WASATCH GLOBAL INVESTORS

Quarterly Commentary

Investor WAAEX / Institutional WIAEX

# Wasatch Small Cap Growth Fund

JUNE 30, 2023

## We Like Small-Cap Growth Companies That Aren't AI Developers but May Be AI Beneficiaries

FUND MANAGERS

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10 YEARS ON FUND / 27 YEARS AT WASATCH

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### OVERVIEW

The Wasatch Small Cap Growth Fund—Investor Class increased 6.08% during the second quarter of 2023. The Fund lagged its benchmark, the Russell 2000® Growth Index, which rose 7.05%. The broader Russell 2000 Index added 5.21%. The last few trading days of the quarter were particularly strong, with investors continuing to be optimistic about the power of artificial intelligence (AI), the reasonable prices of U.S. small-cap growth stocks after last year's rout, the prospect for the Federal Reserve (Fed) to stop hiking interest rates and the possibility of an economic "soft landing."

Among sectors, our holdings in financials, consumer discretionary and communication services—and our zero weight in materials—contributed to Fund performance relative to the benchmark during the second quarter. Conversely, health care (primarily biotechnology), industrials and information technology were disadvantageous.

After a dismal showing in 2022 and early 2023, biotechnology stocks rebounded as investors upped their risk appetite by moving into biotech

*Data show past performance, which is not indicative of future performance. Current performance may be lower or higher than the data quoted. For the most recent month-end performance data, visit wasatchglobal.com. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. The Advisor may absorb certain expenses, without which total returns would have been lower. Wasatch Funds will deduct a 2% redemption fee on Fund shares held 60 days or less. Performance data do not reflect this redemption fee or taxes.* ***Total Expense Ratio: Investor Class—1.15% / Institutional Class—Gross 1.06%, Net 1.05%. The Advisor has contractually agreed to limit certain expenses to 1.50% for the Investor Class and 1.05% for the Institutional Class through at least 1/31/2024.***

names trading at depressed valuations. We hold a basket of attractive biotech companies, but we're significantly below the benchmark's weight of over 9%. Our underexposure hurt the Fund during the quarter, but it's hard for us to commit a major portion of the portfolio to an industry where most companies lose money and few will ever post a profit. Despite this headwind, we're pleased with the Fund's performance for the quarter.

During 2022, stocks were plagued by concerns over supply-chain bottlenecks, unexpectedly high inflation, rising interest rates and the priciness of growth stocks as elevated rates made the future income streams of growth-oriented businesses less attractive in the present. However, during the first half of 2023, these concerns subsided even as three U.S. banks failed and the Swiss government brokered the sale of teetering Credit Suisse Group AG.

Taking the place of what was perhaps *irrational fear* in 2022 has been a level of *irrational enthusiasm* in 2023. Considering the reasons for optimism mentioned above, we think AI has been the dominant source of investor enthusiasm. As a matter of fact, AI has been a theme in almost every major communication from corporate management teams—even to the point where potentially more immediate and more important considerations have been receiving less attention. That's why we say 2023's AI enthusiasm may turn out to be at least somewhat *irrational*.

We don't mean to imply that AI is unimportant. Indeed, it's certainly possible that AI will eventually become as revolutionary as the internet itself. But for every investment home run attributable to AI, many companies could go the way of Pets.com—the failed business that epitomized the dot-com bubble. Our job as analysts and portfolio managers is to distinguish between AI reality and hype.

In the short run, we don't expect to invest in many AI developers because the most reliable innovations currently reside at just several mega-cap tech companies. Instead, we expect to hold small-cap growth companies that aren't AI developers but may be AI beneficiaries. These could include software-as-a-service (SaaS) companies that use AI to help write and debug code.

Beyond AI beneficiaries, we want to own companies whose businesses won't become more generic with the proliferation of AI. For example, a high-value-added industrial company might not be able to use AI for design and manufacturing—but it's also unlikely that AI will reduce or eliminate the need for the company's products.

Given the dismal returns of small-cap growth stocks in 2022 and the longer-term underperformance of small-caps relative to large-caps, we're often asked when we think small-caps will begin a cycle of market leadership. To the surprise of some, we respond that the cycle may have already started. This is because 2023's large-cap index returns have been dominated by the aforementioned mega-cap tech companies. If you look instead at a broad range of companies, small-caps seem to have the upper hand—and we think that will continue based on their attractive stock prices, innovative businesses and headroom for market expansion.

## DETAILS OF THE QUARTER

The second quarter's top contributor to Fund performance was Inspire Medical Systems, Inc. (INSP), a long-term Wasatch holding. The company develops minimally invasive solutions for patients with obstructive sleep apnea. Inspire has experienced strong demand for its products, which serve patients who don't receive adequate relief from traditional CPAP devices. As a result, the company has few competitors, and its gross margins are around 80%. Revenue in Inspire's most recent quarter surged 84% year-over-year, beating expectations. Citing increased utilization at existing sites and the addition of 68 new implanting centers, management upped its full-year revenue forecast. In addition, Inspire received approval from the Food and Drug Administration for an expanded indication that significantly increases the company's addressable market.

