WASATCH GLOBAL INVESTORS

Market Scout

APRIL 7, 2023

Although Stocks Were Volatile During The First Quarter, High Quality Has Come Back Into Favor

From late 2021 through most of 2022, energy stocks and other value-oriented names were some of the best performers—but so far in 2023, dynamic growth companies have regained their status as market leaders.

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Wasatch Long/Short Alpha Fund

DEAR INVESTORS:

After a poor showing in 2022, high-quality growth stocks got off to a strong start in January 2023. Then, in February, stocks sold off based on concerns regarding overheated economic activity, stubbornly elevated inflation, and persistent interest-rate hikes by the U.S. Federal Reserve (Fed) and counterparts around the world. In March, a few well-publicized bank failures worsened market sentiment—causing stocks to slip further.

Nevertheless, investor sentiment improved toward the end of March and U.S. small-cap growth stocks, as measured by the Russell 2000® Growth Index, finished the first quarter of 2023 in positive territory. For the most part, small-cap growth stocks also performed well internationally in both developed and emerging markets. Moreover, the Wasatch-specific approach to high-quality growth investing was generally favored.

In a broad sense, Wasatch defines *high-quality growth* companies as those having innovative products, services and business models, increasing market

share, great management teams, significant returns on capital, relatively low debt and the ability to self-fund expansion. Another element of our approach to quality-oriented investing is that we often attempt to identify excellent companies *before* high quality is evident in their financial results. If we do this well, stock-price appreciation can be particularly strong.

PERSPECTIVE ON RECENT BANK FAILURES

While elevated inflation and interest-rate hikes have impacted markets for over a year, the failures of three U.S. banks in March surprised most investors and sparked stock-price volatility around the world. For background, on March 8, Silvergate Bank announced it would wind down operations due to losses suffered in its loan portfolio. Two days later, on March 10, Silicon Valley Bank (SVB) was placed under receivership of the Federal Deposit Insurance Corporation (FDIC). And on March 12, regulators also closed Signature Bank. The downfalls of SVB and Signature were the second- and third-largest bank failures in U.S. history.

For our part, none of the Wasatch strategies or funds owned any of the banks that failed in March. Furthermore, we believe the few banks that we do hold are structurally quite different from the banks that failed.

WHY OUR BANKS ARE DIFFERENT

All three of the banks that failed in March had concentrated customer bases. Silvergate and Signature both focused heavily on the cryptocurrency industry. And the bulk of SVB's customers were early-stage technology companies, many of which relied on venture capitalists who had vouched for SVB. Moreover, two of the failed banks, SVB and Silvergate, had low loan-to-deposit ratios and depended on sizable long-term securities portfolios to support short-term deposits—which created a timing mismatch. These factors played large roles in the banks' failures.

Conversely, the banks held in the Wasatch strategies and funds are quite different, with reasonable loan-to-deposit ratios and relatively small securities portfolios. Additionally, our banks either focus on retail customers or serve a diversified group of commercial clients.

In the coming months, we'll monitor any knock-on effects from the well-publicized bank failures. As of now, we've already contacted the management teams of the banks we hold. So far, the teams have reported that their operations have remained normal or have actually improved.

BANKING'S EFFECTS ON THE TECHNOLOGY SPACE

Outside of banking, we're aware that the high-profile failures will affect the technology space—as many technology companies hold cash and lines of credit at banks like SVB. The government's decision to protect SVB's depositors means businesses still have access to the working capital needed to support operations in the near term. But we expect to see a somewhat more difficult environment for early-stage technology companies as they seek new banking relationships.

Regarding our own technology holdings, on the other hand, we don't think we'll see much friction. We have very few holdings that had any exposure to SVB. More importantly, we tend to invest in companies that have significant control over their destinies because they're self-funded through their ability to generate positive free cash flows. As a result, we believe our companies are largely insulated from the fallout of events like SVB's failure.

SUMMARIZING INVESTMENT CONDITIONS DURING THE PAST THREE YEARS

For much of 2020 and 2021, the ongoing Covid-19 pandemic accelerated the digitalization of daily activities—working, banking, studying, shopping and accessing entertainment from home. In general, the stocks of companies tied to these themes performed well. The Wasatch strategies and funds benefited as investors extrapolated rapid rates of growth and market penetration far into the future. A backdrop of very low interest rates magnified the positive effects on Wasatch's performance in areas like software as a service (SaaS), technology consulting, semiconductor chips, digital banking and e-commerce.

