

Wasatch Small Cap Growth Strategy

DECEMBER 31, 2022

Macro Headwinds Remained Strong, but We Think Our Companies Continue to Be Well-Positioned For Growth

OVERVIEW

The stocks of U.S. small-cap growth companies moved higher during the fourth quarter of 2022 on the back of optimism about the future paths of inflation and interest rates. The benchmark Russell 2000® Growth Index rose 4.13% for the quarter. The broader Russell 2000 Index gained a more significant 6.23%. The Wasatch Small Cap Growth strategy underperformed both indexes.

From a sector perspective, the strategy's underperformance relative to the Russell 2000 Growth Index was primarily due to the stock-price weakness of our holdings in information technology (IT) and our lack of exposure to high-returning energy names. Conversely, our stocks in the health-care and consumer sectors contributed to relative performance.

During 2022 as a whole, the macro environment presented the most hostile set of conditions for our investment approach in over 20 years. Under more normal circumstances, companies that delivered strong sales growth and surpassed earnings estimates were typically rewarded with higher prices for their stocks. These are the types of companies Wasatch seeks to own. Historically, in both up and down market environments, such strong fundamentals tended to generate positive annual returns that reflected the future earnings power of the underlying businesses. Year in and year out, the Wasatch thesis that earnings drive stock prices generally held true.

PORTFOLIO MANAGERS



JB Taylor
Lead Portfolio Manager

9 / 26
YEARS ON STRATEGY / YEARS AT WASATCH



Ken Korngiebel, CFA
Portfolio Manager

5 / 7
YEARS ON STRATEGY / YEARS AT WASATCH



Ryan Snow
Portfolio Manager

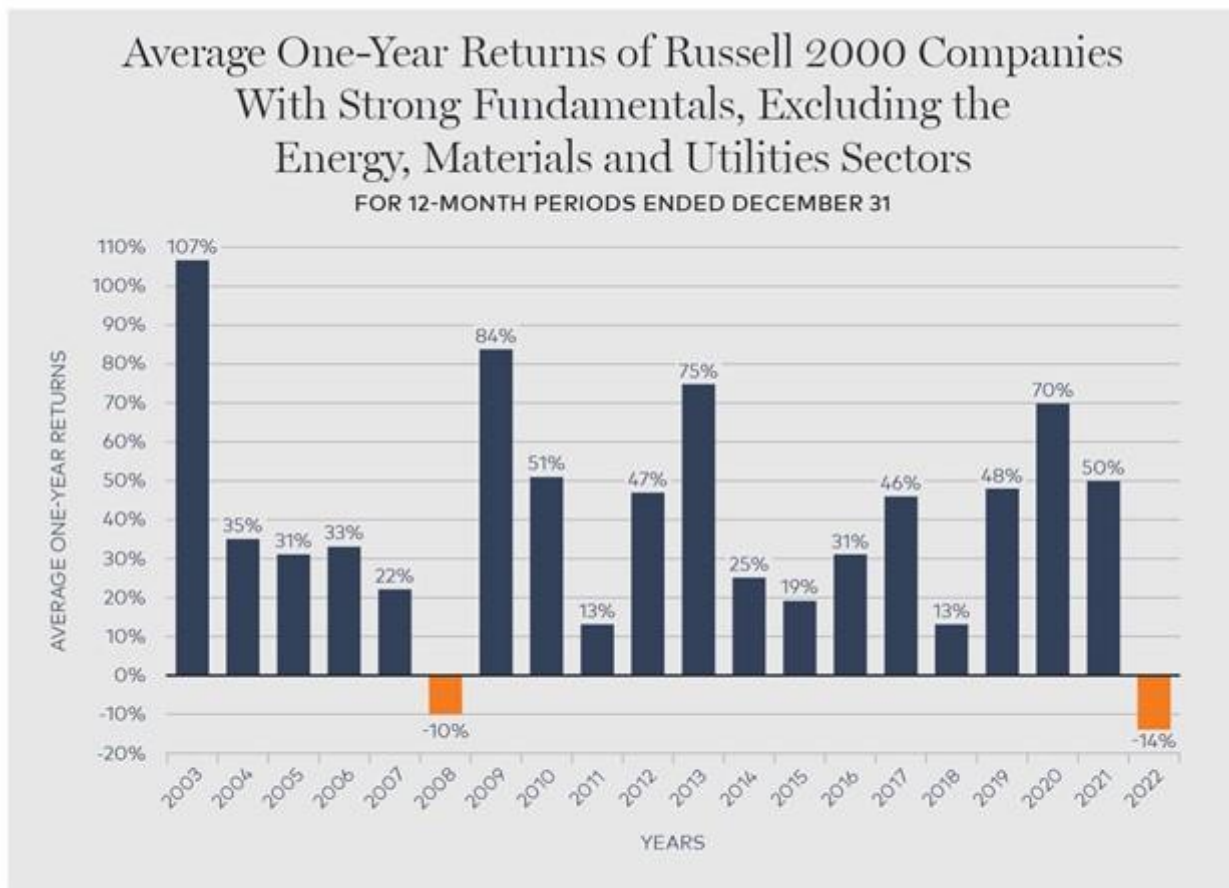
5 / 22
YEARS ON STRATEGY / YEARS AT WASATCH