Medpace Holdings, Inc. (MEDP) was also a significant contributor as the stock gained largely based on a relief rally in the biotechnology industry. Medpace is a contract research organization (CRO) supplying clinical development services to small biotech businesses. During the first quarter, the stock was down partially due to concerns that Silicon Valley Bank's collapse could make it harder for many of Medpace's customers to fund their research programs. At the time, we believed that short-term risks had increased but that the company's underlying fundamentals supported attractive long-term growth. Additionally, since Medpace generates large amounts of cash, we thought the company could enhance shareholder value by repurchasing stock. Our optimism and patience were rewarded during the second quarter as the company's operating performance exceeded expectations. Looking ahead, we expect revenue to grow by more than 20% in 2023 while Medpace maintains healthy margins.

Another strong position in the Fund was landscaper supplier SiteOne Landscape Supply, Inc. (SITE). At Wasatch, we've owned SiteOne for several years. In 2020 and 2021, the company and its stock benefited from customers ramping up home improvements during the Covid-19 pandemic and from the ensuing real-estate boom. In 2022, the stock suffered greatly amid fears of rising interest rates and a real-estate downturn. This year, however, the stock has gained as investors have realized that SiteOne has had better-than-expected operating performance. In fact, with SiteOne improving its competitive position as a one-stop shop for landscaping needs, some locations aren't just treading water in 2023—they're growing.

The second quarter's greatest detractor from Fund performance was Fox Factory Holding Corp. (FOXF), which produces high-performance shock absorbers and suspension components for mountain bikes, offroad vehicles and trucks. Amid the Covid-19 pandemic, the company performed exceptionally well as people bought bikes for enjoyment during their "staycations." As bike production eventually exceeded demand, however, inventories grew too large. Going forward, with dealers offering discounted prices and gradually paring inventories, we think Fox Factory's sales of bike shocks could decline by about -30%. The stock got hammered as some investors worried the decline could be as large as -40% or -50%. Fears of a recession also weighed on the stock. While we acknowledge these challenges, we think the market has already accounted for them. And we note that Fox Factory is still regarded as the leading maker of high-performance bike shocks, which puts it in a strong competitive position for the long term. Moreover, Fox Factory has maintained healthy dealer relationships, and its products for trucks and other powered vehicles aren't facing the same inventory challenges as the bike products.

Sprout Social, Inc. (SPT) was also a major detractor. The company provides tools for social-media management, communication, contact management, lead generation, reporting and analysis. We're impressed with the quality of the leadership team, and we like Sprout Social's competitive position in a growing business segment. During the second quarter, however, a short-seller report called into question the size of the market opportunity. We strongly disagree with the report and used the stock-price weakness as an opportunity to add to our position.

Another detractor in the Fund was RBC Bearings, Inc. (RBC). The company sells highly engineered precision bearings and components to the industrial, defense and aerospace industries. The stock was down slightly during the quarter but, as one of our largest positions, its small decline had an outsized impact. RBC's large position size reflects the confidence we have in the company. Its management team is executing at a high level and has done an excellent job integrating a recent acquisition. We also think investors underappreciate RBC's large, diversified aerospace business, especially given the strong world-wide growth in commercial aviation fleets. (*Current and future holdings are subject to risk and change.)*

## OUTLOOK AND POSITIONING

Investment-related travel is keeping the Wasatch research team as busy as ever. Recent site visits have included technology companies in California and North Carolina and industrial and consumer-discretionary companies in Georgia and Texas. We think our willingness to conduct in-person meetings gives us a competitive advantage among investors. Put bluntly, financial statements, research reports and conference calls don't usually give us enough information to make excellent investment decisions.

An interesting observation from our visits is that many companies still allow employees to have a hybrid work schedule from home and from the office. As might be expected, technology companies are more skewed toward work-from-home than industrial and consumer-discretionary companies. Although we haven't had many experiences of managers being unwilling to come into the office for us, we're alert to potential changes (positive and negative) in corporate culture and productivity as the rank and file have fewer in-person interactions with one another.

Regarding macroeconomic conditions, we believe it's important to stay aware of the broad environment in which our companies operate even though we don't consider ourselves macro-driven investors. For what it's worth, we still think it's likely that at least a mild recession will begin this year or early next year. And we take the Fed at its word that it will raise interest rates two more times in 2023. This means that many businesses will probably struggle with weaker demand and a higher cost of capital.

