Market Scout

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"Button-Mashing" in Video Games... And in the World of Investing

In a frantic effort to compete against my teenage son in *NBA 2K*, I often resort to repeated random strikes on the video-game controller. While I may score a sporadic victory, this is no way to win consistently.

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25 YEARS OF EXPERIENCE / 25 YEARS AT WASATCH

DEAR INVESTORS:

For those of you not familiar with video games, *NBA 2K* is one of the most popular sports titles on the market. This hyper-realistic basketball game is also my son's favorite. While I'm a huge basketball fan, I've never been an avid gamer. But that doesn't stop him from occasionally trash-talking me into accepting a challenge on the virtual basketball court. It's the Utah Jazz (me) versus the Golden State Warriors (him) every time.

What's amazing about today's video games is how intricate and precise the controls are for the informed user. As for me, I've learned where the buttons are to execute basic offensive and defensive moves. But my son can perform around-the-back dribbles, alley-oop dunks, pick-and-rolls and complex defensive schemes.

I haven't spent enough time learning the game—and so often in the heat of battle, I just start pressing buttons frantically. Sometimes, this results in a spectacular but unintended and unrepeatable play for the old man. "You're so lucky, Dad! You're just button-mashing!" my son yells. Although my button-mashing results in an occasional strong run to close out a quarter, I've yet to beat him in an entire game.

INDEXING, FACTOR INVESTING AND QUANTITATIVE TRADING

In trying to keep up with my son in *NBA 2K*, it occurred to me that something analogous has been happening in the world of investing. While trend-following among some investors has always been prevalent—and usually unsuccessful, in my view—the situation seems to have gotten worse. In other words, trend-following has morphed into the investing equivalent of frantic "button-mashing."

Moreover, I believe indexing, factor investing and quantitative trading have made button-mashing especially easy. Any investor can quickly find an exchange-traded fund (ETF) that matches an index or a set of predetermined factors. And the so-called "quants" can execute massive volumes of trades in an instant. As a result, the first quarter of 2022 was one of the most volatile quarters in the past 10 years. The mentality seems to be, just press the buttons because that's what's required to keep up.

GROWTH INVESTING AMID LOW INTEREST RATES AND IN A STAGNANT ECONOMY

From early 2017 through the latter part of 2021, interest rates were contained at a modest level and even trended lower for a while. During that time, growth investing was in favor largely because growth companies have their cash flows more heavily weighted in the future—and distant cash flows were viewed positively as long as rates stayed down.

Amid an intervening period that was the initial phase of the Covid-19 pandemic in the first quarter of 2020, most stocks—regardless of type—fell sharply. In the ensuing rally, however, growth companies were favored again not only due to low interest rates but also due to the perception that growth companies would be especially attractive in a stagnant economy ravaged by the virus. That was when button-mashing started in earnest. Many investors wanted growth companies irrespective of priciness. The frenzy for growth continued through October 2021.

On November 3, the Federal Reserve (Fed) announced that it would begin to taper accommodative monetary policies because economic expansion and inflation were trending higher than previously anticipated.

VALUE INVESTING DURING AN UPTURN IN INTEREST RATES AND A SURGE IN INFLATION

For many years, inflationary pressures had been building. But monetary policy had remained loose—to a large extent for good reason, especially during the height of the pandemic. More recently, with the U.S. Consumer Price Index around a 40-year high, it became clear that the Fed was "behind the curve" and needed to accelerate the schedule for hiking interest rates.

So in late 2021 and early 2022, button-mashing moved away from growth companies and in the direction of value names such as banks that were perceived to benefit from higher interest rates. With Russia's invasion of Ukraine in February causing even greater fears of inflation, button-mashing rotated toward a different segment of value—namely, energy companies.

Toward the end of the first quarter of 2022, stocks generally moved higher and button-mashing seemed to have no clear favorites, at least for the time being.

WE REMAIN GROWTH INVESTORS

At Wasatch, we've never engaged in button-mashing. We've always been growth investors, and we don't believe vacillating preferences for investment styles can be "timed." Having said that, we do use short-term volatility that the market gives us in an effort to pursue long-term advantages. For example, we trimmed overpriced information-technology holdings about a year ago—and we rounded up on what we saw as unfairly punished health-care names more recently.

As for the unnerving downturns that periodically occur in investing, we simply consider them to be inherent factors in the business we've chosen. In this regard, the line graph that follows indicates the path of a hypothetical $100 initial investment in the Russell 2000® Growth Index over the past 20 years. Despite the volatility, the investment increased to $518—more than a fivefold gain.