However, this wasn't the case in 2022 when an inflationary environment and cyclical commodities favored certain sectors that largely produced the best returns in the market.

The following bar chart shows historical average one-year aggregate stock returns of the Russell 2000 companies that met our criteria for having strong fundamentals. But the chart *excludes* companies in energy, materials and utilities because the strategy is normally underinvested in these sectors. We believe these sectors are mostly comprised of capital-intensive

and undifferentiated businesses that typically don't fit well with our preference for dynamic, high-quality companies. Also, energy and materials firms tend to carry significant debt and are often highly cyclical—with success generally linked to a single commodity that's beyond the control of management.

In 2022, strong fundamental performers in energy, materials and utilities generated an aggregate return of about +55%. As the chart shows, the comparable return in other sectors—those typically favored by Wasatch—was



Source: FactSet. Wasatch defines companies with strong fundamentals as those that had sales growth above 15% for the trailing 12-month period and beat their quarterly Wall Street analysts' earnings estimates from the previous year.



approximately -14%. The stark contrast in performance between our underweighted and overweighted sectors was a substantial headwind for the strategy throughout the year.

What distinguished 2022 from the previous 19 years—excepting 2008—was the combination of inflation and sharply higher interest rates. Rising rates usually have an outsized impact on the stock prices of growth companies because their cash flows are typically weighted further into the future. For energy and materials companies, the negative effects of higher rates were offset as inflation boosted the market prices of their products. Utilities also held up well because they're essentially monopolies whose profitability is largely controlled by regulators. In other areas of the market, even strong, growing businesses saw their valuations suffer during 2022 as the Federal Reserve (Fed) hiked interest rates to combat inflation.

As described in the Outlook and Positioning section below, we don't think conditions that characterized 2022 will continue during 2023 and beyond. In short, we believe the benefits of high-quality growth companies will reassert themselves—especially if the economy slows. Some of the most important elements of quality are reasonable debt levels, strong cash flows and management teams that can navigate inevitable challenges.

DETAILS OF THE QUARTER

We made relatively minor portfolio transactions during the fourth quarter. For example, we sold our small position in **DMC Global, Inc. (BOOM)**—which provides a suite of technical products for energy, industrial-processing and infrastructure markets world-wide. As for purchases, we added **Fox Factory Holding Corp. (FOXF)**—which is a producer of high-performance shock absorbers and suspension components for mountain bikes, motorcycles, snowmobiles and other vehicles.

