WASATCH GLOBAL INVESTORS

Quarterly Commentary

Wasatch Micro Cap Value Strategy

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In a Volatile and Ultimately Negative First Quarter, the Strategy Generated a Meaningful Gain and Outperformed the Benchmark

PORTFOLIO MANAGERS

Brian Bythrow, CFA
Lead Portfolio Manager

19 YEARS ON STRATEGY / 20 YEARS AT WASATCH

Thomas Bradley
Associate Portfolio Manager

1 YEAR ON STRATEGY / 8 YEARS AT WASATCH

OVERVIEW

During the first quarter of 2023, the benchmark Russell Microcap® Index fell -2.83%. The Wasatch Micro Cap Value strategy produced a gain and handily outperformed its benchmark.

After strong returns in January, micro-caps sold off in February due to jitters regarding overheated economic activity, stubbornly elevated inflation and persistently rising interest rates. In March, market volatility was exacerbated by failures of three regional banks in the U.S. and troubles at Credit Suisse Group AG, which was forced into a sale by the Swiss government. But by the end of the first quarter, micro-caps had made up some of their lost ground.

Among sectors, our stock selections in financials, health care and consumer discretionary—and our overweighted allocations to industrials and information technology—contributed to strategy performance relative to the benchmark. Conversely, our selections in energy and communication services were disadvantageous.

From a country perspective, the bulk of the strategy's outperformance was delivered by our U.S. holdings. Our investments in the United Kingdom, France and Germany were also positive. However, our positions in Canada and Australia were modest drags on relative performance. We continue to like our positions in non-U.S. companies for their attractive valuations, diversification benefits, and status as likely beneficiaries of potentially lower energy prices and a weaker dollar.

DETAILS OF THE QUARTER

Skyline Champion Corp. (SKY) was the top contributor to strategy performance during the first quarter. The company is one of the largest homebuilders in North America, specializing in modular homes for the single-family, multi-family and hospitality segments as well as accessory dwelling units and park-model recreational vehicles. Skyline delivered earnings and revenues that topped consensus estimates. We think the company looks attractive on a valuation basis. And when the current cycle of hiking interest rates ends, that could mark the beginning of a favorable period for the housing sector. As a result, we're maintaining our position at a large weight.

Another meaningful contributor was Impinj, Inc. (PI). The company, a pioneer in helping develop the "Internet of Things," provides an infrastructure by which everyday things—such as car parts and even shipping containers—communicate over the internet. Impinj offers a wireless inventory management and tracking platform for customers in retail, manufacturing, health care and other areas. Tiny radio-frequency identification (RFID) chips are used to connect, count and track individual items. Impinj is heavily reliant on computer chips—which were in short supply during the post-pandemic rebound—and today's slowing economy helps reduce the former supply-and-demand imbalance, benefiting the company's profitability. The stock rose after Impinj announced a positive earnings surprise. While we maintain a significant position, we sold some of our shares to reduce our risk in the name.

Bowman Consulting Group Ltd. (BWMN) was also a contributor. The company provides a broad range of real-estate, energy, infrastructure and environmental-management services. We expect that the less cyclical nature of government spending will benefit businesses like Bowman, which are involved in public infrastructure projects. In fact, the company was recently selected as the prime design consultant for the Pennsylvania Turnpike Commission's Allegheny Tunnel Transportation Improvement Project. Because we view Bowman's stock as underpriced in the context of the company's strong fundamentals and peer valuations, we're optimistic about the prospect for continued positive performance.

The stock of Napco Security Technologies, Inc. (NSSC) gained on news of strong performance across business lines and expanding profit margins due to progress in moving the company's operating model from one based on infrequent hardware purchases (with occasional maintenance and upgrades) to another based on recurring purchases that ensure ongoing functionality. The company makes electronic security devices, fire-detection products, access-control systems and digital lock equipment for residential, commercial and industrial installations. While competitors were hurt by supply-chain difficulties stemming from overreliance on Chinese manufacturing, Napco was able to stay nimble by having less exposure to China and by maintaining a supply of goods from a production base in the Dominican Republic.

Aris Water Solutions, Inc. (ARIS) was the greatest detractor from strategy performance during the first quarter. Aris is an oilfield-services company that manages the water supplies used in energy exploration and production (E&P). The company's recent pipeline investments allow E&P businesses to increase the amount of water that can be recycled, which significantly lowers costs for its customers. In Texas, for example, water use is one of the greatest expenses incurred for drilling activities. We think investors were disappointed by poor operating results stemming from bad weather that prevented crews from making expected pipeline connections. For our part, we don't think these short-term challenges will materially impact Aris's long-term results.

Another significant detractor was AgileThought, Inc. (AGIL), which provides end-to-end digital transformation services to *Fortune 1000* customers in a diverse group of industries. The company's services include consulting, data management and automation, custom software development and cloud computing. We think the stock was down due to investors' nervousness about the company's plan to raise capital and management's forecast for growth that was a bit lower than investors—including ourselves—had expected.