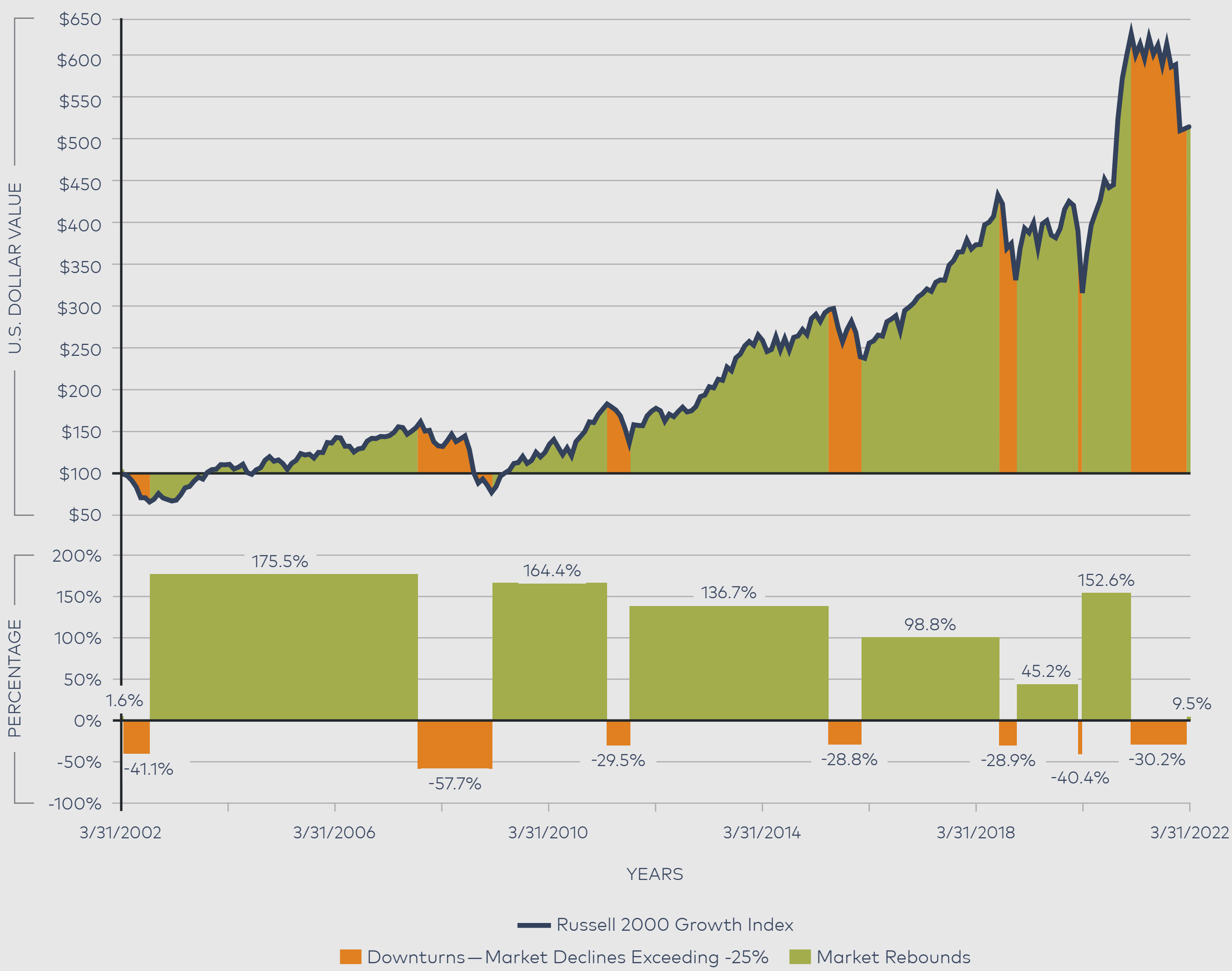
Below the line graph, the corresponding bar graph shows the downturns and rebounds in the Index whenever a decline was -25% or worse. As you can see, in the past 20 years, the Index fell by such amounts seven times—including the most recent downturn exceeding -30%.

What can we take from these graphs? First, significant downturns have been remarkably frequent. Second, downturns have usually been much shorter in duration than subsequent rebounds. (The Covid-19 downturn in the first quarter of 2020 was exceptionally brief.) Third, as disconcerting as they may have been, downturns aren't always particularly memorable in the context of the typically longer and more significant uptrends that have followed. Fourth, in our view, the beginnings and ends of market moves can't be predicted with accuracy. For example, although some investors may currently have well-thought-out reasons to be cautious on the market in the short term, we could see a massive rally if there's especially good news regarding supply chains or if there's a surprise end to the war in Ukraine.

20-Year Path of a Hypothetical $100 Initial Investment In the Russell 2000 Growth Index

SHOWING MARKET DECLINES EXCEEDING -25%, AND MARKET REBOUNDS

BASED ON DAILY VALUES FROM MARCH 31, 2002 THROUGH MARCH 31, 2022



Source: Morningstar Direct. The rates of return are hypothetical and do not represent the returns of any particular investment. Past performance is not indicative of future results. You cannot invest directly in an index.