As mentioned above, health care was the strategy's primary source of strength against the benchmark during the quarter. Because it's an area that's both defensive and growing, we think health care has the potential to do well even as the Fed's interest-rate increases achieve their desired effect of slowing the growth of the broader economy. Top contributors to strategy performance included **Medpace Holdings, Inc. (MEDP)** and **Inspire Medical Systems, Inc. (INSP)**.

Medpace is a contract-research organization that supplies clinical-development services to health-care firms. Shares of Medpace had languished for most of 2022 amid worries that a generally poor funding environment for the company's customers would impact operations. Medpace earns the majority of its revenues from small firms that find it more cost-effective and efficient to outsource the management of clinical trials necessary to bring products to market. Concerns eased in October when quarterly revenues and earnings at Medpace came in ahead of expectations. In addition, the company upped its full-year guidance for 2022 and issued a positive outlook for 2023.

Inspire develops minimally invasive solutions for patients with obstructive sleep apnea. The company has experienced strong demand for its products, which serve a previously unmet medical need. Inspire's management team has executed well, growing revenues at a rapid clip since the company's initial public offering in 2018. Most recently, Inspire reported year-over-year quarterly revenue growth of 77%, surpassing Wall Street estimates. Citing increased utilization at existing sites and the addition of new implanting centers, management raised its full-year revenue forecast and maintained margin guidance in the range of 83% to 85%.

Another strong stock in the strategy was **Five Below, Inc. (FIVE)**. A specialty value retailer, the company offers a variety of merchandise at



discounted prices. Five Below's stock price rose sharply in early December after the company reported better-than-expected financial results and guided higher on revenues and earnings. The upbeat news cheered investors who had been concerned about Five Below's ability to attract shoppers during the upcoming inflation-marred holiday season. We think the company's debt-free balance sheet, substantial free cash flows, expanding store count and new Five Beyond format—in which prices can go as high as \$25 in a designated section of the store—leave Five Below well-positioned for growth even in a potentially difficult retail environment.

IT accounted for several of the greatest detractors from strategy performance during the fourth quarter. Among these were **Grid Dynamics Holdings, Inc. (GDYN)**, **Paylocity Holding Corp. (PCTY)** and **CyberArk Software Ltd. (CYBR)**.

Grid Dynamics provides IT services that include digital transformation, legacy replatforming and cloud computing. Although the company has been migrating employees out of Ukraine, a significant number of them still live and work there. Following the outbreak of war, Grid's stock price quickly rebounded from its initial lows as the company effectively managed the resulting challenges. The stock fell again in October, however, amid escalating Russian attacks on power plants and other vital infrastructure. We view recent weakness in Grid's shares as a buying opportunity. We think digital transformation still has significant potential, and our confidence in the company's management team remains unshaken.

Paylocity is a good example of a company that's seen its stock price come under pressure in spite of strong fundamentals in the underlying business. Paylocity provides cloud-based payroll and human-resources software targeted at smaller firms. Although Paylocity's most recent earnings release contained an abundance of positive takeaways, the Fed's focus on the red-hot U.S. labor market as

a source of inflationary pressures may have spooked some investors. Because a portion of Paylocity's pricing structure is tied to employee headcounts at customer firms, revenues are vulnerable to potential upticks in layoffs and attrition. Another factor may have been the interest Paylocity earns on the cash it holds for customers—which stands to diminish if the Fed cuts interest rates in response to a slowing economy in 2023 as some investors expect.

A cybersecurity company that operates globally, CyberArk specializes in products and services to protect and safeguard customers' IT networks and devices. A recent flurry of buyouts by private-equity firms has fostered an active rumor mill that's at times produced rapid gyrations in the prices of cybersecurity stocks. We suspect CyberArk may have been the target of some of this speculation during the third quarter. Moreover, the growing slate of security products offered by cloud-computing giants Microsoft, Amazon Web Services and Google may have bruised investor sentiment toward the group.

