The State of Small-Cap Growth Stocks In the U.S.

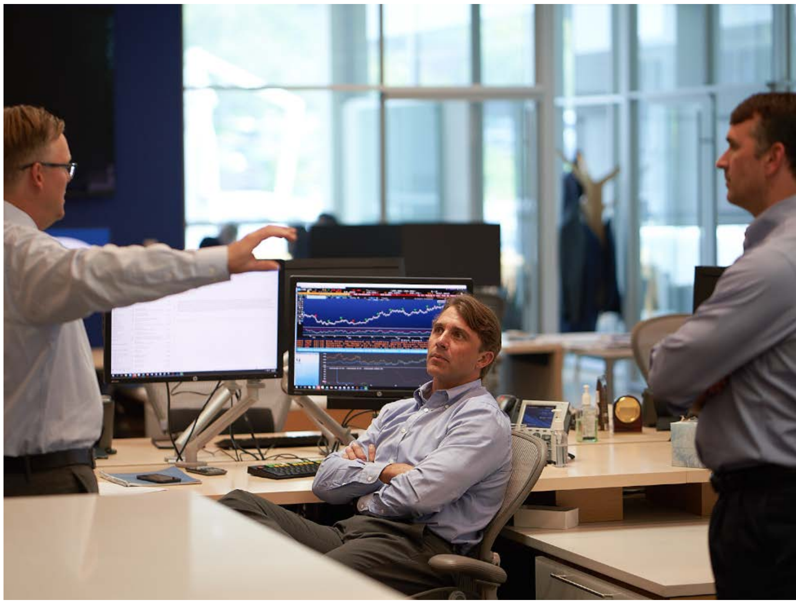
Despite the Potential for Continued Volatility, We Think Our Risk/Reward Trade-Off Is the Most Favorable We've Seen In Years

AUGUST 11, 2022

U.S. small-cap growth stocks endured a sharp correction in 2022, but also a considerable rebound in July. Amid the volatility, investors naturally have plenty of questions about this pocket of the market. Below are a few answers to questions our clients and shareholders have asked us most.

HOW SHARPLY DID STOCKS RALLY IN JULY?

The Russell 2000® Growth Index of U.S. small caps rose 11.2% in July. As of July 31, the Index was up 18.3% from an interim low on June 16. With news about high inflation, the U.S. Federal Reserve (Fed) raising interest rates and the likelihood of the U.S. economy entering recession, some investors may be surprised that we saw positive stock-price momentum during this period. We think the reason was that the market tends to look ahead and has already reflected the negative events that are likely to persist for a while.



DOES THE REBOUND MEAN U.S. SMALL-CAP GROWTH STOCKS HAVE REACHED A DURABLE BOTTOM?

For our part, we don't attempt to pick highs and lows in stock prices. We simply focus on researching company fundamentals rather than on trying to predict macro events. Currently, we believe the market has only reflected moderately elevated interest rates and a mild recession. If rates move much higher and the recession is severe, stocks could be vulnerable to another leg down. Nevertheless, we're relatively optimistic that the worst may be behind us—even if volatility persists.

Our optimism is based on our perception that the prices for many growth stocks are very reasonable, that employment will remain relatively strong, that consumer demand will continue to be healthy and that most excesses in the economy will keep from becoming extreme. For example, homes are expensive, but mortgage lending has been responsible—and there's still a housing shortage, which should continue to support demand. Where excesses did become extreme, we think the perpetrators of poor financial decisions have already been punished. In this regard, consider the financial pain experienced in private equity and in special-purpose acquisition companies (SPACs).

WHAT DOES HISTORY TELL US ABOUT THE SELLOFF BEFORE JULY?

While the Russell 2000 Growth Index had an interim peak in early-November 2021, the absolute peak was in early-February 2021. To put the early-February 2021 to mid-June 2022 market decline in perspective, please refer to the following line and bar graphs. The line graph indicates the path of a hypothetical $100 initial investment in the Index over the past 20 years. Despite significant volatility, the $100 initial investment increased to $636 as of July 31, 2022.

The corresponding bar graph shows the downturns and rebounds in the Index whenever a decline from a previous absolute peak was -25% or worse. As you can see, over the past 20 years, the Index fell by such amounts six times—including the most recent downturn of -42.0%.