Knights Group Holdings PLC was also a detractor. This U.K.-based company provides legal and professional services, including tax advice and debt collection. Knights Group delivered very strong stock performance at the end of 2022 on the back of a solid earnings report and a large purchase of shares by the CEO. Since then, the stock has come down from what in hindsight was an excessive valuation. Currently, however, we think the valuation is quite attractive—and we recently purchased additional shares.

BUYS AND SELLS

Regarding our buys, we initiated a position in Hilton Food Group PLC, a U.K.-based food-packaging company with operations in Europe and Australia. Hilton supplies international food retailers with steaks, chops, marinated meats, barbecue ranges, sauces and ready-to-eat meals. Although inflation and cost-of-living concerns have pressured profits, Hilton has maintained a strong financial position. The company has gained efficiencies by initiating cost-saving measures and investing in automation. Moreover, Hilton has expanded into new markets and products through various joint ventures, partnerships and acquisitions. In 2022, the company announced a long-term collaboration with Country Foods Pte Ltd., a wholly owned subsidiary of SATS—which is one of Singapore's largest food importers, distributors and manufacturers. This partnership gives Hilton the opportunity to expand into Singapore and other Asian markets.

We also bought shares of Harmonic, Inc. (HLIT). The company's broadband division offers software-based solutions and central-cloud services primarily to broadband operators. Harmonic's video division sells processing solutions and services to broadband operators, satellite and telecommunications service providers, and broadcast and media businesses. Harmonic's solutions enable cable providers and multi-service operators (MSOs) to upgrade networks in an extremely capital-efficient manner. The cable market is very competitive, but we believe Harmonic has carved out a unique niche that enables outsized economics as the market leader. The company has favorable partnerships with Comcast and Charter Communications, the two largest MSOs in the industry, and we think other MSOs will join Harmonic over the next three to five years.

As for our sells, we exited our position in Evolution Petroleum Corp. (EPM). The company engages in the exploration and production of oil and gas. Evolution also acquires established oil and gas fields—and applies specialized technology to increase production rates. The stock pulled back from what we believe was an outsized gain in 2022, when supply disruptions drove energy prices higher. We sold Evolution because we think commodity-oriented companies could face a challenging environment if an economic slowdown weighs on demand.

We also sold Castle Biosciences, Inc. (CSTL), which provides diagnostic and prognostic testing services for dermatological cancers. There was no single catalyst for our sale. But the stock is somewhat expensive, the company is losing money, and we're seeing better opportunities in attractively priced growth companies with good balance sheets and strong cash flows.

Another transaction we completed during the first quarter was our sale of va-Q-tec AG. The stock more than doubled after the company received a tender offer from a private-equity firm. Based in Germany, va-Q-tec is a pioneer in the design and manufacture of energy-efficient, space-saving insulation products. The company's hightech products include environmentally friendly vacuum-insulation panels and hot and cold storage elements that contain phase-change materials. va-Q-tec markets its products internationally to the refrigeration, packaging, cold-chain logistics, aircraft, automotive, construction and pharmaceutical industries.

OUTLOOK

The economy and stock market continue to face a number of headwinds. As 2023 has unfolded, investors are experiencing significant uncertainty regarding the robustness of economic activity and the direction of inflation and interest rates. Moreover, given the recent banking crisis, there's concern that credit conditions could become tighter. And investors have been left guessing as to when the federal-funds rate, which is controlled by the Federal Reserve (Fed), will peak. Meanwhile, the labor market remains relatively tight—even with a likely recession on the horizon.

Still, at Wasatch we see several reasons for optimism. First, the federal government has practically assured the market that all bank deposits will be backstopped. Second, after a tumultuous 2022, there's a great deal of bad news *already* factored into equity prices, particularly in the small- and micro-cap areas. Third, during the most recent earning season, we've seen a new dynamic emerge: Stock prices, even those of companies that lowered guidance, have been relatively resilient. This has been in sharp contrast to what occurred last year when stock prices dropped precipitously. And fourth, it follows that the stocks of companies able to beat expectations—and maybe even raise guidance—could have significant room for appreciation.

Our expectation is that the U.S. will enter recession before the end of the year. And we believe the strategy is well-positioned for that outcome. But irrespective of how the broad economy performs, we're optimistic regarding our companies. In meetings with management teams, we've heard that supply-chain pressures—and thus input costs—are easing, which should improve margins or at least provide a buffer to an economic downturn. Similarly, our companies have been reporting that competition for workers isn't as stiff as it was during the past few years. This means wage inflation may begin to moderate.

As always, our focus is on building a diversified portfolio of attractively priced companies that exhibit good visibility into operating performance, strong earnings momentum and the ability to thrive and increase market share across economic cycles. This approach has served shareholders well over time, and we believe it will continue to do so.

Given that recession is largely baked in the cake, we think the main question is: How bad will it get? The answer will affect stock prices in the short term but won't change how we manage the strategy. Based on economic data, the Fed will eventually lower the federal-funds rate. Once that occurs, we think the stage will be set for a durable market advance and a weaker dollar—the latter of which may benefit our international holdings in particular.

Thank you for the opportunity to manage your assets.

Sincerely,

Brian Bythrow and Thomas Bradley

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