OUTLOOK AND POSITIONING

Data released during the final weeks of the fourth quarter suggested the U.S. economy was beginning to slow. Hurt by a drop-off in new orders, a widely followed gauge of U.S. factory activity declined in December at its sharpest pace since May 2020. The downbeat reading followed figures for November showing an unexpected fall in industrial production and a larger-than-expected decline in retail sales. With housing starts and other data points also falling short of forecasts, evidence suggested consumers and businesses were beginning to feel the strains of inflation and higher borrowing costs.

For businesses with debt tied to interest rates, the increased cost of servicing variable-rate debt is claiming a greater share of cash flows and eating into bottom lines. The squeeze of higher borrowing



costs on profitability comes on top of higher expenses for labor, materials, logistics and most everything else. A potentially deeper retrenchment by consumers in 2023 now threatens top lines as well—a development that would leave leveraged companies with even less cash to service their debt and invest for the future. We expect these pressures to send some heavily indebted companies into defensive mode, forcing layoffs and other cost-cutting measures that may ultimately slow their growth trajectories.

Equity prices in the year ahead may begin to reflect the dynamics of debt and cash flows to a much greater extent than they recently have. During 2022, the selling of growth stocks was largely indiscriminate. There was little reason for investors to differentiate between higher-quality and lower-quality companies because business conditions were still mostly favorable. Instead, the stocks of growth companies declined across the board as higher interest rates made discounted future cash flows less valuable in the present.

We think some of this is likely to change in 2023. High-quality companies have strong businesses that produce substantial cash flows. Because they also often carry below-average levels of debt

compared to their peers, more of the cash they generate can typically be used for other purposes. High-quality companies, for example, are positioned to take advantage of falling equity prices—by buying back their own stock and making acquisitions at attractive valuations. Their cash flows can also be used to pay dividends and fund capital-spending initiatives designed to support and enhance the long-term growth of their businesses.

It's often said that when the going gets tough, the tough get going. As the economic situation gets tougher and earnings come under increased pressure, high-quality companies of the type we favor in the strategy have the flexibility to be aggressive and opportunistic—while lower-quality competitors are becoming more defensive. In other words, we believe the upcoming environment will be one in which our companies really earn their stripes.

Thank you for the opportunity to manage your assets.

Sincerely,

JB Taylor, Ken Korngiebel and Ryan Snow



CFA® is a trademark owned by the CFA Institute.

The Russell 2000 Growth Index measures the performance of Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

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.

Indexes are unmanaged. Investors cannot invest directly in these indexes.

The Wasatch Small Cap Growth strategy has been developed solely by Wasatch Global Investors. The Wasatch Small Cap Growth strategy is 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 indexes vest in the relevant LSE Group company, which owns these indexes. Russell® is a trademark of the relevant LSE Group company and is used by any other LSE Group company under license.

These indexes are 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 these indexes or (b) investment in or operation of the Wasatch Small Cap Growth strategy or the suitability of these indexes for the purpose to which they are being put by Wasatch Global Investors.

Wasatch Advisors, Inc., trading as Wasatch Global Investors, ARBN 605 031 909 is regulated by the U.S. Securities and Exchange Commission under U.S. laws which differ from Australian laws. Wasatch Advisors, Inc. is exempt from the requirement to hold an Australian financial services license in accordance with class order 03/1100 in respect of the provision of financial services to wholesale clients in Australia.

This commentary is intended to provide you with information about factors affecting the performance of the Wasatch Small Cap Growth strategy during the period. Information 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. References to individual companies should not be construed as recommendations to buy or sell shares in those companies. Wasatch analysts closely monitor the companies held in the Small Cap Growth strategy. If a company's underlying fundamentals or valuation measures change, Wasatch will reevaluate its position and may sell part or all of its holdings. Past performance is not indicative of future results, and there is no guarantee that the market forecasts discussed will be realized.