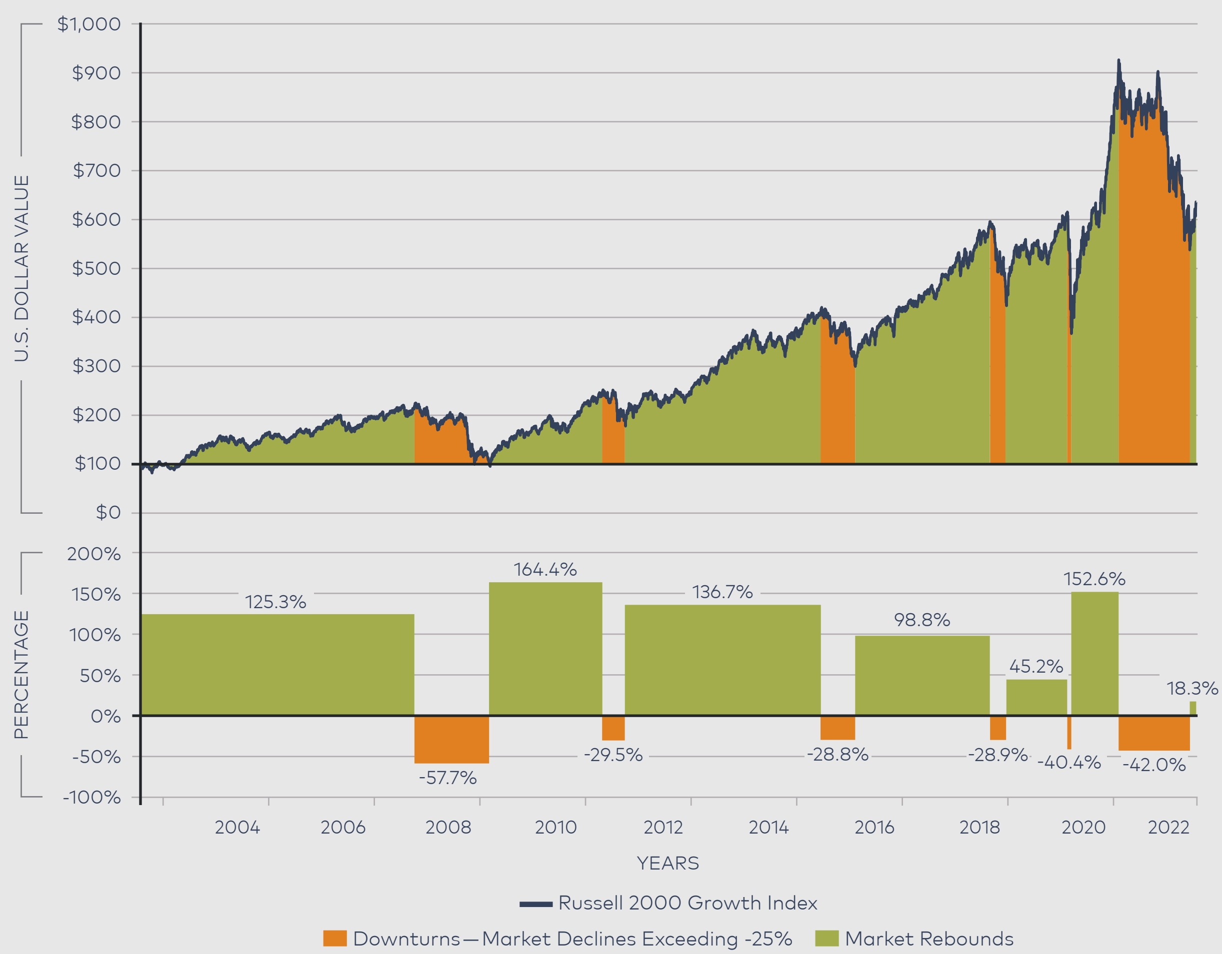
These graphs offer a few key takeaways:

- **First, significant declines were remarkably frequent, and the subsequent rebound was substantial.** The average downturn in the past 20 years was -37.9% compared to the average rebound of 120.5%.
- **Second, declines were usually much shorter in duration than subsequent rebounds.** Notably, the most recent decline lasting 492 days from the absolute peak on February 9, 2021 to the interim low on June 16, 2022 exceeded the average downturn of 256 days by a wide margin.

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 JULY 31, 2002 THROUGH JULY 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.

- **Third, 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 long continuation of the recent rally if there's a surprise end to the war in Ukraine or if there's especially good news regarding supply chains.

WHAT DROVE THE ACCELERATED DOWNTURN IN THE FIRST HALF OF 2022?

While stocks have fallen broadly, growth stocks suffered steeper losses than value stocks. This is because higher growth companies typically have their cash flows weighted further into the future. Amid rising inflation and interest rates, the present value of future cash flows may be perceived by investors to be worth less.

Market sentiment for growth-oriented stocks turned down after an interim peak in early-November 2021. Negative sentiment continued during the first quarter of 2022 and accelerated during most of the second quarter. We think the main reason for conditions worsening was that investors started to see macro forces bite more significantly into company fundamentals. These forces included war disruptions, supply-chain challenges, higher interest rates, and rising costs for labor and other inputs. Additionally, energy and food prices crimped the budgets of average consumers who also saw government stimulus receipts dry up.

WHAT WAS UNUSUAL ABOUT THE SELL OFF?

