

Wasatch Small Cap Growth Fund

SEPTEMBER 30, 2022

A Silver Lining of Stock-Market Weakness: Attractive Valuations

OVERVIEW

During the third quarter of 2022, the benchmark Russell 2000® Growth Index gave up earlier gains and finished with a small increase of 0.24%. Meanwhile, the Russell 2000 Index fell -2.19%. The Wasatch Small Cap Growth Fund—Investor Class underperformed with a decline of -4.73%.

From a sector perspective, the Fund's performance relative to the Russell 2000 Growth Index was primarily impacted by the stock-price weakness of our holdings in health care, consumer staples, information technology (IT) and industrials. Conversely, our only holding in the communication-services sector and our zero weighting in the poor-performing real-estate sector contributed to relative performance.

The Fund underperformed not just for the third quarter but also for the year-to-date period ended September 30, 2022. We think there were three main reasons for the overall underperformance:

- The Fund had outperformed for several years prior to 2022. But no investment strategy can be successful during all market environments.

FUND MANAGERS



JB Taylor
Lead Portfolio Manager

9 / 26
YEARS ON FUND / YEARS AT WASATCH



Ken Korngiebel, CFA
Portfolio Manager

5 / 7
YEARS ON FUND / YEARS AT WASATCH



Ryan Snow
Portfolio Manager

5 / 22
YEARS ON FUND / YEARS AT WASATCH

*Data show past performance and is not indicative of future performance. Current performance may be lower or higher than the data quoted. For the most recent month-end performance data, visit wasatchglobal.com. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. The Advisor may absorb certain expenses, without which total returns would have been lower. Wasatch Funds will deduct a 2% redemption fee on Fund shares held 60 days or less. Performance data does not reflect this redemption fee or taxes. **Total Expense Ratio: Investor Class—1.12% / Institutional Class—Gross: 1.06%, Net: 1.05%. The Advisor has contractually agreed to limit certain expenses to 1.50% for the Investor Class and 1.05% for the Institutional Class through at least 1/31/2023.***

- For the 2022 year-to-date period, rising interest rates were perceived as especially negative for our high-growth companies because the cash flows of these companies are typically more heavily weighted further in the future.
- In evaluating Fund performance relative to the benchmark, it's important to consider the nature of the Fund's holdings versus the benchmark's positions. We were significantly underweighted in energy, the only sector with a positive return for the year-to-date period. For our part, however, we don't usually find many high-quality, differentiated long-duration growth companies in the energy sector.

While it's never pleasant to underperform our benchmark or to see negative returns, we've experienced such conditions before—and we've always emerged gratified that we stuck to our time-tested game plan. For example, compared to the current environment, we experienced even worse underperformance during the few years through mid-2017. But the subsequent years through the end of 2021 were some of our best, on a relative basis, in our history of managing money.

What gave us the confidence to stick to our game plan? The answer in 2017 was the same as it is today: We believe the corporate operating performance that's being "captured" in the Fund isn't being properly reflected in the stock returns. In other words, the revenue growth rates—which may eventually translate into earnings growth—that our high-quality companies have generated while we've held the stocks over the past five years have exceeded the stock returns by wide margins. Based on our experience, this gap between "captured" revenues and stock returns should eventually close—with performance accruing in our favor.

We made relatively few portfolio transactions during the third quarter. As described below, we

sold **ChemoCentryx, Inc. (CCXI)**. Regarding purchases, we initiated small positions in **Dyne Therapeutics, Inc. (DYN)**, a biotech company that develops muscle-targeted therapies, and **JFrog Ltd. (FROG)**, a company that helps clients integrate software development and IT operations.

DETAILS OF THE QUARTER

The greatest detractor from Fund performance for the third quarter was **Vintage Wine Estates, Inc. (VWE)**. In our original analysis, we had liked this wine producer's strategy of consolidating a fragmented industry—and we had been impressed with the company's diversified operating model, which had shown strength across the direct-to-consumer, business-to-business and wholesale channels. More recently, the stock's poor performance was caused by supply-chain headwinds, by reports from a large competitor of post-Covid softness in wine sales and—most importantly—by major inventory-control problems at Vintage. We take some comfort from the company's move to replace its Chief Financial Officer. Assuming no other major problems exist, we believe profits will increase over the long term. Because the company's products are relatively inexpensive, we view Vintage as providing consumer staples that are somewhat resistant to economic downturns. These positive factors notwithstanding, the company's currently low revenue growth and EBITDA growth mean that the debt level is more concerning than we had originally anticipated. (EBITDA is earnings before interest, taxes, depreciation and amortization.)