A "PERFECT STORM"

Regarding the 2021–22 downturn, there's another important point to consider. Many of the Wasatch strategies and funds underperformed their benchmarks during this decline. Historically, our strategies and funds have more often outperformed their benchmarks amid a downturn. We think the reason for the recent underperformance was a "perfect storm" of factors.

The perfect storm included: (1) value exceling relative to growth; (2) positive momentum faltering and trading activity increasingly disconnected from company fundamentals; (3) corporate leverage working to investors' advantage; and (4) procyclical asset-heavy companies gaining support. Clearly, this storm wasn't conducive to our approach—which had previously been favored for several years. In fact, the storm moved against us on a relative basis to an even greater extent than during the value surge following Donald Trump's election victory in 2016. But our bottom-up research today indicates that most of our companies have been improving their competitive positions and have the potential to come out of this challenging period as even stronger market leaders.

To put the recent environment in perspective, we should say a bit more about the perfect storm. We've already discussed issues related to value and growth. As for momentum, on average our stocks had positive price action coming into November 2021, but then that momentum faltered based on button-mashing. In terms of leverage, we typically avoid highly indebted companies in favor of those with healthy balance sheets. And procyclical companies usually have undifferentiated operating models—so even though these companies may benefit on a relative basis from commodity inflation, they don't typically meet our criteria as long-duration growth businesses taking share in expanding markets.

WE HAVE INCREASED CONVICTION IN OUR HOLDINGS TODAY

Even before the perfect storm, we liked our holdings and considered them to be attractive investments for three to five years—and generally much longer. As a result, during the volatility, we weren't shaken out of our well-researched positions.

As we describe in some of our first-quarter strategy- and fund-specific commentaries, we're unlikely to be shaken out of a holding if the company has: (1) a large and growing addressable market; (2) a defensible competitive advantage; (3) a unique business model; and (4) an ability to consistently boost market share. Because we're pleased with our current holdings based on these characteristics, we haven't made many changes to our portfolios recently. In fact, with stock prices having come down and with the well-publicized gap between growth and value having narrowed, our conviction in our names has actually increased.

More specifically, we can report that our companies' 2021 sales and earnings for the fourth quarter and for the full year mostly came in above expectations. Sales and earnings for the first quarter of 2022 haven't been released yet. But going forward, we continue to expect double-digit sales growth overall because positive demand trends have shown no signs of abating. Earnings growth may be a bit weaker due to rising costs for labor and other inputs that can't be immediately offset by charging higher prices.

Furthermore, while we have no forecast regarding when inflation will peak and begin to turn down, we note that such an inflection point has often marked the beginning of a favorable period for small caps.

WE MANAGE MACRO RISKS AT THE PORTFOLIO LEVEL

Another point we make in our strategy- and fund-specific commentaries is that, although we make most of our investment calls on individual companies, we don't usually make calls on macro risks. This doesn't mean macro risks are unimportant. It's just that they generally don't change our long-term views on company fundamentals.

In this regard, consider receiving two equally convincing arguments that in five years oil will (1) exceed $150 per barrel or (2) drop below $50 per barrel. But the fact is that no one knows for sure. And there's risk in both directions. So the way we manage this risk is by having, for example, only reasonable portfolio exposure to energy-sensitive companies like travel-related names. The same logic applies to interest-rate risk for banks, regulatory risk for health-care companies, labor risk for retailers, etc.

As for the risks tied to supply chains and inflationary input costs, the repercussions can be more complicated. Therefore, supply-chain and input-cost issues are high on our agenda when we speak with management teams. Our focus is on trying to understand where there could be long-term damage to a company's competitive position. Similarly, although the war in Ukraine doesn't seem to be a major factor for most of our holdings, we try to assess whether the war could cause permanent destruction to the worth of a business. After all, unlike volatility—which long-term, diversified investors frequently endure—a stock losing most or all of its value is much more impactful on a portfolio.

In closing, I'd like to assure you that we at Wasatch will never participate in button-mashing with investments we manage on your behalf. As for the next *NBA 2K* virtual face-off against my teenage son, I make no such assurances. Then again, maybe I'll just lay down a challenge on a *real* basketball court. This seems like a better bet—as I still have about 90 pounds and 8 inches on him.

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

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DEFINITIONS

The **Consumer Price Index (CPI)***, also called the cost-of-living index, is an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. The CPI is published monthly. The headline CPI includes volatile food and energy prices, while the core CPI excludes food and energy.*

Earnings growth *is a measure of growth in a company's net income over a specific period, often one year.*

Sales growth *is the increase in sales over a specified period of time, not necessarily one year.*

The **Russell 2000 Growth Index** *measures the performance of those 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. The Russell 2000 is widely used in the industry to measure the performance of small company stocks. You cannot invest directly in these or any indexes.*

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