Market Scout

OCTOBER 10, 2022

Our Senses Are Heightened When Stock Returns Diverge Too Far From Revenue- And Earnings-Growth Trends

Over the long run, we believe stock returns are driven by corporate revenue and earnings growth. As a result, we think some of the best investment prospects are created when there's a mismatch in a stock's return versus the revenues and earnings that can be "captured" by owning the company.

Eric Bergeson
President
Wasatch Global Investors

DEAR INVESTORS:

Many Wasatch portfolio managers and research analysts recently participated in our 2022 Institutional Client Conference. This *Market Scout* presents some of the information discussed at the conference and a few highlights from our written commentaries.

NEGATIVE MARKET SENTIMENT

Market sentiment for growth-oriented small-caps turned down after an interim peak in November 2021. This negative sentiment continued during the first quarter of 2022 and accelerated during the second quarter. After a summer rally, the Russell 2000® Index of U.S. small-caps finished the third quarter of 2022 near the low point for the year.

We think the main reason for conditions worsening in the market 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, recession fears became more pronounced as the Fed increased interest rates and signaled more increases in the future. To top things off, energy and food prices crimped the budgets of average consumers who also saw government stimulus receipts dry up.

U.S. team discussion at the Wasatch 2022 Institutional Client Conference.

One of the most disconcerting aspects of investing is that you never know whether actual conditions will get as bad as forecasts. This is a reason it's impossible to predict a bottom in the market. Having said that, after the recent decline, we feel much better about stock prices being very attractive and about the prospects of our companies to maintain or improve their revenues and earnings over a reasonably long investment horizon. Of course, continued short-term dislocations are always possible.

QUALITY AMID MARKET DOWNTURNS

During market downturns like the one that started in November 2021, we *typically* see that stocks punished the most are of companies that may be a step lower in quality. Because these stocks can rebound very quickly, it sometimes makes sense to take a nuanced approach with respect to quality in order to participate more heavily in a post-downturn rally.

What we also saw recently, which was rather *unusual*, was that some—but certainly not all—of the highest-quality stocks were down on the same order of magnitude as some of the lower-quality stocks. As a result, we think certain high-quality growth stocks—especially those of companies with little debt and significant cash on hand—may also be excellent performers in a post-downturn rally.

Based on the *typical* and the *unusual* aspects of the recent downturn, our tactics over the past several months have required slightly more portfolio adjustments as described below. Still, our primary investment criteria are:

- Top-notch management
- Innovative products, recurring revenues and sustainable business models in markets with headroom for long-duration growth
- Ability to increase prices if necessary and still gain market share—which is a powerful combination in maintaining profit margins, especially amid rising inflation
- Operations that are comparatively insensitive to economic cycles such as recessions
- Significant returns on capital, relatively low debt and cash-rich balance sheets

MAKING SLIGHTLY MORE PORTFOLIO ADJUSTMENTS

During the extreme volatility in stock prices since November 2021, we've responded the way we always do amid market dislocations. More specifically, on the margin, we've sold some positions that we considered relatively expensive—and we've rotated into companies that we believe are at bargain prices.

From a tactical perspective, we've made slightly more portfolio adjustments compared to what we'd do amid a more typical downturn. As mentioned above, we think certain top-quality stocks will be excellent performers in a post-downturn rally. But we also think that, despite the largely negative market environment since November 2021, the stocks of some companies that we believe have "operationally stellar" businesses may not be poised to outperform because they haven't traded down as much as the overall small-cap market. And the stocks of some "merely good" companies have been pummeled unfairly in our view. So we've exited several "operationally stellar" positions due to extreme priciness, and we've bought several "merely good" companies based on compelling valuations.

Although these sales and corresponding purchases could be viewed as making minor trades down in quality, our approach is to always maintain high standards—but not overpay. For example, in the current environment, a "merely good" company that's already fallen -60% might be a better investment than an "operationally stellar" company that's dropped only -25%. Again, any trades we've made in this regard are important but don't represent major changes to our funds and strategies.