Neogen Corp. (NEOG) was also a significant detractor. The company provides products to food and animal producers that help keep the world's food supply safe from pathogens and other risks. Although rising costs for freight and supply-chain management have impacted gross margins, we don't think Neogen is any more vulnerable than competitors. Additionally, we believe Neogen's

margin erosion is temporary because the company's products are still in strong demand. Another factor that may have impacted the stock was Neogen's acquisition of 3M's food-safety business, which has increased the debt on the balance sheet. In our view, the acquisition was strategically sound, and we see the debt level as reasonable.

Another detractor was **SiTime Corp. (SITM)**, a developer of silicon-based timing components—which we believe are superior to less-expensive quartz-based components. The stock was down because the company lowered earnings guidance based on temporarily weaker consumer demand. We recently visited SiTime in Santa Clara, California, and came away even more optimistic that consumer demand will rebound over the long term. Additionally, the company doesn't have many supply-chain challenges because it has greater in-house control of its manufacturing processes compared to typical electronics businesses.

The top contributor to Fund performance was **Paylocity Holding Corp. (PCTY)**. The stock was up substantially after the company reported revenue and earnings that topped consensus expectations. We continue to like the strong, recurring revenue streams associated with the company's cloud-based payroll and human-capital-management software targeted at smaller businesses. Because Paylocity holds significant customer cash on its balance sheet, earnings get a boost in a rising interest-rate environment. While that advantage is an attractive sweetener, it's not a reason why we own the company. Instead, we value Paylocity for its core operations.

Another large contributor was **ChemoCentryx, Inc. (CCXI)**. The stock more than doubled during the third quarter. The company's promising medication for the treatment of inflammatory diseases led to Amgen's bid to acquire ChemoCentryx for approximately \$3.7 billion. We sold our position following the announcement of

the acquisition. Going forward, we expect to see more merger-and-acquisition activity in the biotech space.

XPEL, Inc. (XPEL) also contributed. The company manufactures and distributes automotive paint and surface-protection films, window films, and ceramic coatings. XPEL benefits as buyers of luxury vehicles adopt products previously sold primarily to automotive enthusiasts. The stock had been down in the first half of 2022 as investors wrestled with concerns over supply-chain pressures and difficulties facing consumers. However, we continued to have confidence in XPEL's management team and business model. We thought the company would withstand temporary challenges and was still on track to produce the growth we had expected over the long term. During the third quarter, we were gratified as the stock rebounded based on strong earnings that defied the negative trend for many consumer-oriented businesses. *(Current and future holdings are subject to risk.)*

OUTLOOK AND POSITIONING

There's no doubt that significant fears still exist among investors. Broadly speaking, these fears relate to persistently high inflation, rising interest rates, the possibility of recessions around the world, the war in Ukraine and ongoing supply-chain challenges—exacerbated by China's zero-Covid policy.

The main offset to these fears is that many of our small-cap companies have stocks trading at some of the best valuations we've seen in more than a decade. As a result, we're very excited about return prospects going forward. While it's true that macro forces can keep a lid on valuations for a period of time, it's impossible to predict the direction of such forces. And even moderately good news on the macro front could trigger unexpected spikes in stock prices.



As portfolio managers, there's nothing we can do to control macro forces or the timing of the returns on our stocks. But here's what we *can* do for shareholders:

- Focus on high-quality management. When we look historically at our best-performing stocks, they were generally of companies in which our investment team had reached a consensus that management was top-notch.
- Focus on innovative products, recurring revenues and sustainable business models in markets with headroom for long-duration growth. If we make good assessments in these areas, even relatively pricey companies can go on to be very successful investments for a decade or more.
- Focus on significant returns on capital and relatively low debt. These characteristics often indicate that a company will be able to self-fund its growth, which can be important in preventing the need to raise money and dilute the ownership of existing shareholders.