Amid market downturns like the one that started in early-November 2021, we often see that stocks punished the most are of companies that may not be the highest quality. What we saw from early-November 2021 through mid-June 2022, however, was that the stocks of some of the highest-quality companies were down on the same order of magnitude as the stocks of some of the lowest-quality companies. As a result, we think certain high-quality stocks—especially those of companies with significant cash and low debt—may be excellent performers in the post-downturn rally.

HOW DOES THE WASATCH TEAM FEEL ABOUT SMALL-CAP GROWTH STOCKS AS OF THE END OF JULY?

Continued short-term dislocations are always possible, and it's still too early to know if the market has reached a durable bottom. But after the large decline—and even with the subsequent rally through July—we feel much better about stock prices being attractive and about the prospects of our companies to maintain or improve their earnings over a reasonably long investment horizon.

Based on our recent portfolio additions and our other long-term holdings, we think the risk/reward trade-off of our small-cap growth strategies and funds is the most favorable we've seen in years. Once macro conditions become less dominant in the headlines, we believe investors will focus more on company fundamentals—which we believe are outstanding among our holdings.

HOW HAS WASATCH RESPONDED TO MARKET VOLATILITY?

During recent volatility in stock prices, we've responded the way we always do amid market dislocations. We've reviewed every holding to validate its investment thesis. In doing so, we've sold some positions that we considered relatively expensive or that were no longer among our highest-conviction ideas.

One thing we've learned from prior downturns is that the high-quality stocks that were hit hardest are often spring-loaded to rebound very quickly. As such, we've added capital to businesses whose fundamentals remained strong, but whose stocks we felt had been unduly oversold.

Stock-market volatility has also provided us an opportunity to invest in some especially high-quality growth companies that had previously gotten too expensive and/or too large amid the 2020–21 market rally but that are now back in our sweet spot for price and market capitalization. For example, even after the 18.3% gain in the Russell 2000 Growth Index from June 16 through July 31, 2022, the median tech stock in the Index was still down about -56% from the peak.

Many companies in the tech segment have been especially vulnerable because they have negative cash flows and are likely to need capital infusions over the next few years. For our part, we tend to invest in tech companies that have positive cash flows or that have the flexibility to dramatically improve their cash positions by temporarily spending less on advertising and promotion.

ARE THERE REASONS FOR OPTIMISM?

Many investors have been worried about Fed policies designed to increase borrowing costs and curb demand. Moreover, Russia's war against Ukraine and the impacts of China's Covid-19 lockdowns have contributed to their uncertainty. Even with these legitimate concerns, we think there are reasons for optimism:

- Despite temporary pressure on margins and earnings from rising input costs, most of our companies have continued to forecast fairly strong pricing power, healthy customer demand and significant revenue growth.
- Based strictly on fundamentals, we're finding high-quality growth companies that aren't just reasonably priced but that are very inexpensive in our view.
- The most recent downturn in U.S. small-cap growth stocks reached a level during June that, based on historical precedents, could be in the vicinity of a durable bottom.
- Relative to large caps, small caps tend to trough earlier in stock-market cycles.
- Precedents also suggest that after the worst of the current rising inflation and interest-rate cycle has occurred, the environment for small caps is likely to be especially positive.
- Small-cap rebounds after market downturns have historically tended to be strong and sustained.
- Like downturns, rebounds can start without warning.
- Corporate share buybacks have increased, indicating that management teams find their stock prices attractive.
- We've been seeing more stock-pricing inefficiencies, which have allowed us to make especially opportunistic purchases and sales.
- China's virus-containment lockdowns of large population centers notwithstanding, certain supply-chain segments have been running more efficiently.
- High-quality, low-debt companies—particularly those favored by Wasatch—should be well-positioned to attract talent, develop innovations and increase market share in difficult environments.

CLOSING THOUGHTS

Going forward, we believe we're well-positioned in high-quality companies with relatively low debt and the potential for positive returns on capital. We think such companies have greater control over their destinies by virtue of having innovative products and services that generate strong demand in growing end markets. These characteristics have historically helped companies withstand difficult periods in the economy.

In considering the likelihood for ongoing volatility in the market, what tenets should we keep in mind? First, we should welcome volatility because it will likely give us additional opportunities to find mispriced stocks. Second, we should remain as growth-oriented investors—and we believe all investors should uphold their discipline because switching back and forth can't be executed effectively. Third, we should remember that there's no evidence of macro predictions being used with consistent success to "time" moves in the market.

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 currency fluctuations and political uncertainties, which are described in more detail in the prospectus.

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DEFINITIONS

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

A **special purpose acquisition company (SPAC)**, *also known as a "blank check company," is a company with no commercial operations that is formed specifically to raise capital through an initial public offering for the purpose of acquiring an existing company.*

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. You cannot invest directly in these or any indexes.*

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