STEADY ASCENTS DON'T EXIST IN SMALLER-CAP STOCKS

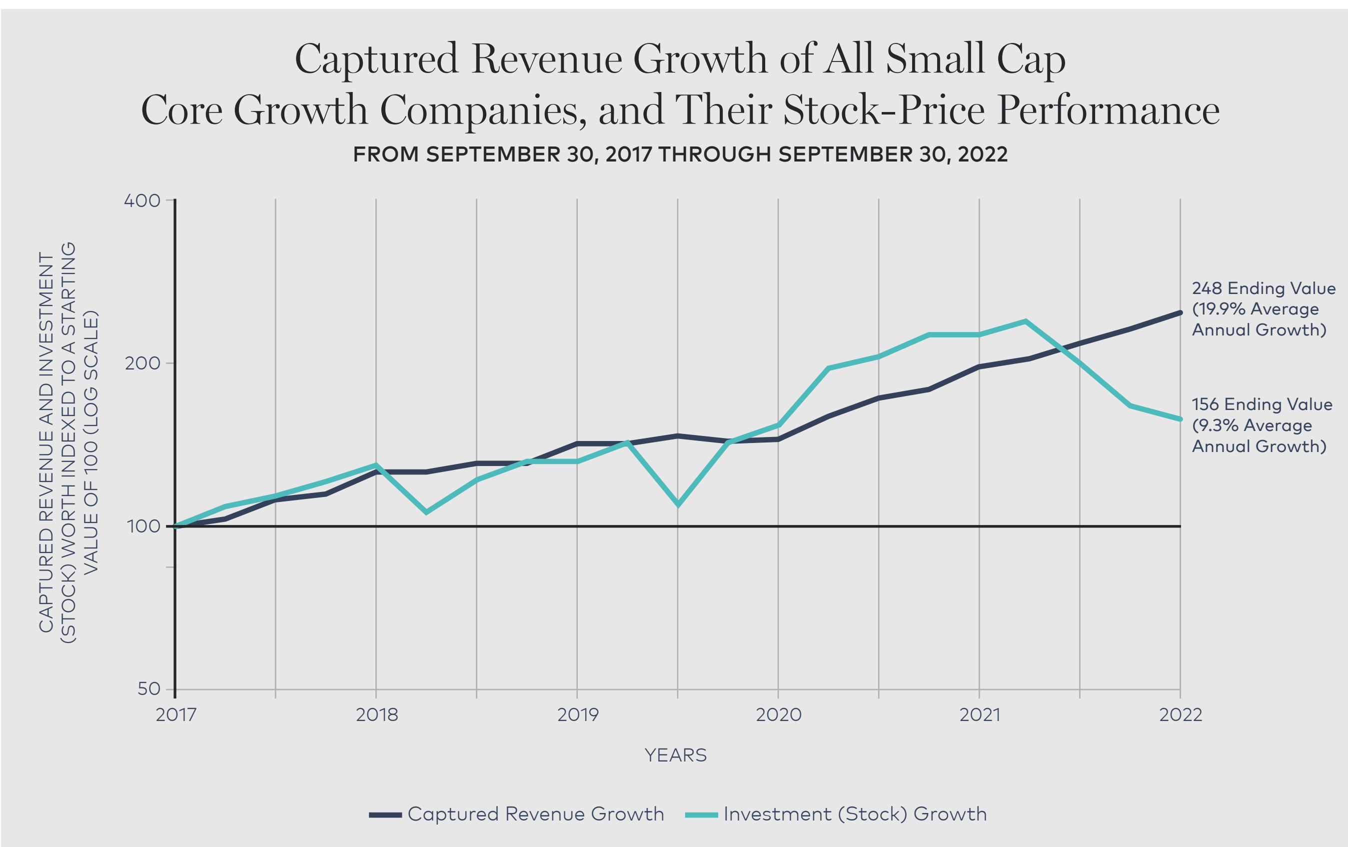
When we discuss historical Wasatch holdings, many of our shareholders and clients are surprised to learn that some of our most successful long-term investments periodically fell by more than -60%—often multiple times. Beyond overall negative psychology, reasons for such declines could be nervousness among investors that a company is too small, too illiquid and/or too difficult for establishing a desired position size. In these and certain other cases, high-quality micro-caps and small-caps could be ripe for acquisitions at premiums above their market prices. Currently, the significant amount of money in the hands of private-equity firms may be a tailwind for such acquisitions.

The most obvious benefit of buying a stock that's declined in the vicinity of -60% is that the price could be poised to rebound very quickly. Another benefit can be that a smaller company often flies under the radar of geopolitical events and isn't especially vulnerable after a decline has already occurred. This is more likely if the stock wasn't down due to geopolitics in the first place. Making such a determination is part of our research process.

STICKING TO OUR GAME PLAN

In the rising interest-rate environment since late-2021, several Wasatch funds and strategies have underperformed their benchmarks largely because the discounted cash flows of growth companies are generally weighted further into the future. While it's never pleasant to underperform 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, similar to the recent environment, we experienced dramatic underperformance in 2016. But the subsequent years through the end of 2021 were some of our best, on a relative basis, in our nearly five decades of managing money.