During most of 2022, by contrast, rising inflation and interest rates—and a shift in market leadership—created an environment that proved quite hostile to the Wasatch approach to growth-oriented investing. Because long-duration growth companies of the type we favor generate cash flows that tend to occur further into the future, higher interest rates make the income streams of these companies less valuable in the present.

With fallout from the Omicron variant of Covid-19 less severe than initially expected, the stocks of companies tied to digitalization and other areas that had benefited from the pandemic and helped Wasatch's performance in 2020 and 2021 tended to be hurt the most in 2022. Even so, we believe these themes are enduring and will continue to offer attractive opportunities for long-term investors.

While inflation was already set to rise in 2022 due to pandemic-induced supply-chain challenges and increased

consumer demand, the war in Ukraine exacerbated inflationary pressures. These pressures supported cyclical, value-oriented areas of the market such as energy and some segments of materials and utilities, where Wasatch was structurally underweighted. We believe these sectors are mostly comprised of capital-intensive and undifferentiated businesses that typically don't fit well with our preference for dynamic, high-quality companies. Also, energy and materials firms tend to carry significant debt and are often highly cyclical—with success generally linked to a single commodity that's beyond management's control.

Worsening inflation also forced central banks to raise interest rates aggressively in 2022, posing stronger headwinds for our long-duration growth stocks. Late in the first quarter of 2023, however, these headwinds showed signs of reversing.

THOUGHTS AND POSITIONING FOR 2023 AND BEYOND

Before discussing our thoughts and positioning, we must first acknowledge that macro predictions are inherently unreliable. To understand why, investors may want to consider just a few of the high-profile misjudgments over the past three years. Mainstream experts on Russia failed to foresee the invasion of Ukraine. The Fed incorrectly assumed that inflation was only "transitory." Banks got into trouble because they loaded up on long-term bonds based on the wrongheaded belief that interest rates wouldn't rise sharply in such a short period of time.

Regarding these macro issues, we freely admit that our judgments ahead of time may have turned out to have been equally incorrect. The difference was that we didn't make major decisions based on these judgments. Instead, what we always try to do is invest in companies—or a combination of companies—that we think can perform well under a variety of scenarios. This doesn't prevent us from occasionally encountering periods like 2022 that are hostile to our investment approach. But over the long term, we think our approach will deliver attractive risk-adjusted returns.

Now we come to our thoughts and positioning for 2023 and beyond. As mentioned above, despite continued volatility, high-quality growth stocks reasserted their attractiveness and performed well during the first quarter. While we don't know what's in store for us in terms of geopolitics and market conditions, we like our companies regardless of the macro environment.

If the economy enters a significant recession and interest rates fall dramatically, we think we'll be well-positioned with the likes of profitable technology companies, recession-resistant health-care providers and recurring-revenue businesses that can self-fund expansion—as raising capital may become more difficult. Additionally, in a lower interest-rate environment, investors tend to prize high-quality growth companies.

On the other hand, if the economy stays strong or even gains momentum, we believe we'll benefit from generally less expensive investments in the consumer-discretionary and industrials sectors. These sectors tend to be somewhat more sensitive to economic development. Having said that, our individual companies aren't "make or break" economically cyclical businesses.

WE THINK OUR COMPANIES ARE ATTRACTIVELY PRICED

Across all of our investments, whether they be more or less sensitive to economic development, we're paying particular attention to operating margins because we've entered a period in which some companies are seeing margins squeezed due to rising input costs. By investing in companies with pricing power, we think we're less vulnerable to margin pressures. As always, we also seek the aforementioned characteristics:

- Innovative products, services and business models
- Increasing market share
- Great management teams
- Significant returns on capital
- Relatively low debt

Broadly speaking, after the market selloff in 2022—a period that was particularly hard on growth stocks—we think our companies are attractively priced for the next five years, which is our baseline investment horizon. And now that fourth-quarter earnings have been fully reported, it's evident that businesses are delivering increasingly normal results, which are being more appropriately reflected in the stocks.

