Wasatch Micro Cap Growth—U.S. Strategy

SEPTEMBER 30, 2023

Our Investment Approach Doesn't Rely on Macro Forecasts, As We Apply Disciplined Risk Management and Select Investments One Stock at a Time

PORTFOLIO MANAGERS

Ken Korngiebel, CFA
Lead Portfolio Manager
6 YEARS ON STRATEGY / 8 YEARS AT WASATCH

Natalie Pesqué, CFA
Portfolio Manager
1 YEAR ON STRATEGY / 8 YEARS AT WASATCH

OVERVIEW

Micro-cap equities struggled during the third quarter of 2023 as hawkish comments from the Federal Reserve (Fed) dashed hopes for an early pivot toward lower interest rates. Labor strikes and the potential impact of a government shutdown added to jitters in financial markets. The Wasatch Micro Cap Growth—U.S. strategy declined during the quarter but outperformed the benchmark Russell Microcap® Growth Index, which fell -11.95%. Over the past 12 months, the strategy logged a gain, well ahead of the benchmark's -3.10% decline.

Selloffs in the stock and bond markets deepened in September after the Fed signaled a more aggressive future path for interest rates than investors had been expecting. Fed officials also upped their near-term growth forecasts, further contributing to a bias in equity markets toward cyclical sectors such as energy and materials. The benchmark's energy component was the only sector with a positive return in the quarter—it posted a double-digit percentage gain as U.S. crude oil briefly traded above $95 a barrel.

These factors didn't fit especially well with the strategy's sector profile, which naturally arises from our bottom-up focus on growing companies with attractive quality attributes. Along with the benchmark's top-performing energy sector, materials also performed relatively well in the third quarter. The strategy, however, has no holdings in materials and is underweight in energy because we

think companies in those sectors tend to have less differentiated business models and perform well only when the business cycle is in their favor. In the benchmark, financial stocks did well on a relative basis, but our holdings in the sector underperformed modestly. Consumer discretionary was an additional source of weakness in the strategy.

Despite these headwinds, the strategy held up much better than its benchmark. Industrials and information technology (IT) were the strategy's main sources of outperformance, which we attribute to advantageous stock selection and our preference for high-quality companies. As measured by ROE (return on equity), the four highest-quality deciles of the Index outperformed the Index as a whole, while the four lowest-quality deciles underperformed. Although IT suffered the worst decline among all sectors of the Index, the strategy's IT stocks generated impressive relative performance across all industry groups.

DETAILS OF THE QUARTER

The strongest contributor to strategy performance for the quarter was DMC Global, Inc. (BOOM). Trends in revenues and margins have been favorable across all three of DMC's business segments. The company's perforating systems for the oil and gas industry, which are used in fracking, enjoy key advantages over alternative methods. DMC has also experienced strong demand for its explosion-welded metal plates used in industrial applications. And the company's investment in additional capacity for Arcadia, its majority-owned architectural building products business, has fueled optimism that DMC will purchase the remaining minority stake.

Grid Dynamics Holdings, Inc. (GDYN) was also a top contributor. The company provides enterprise-level digital-transformation consulting and implementation services to *Fortune 1000* businesses and other clients. Grid's substantial operations in Ukraine at the outbreak of hostilities there—as well as a temporary slowdown in the global trend toward digitalization—had weighed on the company's stock price since early 2022. Recently, however, an upturn in investor sentiment toward digitalization has boosted shares of Grid and other IT service providers. From a fundamental standpoint, management's ability to navigate inevitable challenges and thrive in the digitalization space has impressed us, and the company's long-term growth prospects remain attractive in our view.

The greatest detractor from strategy performance for the quarter was Silk Road Medical, Inc. (SILK). The company provides medical devices used in its minimally invasive procedure (called Transcarotid Artery Revascularization, or TCAR) to treat blockages in the carotid artery. Silk Road's stock price fell sharply after the Centers for Medicare & Medicaid Services (CMS) issued a proposed coverage decision placing traditional carotid stenting at the same reimbursement level as TCAR, a move some investors feared could hurt Silk Road's revenues. Although CMS has leveled the playing field on reimbursements, we think that over time the competitive landscape may be shaped more by outcomes than by reimbursements.

Another weak stock in the strategy was Kornit Digital Ltd. (KRNT). The company sells machines and supplies for the digital printing of designs and images on clothing and fabrics. Kornit's share price ran up sharply earlier in the year amid optimism that a pickup in sales of the company's machines was just around the corner. The stock retreated to previous levels during the third quarter as those hopes failed to materialize. We expect growth to resume in 2024 and continue to own the company in the strategy. Kornit's printing technology uses less water than traditional methods and greatly reduces the need for inventory on hand and in supply chains, making consumption and production more sustainable.

GCM Grosvenor, Inc. (GCMG) was a new addition to the strategy. An investment-management firm serving customers world-wide, Grosvenor focuses on private markets, infrastructure investments, real estate, credit finance and absolute return. Wasatch's experience as long-term investors in similar companies enabled us to leverage

insights that gave us confidence in adding Grosvenor to the strategy. We especially like the company's private-markets business, which features high growth rates, strong margins and—most importantly—much stickier client capital. In addition, Grosvenor's stock provides an attractive dividend yield supported by the company's substantial cash flows.