What gave us the confidence to stick to our game plan? The answer in 2016 was the same as it is today: We believe the corporate operating performance that's being "captured" by our funds and strategies 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



Source: FactSet. For the five years ended September 30, 2022. Captured revenue growth represents the quarterly, cumulative revenue growth achieved by all the companies owned in the Wasatch Small Cap Core Growth strategy (representative account) for the five years.

returns should eventually close—with performance accruing in our favor.

The line graph above shows the cumulative "capture" of quarterly revenue growth for the companies in the Wasatch Small Cap Core Growth strategy (representative account) over the five years through September 30, 2022. In addition, the graph shows how the cumulative stock returns have periodically deviated from the trend in "captured" revenue growth—but also how they've generally come back into rough alignment. Most recently, the cumulative stock returns have dropped significantly below the revenue trend—potentially signaling better returns ahead.

You can read more about *The State of Small-Cap Growth Stocks in the U.S.* by going to our Q&A, which is located in the News & Insights section of our website at ***wasatchglobal.com***.

INTERNATIONAL EQUITIES: INVESTING IN AN ERA OF LOCALIZATION

International team discussion at the Wasatch 2022 Institutional Client Conference.

On the international front, the shift from globalization to localization is a critical change that we think will define markets over the next decade. Brexit, Chinese nationalism, "America First" policies and Covid-19 have all played roles in making trade less open.

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

THREE COUNTRIES WHERE THE WASATCH INTERNATIONAL TEAM IS FINDING THE MOST OPPORTUNITIES

While the Wasatch 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 investment prospects 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 United Kingdom, 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 revenue and earnings growth they've continually produced.
- We also see greater opportunities in Japan, which 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.

You can read more about our take on Canada, the U.K. and Japan in our white paper, *Growth World-Wide: Three International Markets Where Wasatch Is Finding Opportunities*, which is located in the News & Insights section of our website at ***wasatchglobal.com***.

SIX WASATCH FUNDS / STRATEGIES HAVE REOPENED, AND WASATCH'S COMPLETE LINEUP OF OFFERINGS ARE FULLY AVAILABLE

On September 7, 2022, we announced the reopening of six Wasatch funds/strategies:

- Core Growth Fund / Small Cap Core Growth strategy
- International Opportunities Fund / International Micro Cap strategy
- Micro Cap Fund / Micro Cap Growth—U.S. strategy
- Small Cap Growth Fund / Small Cap Growth strategy

- Small Cap Value Fund / Small Cap Value strategy
- Ultra Growth Fund / Small Cap Ultra Growth strategy

All fund share classes and the related institutional strategies are now open to new investors. With this announcement, Wasatch's complete lineup of offerings are fully available.

Consistent with our longstanding commitment to shareholders and clients, certain funds and strategies had periodically closed to new investors so we could maintain our disciplined and focused investment approach. Wasatch remains financially strong and hasn't seen significant outflows. The full reopening simply reflects our view that the current market environment may present attractive prospects for long-term investors. We remain committed to thoughtfully managing capacity and will continue to close funds and strategies when we think it's in the best interest of existing shareholders and clients to do so.

With sincere thanks for your continuing investment and for your trust,
Eric Bergeson

RISKS AND DISCLOSURES

Mutual-fund investing involves risks, and the loss of principal is possible. Investing in small-cap funds will be more volatile, and the loss of principal could be greater, than investing in large-cap or more diversified funds. Investments in value stocks can perform differently from the market as a whole and from other types of stocks and can continue to be undervalued by the market for long periods of time. Investing in foreign securities, especially in frontier and emerging markets, entails special risks, such as unstable currencies, highly volatile securities markets, and political and social instability, 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.

Information in this document regarding market or economic trends, or the factors influencing historical or future performance, reflect the opinions of management as of the date of this document. These statements should not be relied upon for any other purpose. **Past performance is no guarantee of future results, and there is no guarantee that the market forecasts discussed will be realized.**

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The primary investment objective of the Wasatch Core Growth, Wasatch Micro Cap, Wasatch Small Cap Growth, Wasatch Small Cap Value and Wasatch Ultra Growth funds is long-term growth of capital. Income is a secondary objective, but only when consistent with long-term growth of capital. The investment objective of the Wasatch International Opportunities Fund is long-term growth of capital.

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DEFINITIONS

Brexit *is an abbreviation for "British exit," which refers to the June 23, 2016 referendum whereby British citizens voted to exit the European Union. The referendum roiled global markets, including currencies, causing the British pound to fall to its lowest level in decades.*

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.*

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

Valuation *is the process of determining the current worth of an asset or company.*

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 in these or any indexes.*

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