WASATCH GLOBAL INVESTORS

Quarterly Commentary

Wasatch Small Cap Growth Strategy

SEPTEMBER 30, 2023

Although Companies Have Reported Strong Revenues And Earnings, Stocks Were Down During the Quarter Based on the Uncertain Economic Outlook

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OVERVIEW

During the third quarter of 2023, the economy stayed strong and the unemployment rate remained low. Additionally, wages, energy prices and overall inflation continued to be elevated. In response, the Federal Reserve (Fed) announced that although it didn't hike interest rates in September, it would keep rates higher for longer going forward. Stocks broadly declined on concerns over the effects of higher interest rates and a potential recession. The Wasatch Small Cap Growth strategy ended the quarter with a loss but outperformed the benchmark Russell 2000® Growth Index, which fell -7.32%. The broader Russell 2000 Index lost -5.13%.

From a quality perspective, we noticed that the stocks of higher-ROE (return on equity) companies generally performed better than those of lower-ROE companies. For example, each of the top three ROE deciles in the Russell 2000 Growth Index outperformed the benchmark's overall return. And each of the bottom three ROE deciles underperformed the benchmark's overall return. At Wasatch, we tend to invest in higher-quality names during all market environments.

Among sectors, our stock selections in information technology (IT), health care and consumer staples—and our overweight in financials—contributed to strategy performance relative to the benchmark during the third quarter. Conversely, our selections in communication services—and our zero weight in the strong-performing energy sector—were disadvantageous.

In 2022, stocks were down mostly based on dramatically rising inflation and interest rates. The stocks of growth-oriented and small-cap companies were hit especially hard. These companies tend to have their cash flows more heavily weighted further into the future. Higher interest rates have greater negative impacts on the present values of these cash flows. Therefore, the strategy's approach to growth investing wasn't in favor for most of the year.

In the first half of 2023, investors were expecting a recession. When that didn't occur and consumer spending was surprisingly strong, some of the worst-performing stocks of 2022 rebounded the most during Q1 and Q2—and our approach produced very attractive results. What was especially gratifying was that when the environment turned negative again in Q3, our approach also delivered outperformance.

Currently, we think most of our growth-oriented companies and their stocks have already adjusted to an environment of higher-for-longer interest rates. So we're optimistic that, going forward, the strategy has the potential to hold up well in down markets—which is a characteristic we often view as even more important than outperforming in up markets. And whether the economy goes into a recession or experiences a "soft landing," we believe the strategy is well-positioned for either scenario.

DETAILS OF THE QUARTER

The third quarter's top contributor to strategy performance was Ollie's Bargain Outlet Holdings, Inc. (OLLI). The company's stores offer a constantly changing selection of close-out items and other brand-name merchandise at deeply discounted prices. A steady flow of inventory acquired from distressed retailers has attracted customers to Ollie's and boosted sales. In the company's most recent quarter, net sales rose a better-than-expected 13.7% year over year, driven by an increase of 7.9% in comparable-store sales and the addition of six new locations. With margins and earnings also exceeding estimates, management upped its guidance for fiscal year 2023. Because the discounts at Ollie's help consumers stretch their dollars, we think the company is better situated than most other retailers in the current inflationary environment.

YETI Holdings, Inc. (YETI) was also a significant contributor. The company designs, markets and distributes coolers, beverage holders, and other types of outdoor and recreational gear. Last year, the stock was down because YETI issued a recall on a popular line of coolers due to defects in magnet-lined closures. That recall negatively impacted sales and earnings, especially during the important holiday shopping season. This year, YETI has benefited because the defects have been fixed and consumer spending has been strong. Going into 2023's holiday shopping season, we think the stock will be supported by the company beating year-ago revenues and earnings. We recently met with the management team in Austin, Texas. We came away from the meeting with confidence in our investment thesis: YETI offers premium products at premium prices, generates high margins, self-funds its expansion without debt, and operates in a market that allows for double-digit annual revenue and earnings growth for years on end.

Another strong position in the strategy was HealthEquity, Inc. (HQY). The company is the largest U.S. non-bank custodian for health savings accounts (HSAs). HealthEquity also facilitates employer-sponsored lifestyle and commuter benefits, which include fitness classes, nutrition counseling, parking programs and transit passes. As of July 31, 2023, the company's total HSA assets were up 13% from a year ago to $23.2 billion—$14.0 billion of which

was held in cash with a duration of approximately three to four years. Reinvesting those funds at higher interest rates as they mature should accelerate HealthEquity's top- and bottom-line growth over the next few years. The company's commuter-benefit programs are also positioned to grow as at-home workers return to offices.

The third quarter's greatest detractor from strategy performance was Inspire Medical Systems, Inc. (INSP). The company develops minimally invasive solutions for patients with obstructive sleep apnea. Inspire and other medical-technology firms saw their stock prices decline on concerns that the growing use of GLP-1 weight-loss drugs would reduce the need for treatments of obesity-related illnesses such as diabetes and sleep apnea. However, Inspire's nerve-stimulating device can't be prescribed to people with high body mass. Falling rates of moderate to severe obesity may even expand the company's addressable market among patients who currently are too heavy to benefit from Inspire's treatment solution. Additionally, we believe simplifications in both the airway exam and the surgical procedure used with Inspire's device will increase patient throughput, decrease backlogs and potentially accelerate revenue growth in 2024.

