seem poised to improve—which may reduce uncertainty in the financial markets. And less uncertainty should enhance the tendency of capital to flow to the best investment opportunities.

In emerging markets, technology is enabling companies to thrive based on human knowledge and sophisticated services—rather than based mainly on the exploitation of physical commodities like oil and minerals. Moreover, given the enormous headroom for growth in emerging markets, we think company valuations are especially attractive overall. And although we believe that China is too big to ignore from an investment standpoint, we acknowledge that the Biden administration will have no magic formula for improving U.S.-Sino relations.

Fortunately, we don't view currency risks as major unaccounted influences on our emerging-market investments. We did lower our weight in South Africa based on currency concerns. But most other emerging-market currencies appear undervalued to us. We think undervalued currencies, high foreign-exchange reserves and low inflation expectations in emerging markets—along with reasonably priced oil—should provide tailwinds going forward.

Perhaps the best way to summarize our approach is that we're active, bottom-up investors looking to benefit from long-term, company-specific factors. We don't try to invest based on overall economic trends, on general movements in the markets or on other macro factors that may have unpredictable interactions. We've always found that "great companies find a way" and that high-quality investment opportunities exist in all market environments. We believe today is no different.

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

JB Taylor

Ajay Krishnan

Ken Applegate

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.***

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.

CFA® is a trademark owned by the CFA Institute.

DEFINITIONS

Brexit *is an abbreviation for "British exit," which refers to the June 23, 2016 referendum whereby British citizens voted to exit the European Union. The referendum roiled global markets, including currencies, causing the British pound to fall to its lowest level in decades.*

Gross domestic product (GDP) *is a basic measure of a country's economic performance and is the market value of all final goods and services made within the borders of a country in a year.*

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

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

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 UK Small Cap Index** *is designed to measure the performance of the small cap segment of the UK equity market. The index represents approximately 14% of the free float-adjusted market capitalization in the UK. 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 redisseminated 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

Institutional Investors
p: 800.381.1065
institutionalinfo@wasatchglobal.com

Financial Advisors
p: 800.381.1065
advisorservices@wasatchglobal.com

Individual Investors
p: 800.551.1700
shareholderservice@wasatchfunds.com

 Wasatch Funds are distributed by ALPS Distributors, Inc. WAS005319 4/30/2021