In Case You Missed It—

Highlights From Wasatch's Client Conference

From September 12 to 13, 2022, Wasatch Global Investors held its institutional client conference, an event bringing together our portfolio managers and investors to share the firm's latest thinking. The following is a collection of highlights from the Market Environment & Outlook session, a half-day presentation including insights from our U.S., international developed markets and emerging markets teams.

CONTEXT ON THE MARKET SELLOFF

Wasatch's U.S. small cap team led off the presentation, providing context on the market selloff. The downturn represents the sixth time in the past 20 years that the Russell 2000® Growth Index has experienced a drawdown of 25% or more. Already, the current downturn has been more severe and has lasted longer than all but one of those prior events. While painful, each drawdown was followed by longer periods of positive returns in which the Index reached new highs, underscoring the importance of long-term investing.

WHILE PERFORMANCE HAS BEEN DISAPPOINTING, FUNDAMENTALS OF WASATCH-OWNED COMPANIES ARE STRONG

While Wasatch strategies have generally underperformed their benchmarks in 2022, fundamentals of companies in the portfolios remain strong. For example, the weighted average revenue and forward earnings-per-share growth of stocks in the Wasatch Small Cap Growth strategy are more than 1.5 times that of the Russell 2000 Index. The strategy also compares favorably to the Index on measures of quality, such as gross margins and net-debt-to-EBITDA ratios. (EBITDA is earnings before interest, taxes, depreciation and amortization.)

Those factors are important because over longer time horizons, stock prices track earnings and revenue growth. As such, the U.S. team expects its strategies to compound returns at a higher rate than the Index once investors refocus on company fundamentals. Wasatch international and emerging markets strategies have also experienced a dislocation between earnings growth and stock performance. Portfolio managers from those teams expressed similar expectations for long-term performance.

The U.S. team compared the current environment to a period from 2015 to 2017. At that time, the Wasatch Small Cap Growth strategy also underperformed the Russell 2000 Index, even though its revenue and earnings growth were higher than the Index, and quality metrics were also favorable. That period was followed by a stretch from 2017 to 2019 in which the annualized performance of the strategy was more than five times higher than the Russell 2000 Index.

To further demonstrate the role earnings and revenue growth have on long-term stock performance, the team shared a chart showing the five-year return of companies in the Russell 2000 Index that were among the top quintile of revenue growers for the same five-year period. In every calendar year from mid-1998 to 2017, those companies that ended up being in the top quintile of revenue growth for the following five years ended up outperforming the broader Index. This is why the U.S. team, and other teams at Wasatch, remain focused on fundamentals and earnings growth potential during recent market volatility.

FOR THE WASATCH SMALL CAP VALUE STRATEGY, OPPORTUNITIES APPEAR GREATER THAN AT ANY POINT SINCE THE GLOBAL FINANCIAL CRISIS

Wasatch's U.S. small cap value team noted that by some metrics, they're finding more compelling investment opportunities than at any point since the global financial crisis of 2008–09. For example, the number of companies in the Russell 2500™ Index that are free cash flow positive, are experiencing more than 15% annual earnings growth and are trading at a 20% or greater discount to their five-year average price-to-sales ratio is at the highest level since the global financial crisis. This has created an exceptional opportunity to add "fallen angels" to the portfolio.

INTERNATIONAL EQUITIES: INVESTING IN AN ERA OF LOCALIZATION

The shift from globalization to localization is a critical change that we think will define international markets over the next decade. Brexit, China's localization policy, "America First" policies of the past several years and Covid-19 have all played a role in making trade less open.

While localization has risks, it also creates opportunity for international investors. Beneficiaries of localization include companies that localize data or specialize in data privacy, firms that provide supply-chain resilience and agility and businesses that provide automation to improve other companies' efficiency. Many other individual companies may benefit in their local markets by having less competition from global competitors.