We sold Heritage-Crystal Clean, Inc. (HCCI) after the environmental-services company disclosed that it had agreed to be acquired by a private-equity firm in an all-cash deal expected to close in the fourth quarter of 2023. Because the acquisition was priced at a significant premium to Heritage-Crystal Clean's market valuation before the announcement, the stock was a top contributor to third-quarter strategy performance. We had owned the stock with an eye toward growing opportunities tied to the remediation of water contaminated with per- and polyfluoroalkyl substances (PFAS)—so-called "forever chemicals" found in products ranging from firefighting foam to fast-food wrappers, clothing and carpeting.

OUTLOOK

With the recent period having lived up to its reputation as a historically poor season for equities, we now approach what's tended to be a better environment. According to data from Ned Davis Research, most of the stock market's gains in the years since 1950 have occurred during the period from November through April. So, based on the calendar and historical averages, there are reasons to be optimistic.

There are also reasons to be cautious. After a strong summer, recent figures from Bank of America showed that spending on credit cards has slowed since Labor Day, especially in discretionary categories such as furniture. Meanwhile, credit-card losses and delinquencies are climbing at their fastest pace since the recession of 2008. Auto-loan delinquencies and Chapter 11 bankruptcy filings are also on the rise. The end of the student-loan moratorium on October 1 will add a new wrinkle for many households already grappling with rising costs for basic items such as groceries and gasoline.

Because consumption accounts for about 70% of U.S. GDP, it makes sense to consider how the mood of consumers may affect the broader economy heading into the holiday shopping season. Recent data on that front has been mixed. Although consumer confidence declined in September, and high interest rates are constraining discretionary purchases, surveys have shown that consumers plan to begin their holiday shopping earlier this year and spend more. Other positive signs include a strong job market and high labor-participation rates.

Whether the final months of 2023 will bring holiday cheer or a lump of coal for the U.S. economy is hard to predict. However, our investment approach doesn't rely on macro forecasts. While we pay close attention to the risk environment—which we strive to navigate through disciplined risk management—we select investments from the bottom up, one stock at a time. In this environment, we're vigilant about the quality of our companies, and we've allocated a larger portion of the strategy to holdings with stable growth. We believe our focus on seeking high-quality micro-caps with strong underlying fundamentals will benefit the strategy through this period of macro uncertainty.

Thank you for the opportunity to manage your assets.

Sincerely,

Ken Korngiebel and Natalie Pesqué

CFA® is a trademark owned by the CFA Institute.

The Russell Microcap Growth Index is an unmanaged total return index measuring the performance of the micro-cap growth segment of the U.S. equity market. The Russell Microcap Index is an unmanaged total return index of the smallest 1,000 securities in the small-cap Russell 2000 Index along with the next smallest 1,000 companies, based on a ranking of all U.S. equities by market capitalization.

Indexes are unmanaged. Investors cannot invest directly in an index.

The Wasatch Micro Cap Growth—U.S. strategy has been developed solely by Wasatch Global Investors. The Wasatch Micro Cap Growth—U.S. strategy is not in any way connected to or sponsored, endorsed, sold or promoted by the London Stock Exchange Group PLC and its group undertakings (collectively, the "LSE Group"). FTSE Russell is a trading name of certain of the LSE Group companies.

All rights in the Russell indexes vest in the relevant LSE Group company, which owns these indexes. Russell® is a trademark of the relevant LSE Group company and is used by any other LSE Group company under license.

These indexes are calculated by or on behalf of FTSE International Limited or its affiliate, agent or partner. The LSE Group does not accept any liability whatsoever to any person arising out of (a) the use of, reliance on or any error in these indexes or (b) investment in or operation of the Wasatch Micro Cap Growth—U.S. strategy or the suitability of the Index for the purpose to which it is being put by Wasatch Global Investors.

Wasatch Advisors LP, trading as Wasatch Global Investors, ARBN 605 031 909 is regulated by the U.S. Securities and Exchange Commission under U.S. laws which differ from Australian laws. Wasatch Global Investors is exempt from the requirement to hold an Australian financial services licence in accordance with class order 03/1100 in respect of the provision of financial services to wholesale clients in Australia.

This commentary is intended to provide you with information about factors affecting the performance of the Wasatch Micro Cap Growth—U.S. strategy during the period. Information regarding market or economic trends or the factors influencing historical or future performance reflects the opinions of management as of the date of this document. These statements should not be relied upon for any other purpose. References to individual companies should not be construed as recommendations to buy or sell shares in those companies. Wasatch analysts closely monitor the companies held in the Micro Cap Growth—U.S. strategy. If a company's underlying fundamentals or valuation measures change, Wasatch will reevaluate its position and may sell part or all of its holdings. Where performance results of a subset of investments in the portfolio are presented, Wasatch will provide promptly, upon request, the results of the total portfolio from which the performance was derived. Past performance does not guarantee future results, and any market forecasts discussed may not be realized.