Silk Road Medical, Inc. (SILK) was also a significant detractor. The company provides medical devices used in its minimally invasive procedure (called Transcarotid Artery Revascularization, or TCAR) for the treatment of blockages in the carotid artery. Silk Road's stock price fell sharply in July after the Centers for Medicare & Medicaid Services (CMS) issued a proposed coverage decision placing traditional carotid stenting at the same reimbursement level as TCAR. The concern is that CMS support for the competitive method could hurt Silk Road's revenues.

We think investors have overreacted. Although CMS has leveled the playing field on reimbursement, we believe outcomes—not reimbursements—will be a more important competitive factor. Silk Road's innovative system to reverse blood flow during TCAR directs any stroke-causing material away from the brain and into a filter, resulting in better outcomes than traditional stenting. Over time, we expect TCAR to continue to take market share and become the new standard of care for treating carotid artery disease.

Another weak stock in the strategy was Five Below, Inc. (FIVE). This discount retailer has set itself apart with its branding and unique approach of, as its name suggests, pricing most items at five dollars or less. Second-quarter revenues and earnings met expectations, and management projected that third- and fourth-quarter revenues would be in line with forecasts and better than industry peer comparisons. But the stock was down because upcoming quarterly margins and earnings are projected to decline due to theft and expenses associated with theft prevention. While this news was disappointing, we think management has responded appropriately. We still expect the company's new-store growth rate to accelerate from the low teens to the high teens over the next 12 months. Five Below plans to add approximately 250 new locations, which we think will position the company to take advantage of both the 2023 and 2024 holiday shopping seasons.

BUYS AND SELLS

Among our buys during the third quarter, we added Shake Shack, Inc. (SHAK), a company we've owned in the past. Shake Shack is a U.S. and international operator of fast-casual restaurants focused on a range of American classics like burgers, crinkle-cut fries, shakes, beer and wine. We're impressed with its business model and well-established brand, which continue to inspire a loyal following. The company and the stock stumbled during the Covid-19 pandemic and were slow to recover. However, we think management has finally righted the ship. And Shake Shack now seems poised to resume its growth trajectory.

Among our sells, we exited Euronet Worldwide, Inc. (EEFT)—which was a poor performer during the third quarter. The company provides cash-dispensing automated-teller machines (ATMs), point-of-sale transaction processing and related financial services. Euronet has historically benefited from the need for physical cash when Westerners travel abroad—as its ATM network in vacation hotspots has long been an outsized contributor to the company's earnings. However, we recently noticed that while travel had returned to pre-pandemic levels, Euronet's ATM traffic hadn't. During the pandemic, travelers and retailers increasingly moved toward electronic payments as a way to avoid handling physical cash. We had forecasted for some time electronic payments would grow in popularity, but the speed at which that occurred was unexpected. Although we believe Euronet will have a profitable business of dispensing physical cash for years to come, the company will need to make significant capital expenditures in the more competitive business of electronic payments.

OUTLOOK AND POSITIONING

We think one of the main focal points of investors during the past two years has been *fear*. In 2022, the fear was over inflation and interest rates. When those conditions turned out to be worse than feared, stocks sold off. In the first half of 2023, the fear was over a potential recession. Because that didn't happen, stocks—particularly growth-oriented small-caps—held up relatively well.

In Q3, the fear of inflation and interest rates returned—and recession worries lingered. With the Fed announcing higher-for-longer rates, stocks sold off again even though GDP growth ticked up and consumer spending remained robust. In other words, what was good for the economy was bad for stocks due to interest-rate concerns. And the stocks of unprofitable companies were hit particularly hard.

As mentioned above, we think most of our growth companies and their stocks have already adjusted to an environment of higher-for-longer interest rates. So what's the next fear? We believe a recession is still the main issue but more specific concerns have grown regarding government infighting, global tensions and consumers' well-being. A potential warning sign has been the increasing rate of theft at warehouses and retailers.

The managers at most of the consumer-centric companies we own have told us that underlying business conditions have been reasonably strong. But the managers have also said that they have some concerns about what lies ahead.

For our part, we don't invest based on fears or predictions surrounding those fears. We buy high-quality companies with headroom for growth, significant returns on capital, healthy cash flows and low debt levels. We think these companies can weather a variety of economic scenarios. Moreover, we stay diversified with respect to sectors and factors like economic cyclicality and interest-rate sensitivity.

Although many investors are concerned that a deep recession is on the horizon, we think they should also be psychologically prepared for a different outcome: It's possible that previous interest-rate hikes have yet to be felt throughout the economy. As a result, the Fed could respond to slower economic growth and act counter to its previous rhetoric by skipping further rate hikes, and perhaps by cutting rates in the not-too-distant future. If this is the outcome, we could see a resilient stock market based on steady consumer demand and reasonable valuations among small-caps—especially relative to large-caps.

In conclusion, we'd like to say that our travel schedule for visiting companies has continued to ramp up. Our most recent trips included visits to eight companies in Texas, New York, New Jersey and Pennsylvania. Overall, the tone of

our meetings was cautiously optimistic. And it was nice to see that increasing numbers of employees were back in the office, hard at work.

Thank you for the opportunity to manage your assets.

Sincerely,

JB Taylor, Ken Korngiebel and Ryan Snow

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