THREE COUNTRIES WHERE THE INTERNATIONAL TEAM IS FINDING THE MOST OPPORTUNITIES

While the international team relies on a bottom-up research process to select individual stocks, larger forces can tilt the playing field to provide more company-specific opportunities within a country. Currently, the team sees favorable dynamics creating greater opportunities in three countries:

- In Canada, burgeoning health-care and information-technology sectors are giving rise to more high-quality growth companies. The country is also at an ideal size and has enough domestic wealth to nurture global businesses before they compete around the world.
- In the U.K., Brexit and other political and macroeconomic headwinds have led to lower stock valuations. But these same headwinds have forced management teams to run leaner operations and take actions to improve their competitive positions. We believe today's low valuations leave our U.K. holdings spring-loaded for better performance when the companies get credit for the earnings growth they've continually produced.
- We also see greater opportunity in Japan. The country was slower than many countries to emerge from Covid-19, causing Japanese equities to lag other markets. The underperformance belies structural improvements taking place within many Japanese businesses. Investors have also overlooked the fact that management teams are becoming much more focused on creating value for shareholders.

EMERGING MARKETS: A TALE OF TWO DECADES

The cumulative performance of emerging market equities over 20 years illustrates why it's beneficial to take a long-term view with the volatile asset class. For the decade ending in 2010, the MSCI Emerging Markets Small Cap Index returned 446%, compared to just 26% for the MSCI World Index. Over the next decade the trend reversed, with the MSCI World Index returning 156%, compared to 25% for the MSCI Emerging Markets Small Cap Index. Over the 20-year horizon, staying the course with emerging markets benefited investors, as the MSCI Emerging Markets Small Cap Index returned 585%, compared to 222% for the MSCI World Index.

We believe investors should keep that long-term performance in mind as individual emerging-market countries experience macroeconomic or geopolitical headwinds.

WITHIN EMERGING MARKETS, INFLATION ISN'T A NEW PHENOMENON

Inflation has rattled global equity markets this year, but rising prices are not a new phenomenon for emerging-market countries. In fact, many governments have combatted higher inflation rates at previous points in the past two decades.

Compared to the "taper tantrum" that began in 2013, emerging-market economies are in a better position to withstand rising rates in developed markets. Foreign exchange reserves of emerging-market countries have grown more than six-fold since 2000. This should support these countries' currencies as central banks in developed markets raise interest rates to combat inflation.

INDIA STANDS OUT

One of the countries the emerging markets team is most excited about is India. Wasatch emerging markets strategies maintain a larger weight in India than any other country. We see opportunities stemming from the ongoing digitalization, financialization and formalization of the Indian economy. More recently, India is benefiting from the megatrend of industrialization, as the country becomes a key manufacturing hub for the global economy and as companies diversify their supply chains outside of China.

PORTFOLIO HOLDINGS ARE ATTRACTIVELY VALUED

Currently, 62.5% of Wasatch's emerging markets small cap holdings trade at a price-to-earnings ratio that's below the stock's 10-year average. Given the attractiveness of valuations, the team feels very positive about the return potential of the emerging market strategies over the next several years.

WANT TO LEARN MORE?

Recordings of conference presentations, including breakout sessions that go more in depth on specific topics, can be found here.

*You can also read about select topics, including our perspective on the equity-market selloff, the opportunities our emerging markets team sees in India, and three countries where the international team is finding the most opportunities, in the **News & Insights** section of our website **wasatchglobal.com**.*

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The **MSCI Emerging Markets Small Cap Index** *is a free float adjusted market capitalization index designed to measure the equity market performance of small company stocks in emerging markets.*

The **MSCI World Index** *is a free float adjusted market capitalization index designed to measure the equity market performance of large- and mid-cap securities in 23 developed-market countries.*

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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.*

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 2500 Index** *measures the performance of the small- to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000 Index. It includes approximately 2,500 of the smallest securities based on a combination of their market cap and current index membership.*

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