In isolation, these conditions might not seem favorable for small-cap growth investing. After all, "conventional wisdom" says to hold large-caps going into a recession and small-caps coming out. Conventional wisdom also advises against owning growth companies amid rising interest rates. The fact is, however, conventional wisdom isn't always so wise. If it were, markets would become perfectly efficient and there would be no advantage in following conventional wisdom anyway.

As discussed above, after a decade of underperformance relative to large-caps, we think small-caps are now positioned for long-term market leadership. Beyond the priciness of large-caps, we've noticed that their revenue and earnings growth rates have become comparatively less inspiring. For example, many large-caps have seen their growth rates decline from around 10% to just 1% or 2%. On the other hand, we own small-caps with growth rates in the mid-teens—which are still very attractive even if the rates have come down from 20% or more.

In terms of our investment style, we're especially comfortable with a growth orientation for several reasons. First, higher interest rates are already factored into the stock prices of many growth companies. Second, after 10 straight interest-rate increases and two more on the way, the Fed is probably near the end of its rate-hiking cycle. Third, our companies tend to have low debt levels and strong balance sheets—so their cash flows are relatively unaffected by interest payments. Fourth, we think our conservative approach with respect to AI will prevent the Small Cap Growth Fund from being whipsawed in the short term as we assess the technology's effects over the longer term.

We want to make a final point about the folly of trying to follow "conventional wisdom" amid a potential recession. Because modern recessions typically last only about six to 18 months and because market participants try

to anticipate better times ahead even before a recession ends, buying and selling around one would require having a time horizon of less than a year. As far as we're concerned, that's trading—not investing. And at Wasatch, above all else, we consider ourselves to be long-term investors.

Thank you for the opportunity to manage your assets.

Sincerely,

JB Taylor, Ken Korngiebel and Ryan Snow

## AVERAGE ANNUAL TOTAL RETURNS

FOR PERIODS ENDED JUNE 30, 2023

| | Quarter* | 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|
| Small Cap Growth Fund—Investor | 6.08% | 11.06% | 2.00% | 7.45% | 9.55% |
| Small Cap Growth Fund—Institutional | 6.09% | 11.16% | 2.10% | 7.57% | 9.66% |
| Russell 2000® Growth Index** | 7.05% | 18.53% | 6.10% | 4.22% | 8.83% |
| Russell 2000® Index† | 5.21% | 12.31% | 10.82% | 4.21% | 8.26% |

**Returns less than one year are not annualized.*

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Total Annual Fund Operating Expenses include operating expenses, including the management fee, before any expense reimbursements by the Advisor. **The Advisor has contractually agreed to limit certain expenses to 1.50% for the Investor Class and 1.05% for the Institutional Class through at least 1/31/2024.** See the prospectus for additional information regarding Fund expenses.

*Wasatch Funds will deduct a 2.00% redemption fee on Fund shares held 60 days or less. Performance data do not reflect the deduction of fees or taxes, which if reflected, would reduce the performance quoted. For more complete information including charges, risks and expenses, read the prospectus carefully.*

Performance for the Institutional Class prior to 2/1/2016 is based on the performance of the Investor Class. Performance of the Fund's Institutional Class prior to 2/1/2016 uses the actual expenses of the Fund's Investor Class without any adjustments. For any such period of time, the performance of the Fund's Institutional Class would have been substantially similar to, yet higher than, the performance of the Fund's Investor Class, because the shares of both classes are invested in the same portfolio of securities, but the classes bear different expenses.

**Investing in small cap funds will be more volatile and loss of principal could be greater than investing in large cap or more diversified funds. Investing in foreign securities, especially in emerging markets, entails special risks, such as currency fluctuations and political uncertainties, 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.***

The Small Cap Growth Fund's primary investment objective is long-term growth of capital. Income is a secondary objective, but only when consistent with long-term growth of capital.

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***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 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 directly in these indexes.*

*The Wasatch Small Cap Growth Fund has been developed solely by Wasatch Global Investors. The Wasatch Small Cap Growth Fund 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.*

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*Earnings growth is a measure of growth in a company's net income over a specific period, often one year.*

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

## SMALL CAP GROWTH FUND — TOP 10 HOLDINGS

AS OF MARCH 31, 2023

| Security Name | | Percent of Net Assets |
|---|---|---|
| Ensign Group, Inc. | | 4.3% |
| Nova Ltd. | | 3.9% |
| Medpace Holdings, Inc. | | 3.5% |
| HealthEquity, Inc. | | 3.4% |
| RBC Bearings, Inc. | | 3.3% |
| BellRing Brands, Inc. | | 3.2% |
| CyberArk Software Ltd. | | 3.2% |
| Fox Factory Holding Corp. | | 3.2% |
| Five Below, Inc. | | 3.1% |
| SiteOne Landscape Supply, Inc. | | 3.1% |
| | Total | 34.0% |

*Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Fund or its Advisor. Current and future holdings are subject to risk.*