At Wasatch, we're looking beyond what we can't control and we're doubling down on what we *can* control. We're taking care to ensure that the investment thesis for each of our companies is still sound in order to avoid negative earnings surprises.

We're on the road visiting management teams at their places of business. And although we haven't found the need to make significant changes to the Fund, we're making incremental moves to consolidate assets in our highest-conviction names.

Finally, we'd like to comment on the attractiveness of holding growth-oriented companies in the midst of continually elevated interest rates and inflation. While it's true that growth stocks took an outsized hit during the early stages of rate increases, there are other factors to consider. First, our growth companies generally don't have significant debt loads that would be impacted by higher interest rates. Second, quality growth companies should be better able to attract talent and raise prices during an environment of escalating wage and input-cost inflation. Third, in general, we believe the top growth companies are best positioned to navigate especially difficult challenges—ranging from logistical problems amid a booming economy, to the need for increased market share amid a recession.

Thank you for the opportunity to manage your assets.

Sincerely,

JB Taylor, Ken Korngiebel and Ryan Snow



AVERAGE ANNUAL TOTAL RETURNS

FOR PERIODS ENDED SEPTEMBER 30, 2022

	Quarter*	1 Year	3 Years	5 Years	10 Years
Small Cap Growth Fund—Investor	-4.73%	-42.42%	3.02%	8.47%	9.34%
Small Cap Growth Fund—Institutional	-4.72%	-42.35%	3.12%	8.59%	9.44%
Russell 2000® Growth Index**	0.24%	-29.27%	2.94%	3.60%	8.81%
Russell 2000® Index*	-2.19%	-23.50%	4.29%	3.55%	8.55%

*Returns less than one year are not annualized.

Data show past performance, which is not indicative of future performance. Current performance may be lower or higher than the data quoted. To obtain the most recent month-end performance data available, please visit wasatchglobal.com. The Advisor may absorb certain Fund expenses, without which total returns would have been lower. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. **Total Expense Ratio: Investor Class—1.12% / Institutional Class—Gross: 1.06%, Net: 1.05%**

Total Annual Fund Operating Expenses include operating expenses, including the management fee, before any expense reimbursements by the Advisor. **The Advisor has contractually agreed to limit certain expenses to 1.50% for the Investor Class and 1.05% for the Institutional Class through at least 1/31/2023.** See the prospectus for additional information regarding Fund expenses.

Wasatch Funds will deduct a 2.00% redemption fee on Fund shares held 60 days or less. Performance data does not reflect the deduction of fees or taxes, which if reflected, would reduce the performance quoted. For more complete information including charges, risks and expenses, read the prospectus carefully.

Performance for the Institutional Class prior to 2/1/2016 is based on the performance of the Investor Class. Performance of the Fund's Institutional Class prior to 2/1/2016 uses the actual expenses of the Fund's Investor Class without any adjustments. For any such period of time, the performance of the Fund's Institutional Class would have been substantially similar to, yet higher than, the performance of the Fund's Investor Class, because the shares of both classes are invested in the same portfolio of securities, but the classes bear different expenses.

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 currency fluctuations and political uncertainties, 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.



***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.

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The Small Cap Growth Fund's primary investment objective is long-term growth of capital. Income is a secondary objective, but only when consistent with long-term growth of capital.

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.

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.

SMALL CAP GROWTH FUND – TOP 10 HOLDINGS

AS OF JUNE 30, 2022

Security Name	Percent of Net Assets
Medpace Holdings, Inc.	3.8%
Ensign Group, Inc.	3.4%
CyberArk Software Ltd.	3.4%
Rapid7, Inc.	3.1%
HealthEquity, Inc.	3.1%
Ollie's Bargain Outlet Holdings, Inc.	3.0%
Helios Technologies, Inc.	2.9%
Pinnacle Financial Partners, Inc.	2.8%
RBC Bearings, Inc.	2.6%
Globant SA	2.5%
Total	30.5%

Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Fund or its Advisor. Current and future holdings are subject to risk.