What adds to our optimism, particularly among technology companies, is management teams have received a message loud and clear that profitability must be a top priority. The mantra of "growth at all costs" from the past several years is no longer acceptable. This greater level of fiscal discipline should be one factor that lessens the risk and improves the consistency of returns, especially in tech investing.

Still, other factors may increase general market volatility. These factors include a possible recession, rising costs of doing business, uncertainty regarding the direction of interest rates and inflation, heightened geopolitical tensions and central banks walking a tightrope in trying to balance various—often conflicting—priorities.

For shareholders who seek access to our stock-picking skill (alpha) but with a reduced level of market exposure (beta), we now offer the ***Wasatch Long/Short Alpha Fund***. We believe the Fund provides a truly unique approach to pursue risk reduction that cannot be accomplished by simply holding extra cash in a portfolio. This is because we quantitatively and qualitatively select our specific short positions to work in tandem with our specific long positions.

We also believe our approach cannot be duplicated because only Wasatch has the particular insights that inform our stock selections. For example, all of our analysts and portfolio managers rank the quality of our companies' management teams. These rankings help determine the holdings of the Long/Short Alpha Fund and may support some of the Fund's idiosyncratic (non-market) performance.

THE LONG/SHORT ALPHA FUND: A PURE WASATCH APPROACH

As a learning organization for almost 50 years, Wasatch continually strives to improve the investment decisions for all of our strategies and funds. Moreover, when we launch a new strategy or fund, we only do so if we'd willingly invest our own money in it and have existing resources to manage it properly. With that as background, we're extremely excited about the Wasatch Long/Short Alpha Fund—which began on October 1, 2021. The Fund employs a *directional* (long-biased) approach that was developed purely by Wasatch.

Part of our process of continual improvement includes researching and developing quantitative methods that might enhance performance. Although we decide which companies we like based mostly on bottom-up, fundamental analysis, we've found that multi-factor quantitative methods can support portfolio-management decisions like entering and exiting positions, sizing portfolio weights, achieving proper diversification and trading efficiently.

Once we developed our data-driven quantitative methods to enhance the performance generated by the stocks held in our existing strategies and funds, we realized we could use these same methods—plus further refinements—to pick stocks for short sales. Additionally, we could specifically select these short positions to reduce risk based on market conditions and the characteristics of our stocks purchased on the long side.

That's why we launched the Long/Short Alpha Fund, which is supported by all of the Wasatch research teams. Our newest white paper describes the details of the Fund. To read the full paper, please visit the News & Insights section of our website at ***wasatchglobal.com***. Here are some of the key takeaways:

- The Long/Short Alpha Fund gives shareholders the potential benefits of Wasatch's company-specific insights while seeking protection from many of the risks that come with long-only growth investing.
- Through our use of short positions (shorts) to offset long positions (longs), our goal is to keep the Fund's market exposure at about half that of the Russell 2500™ Index over a full investment cycle while limiting other sources of systematic risk.
- Our aim is to *optimize* rather than *maximize* risk reduction, and this creates a bias toward growth and high quality.
- On the long side, we pick U.S. stocks with the same bottom-up, fundamental analysis used in our long-only small- and mid-cap strategies and funds.
- On the short side, we've developed highly quantitative methods—with qualitative overlays—to pick stocks that *complement* our long positions.
- *Idiosyncratic performance* is performance that isn't tied to the general market, and we expect our longs to generate more idiosyncratic performance than our shorts—so our stock-picking skill should be more evident in our long positions.

Why do we focus on small- and mid-cap companies? As one of the most experienced managers of small-caps, Wasatch has tremendous insight and expertise in this investment universe. We like the potential for strong revenue and earnings growth, combined with the underappreciated prices, that can be found among small-caps. We also see great opportunities among mid-caps, as our favorite businesses often still have meaningful upside even after they move beyond the small-cap threshold. Moreover, some of the most disruptive growth companies are now going public when they're higher on the market-cap spectrum.

Due to our pursuit of lower volatility and lower risk, we don't necessarily expect the Fund to outperform the benchmark during rising market environments. What we do expect, however, is for the Fund to generally hold up better amid negative conditions. And upon completion of a full investment cycle, we'd be pleased if the Fund achieved over 80% of the benchmark's full-cycle return while incurring 50% or less of the periodic downturns.

THE FUND SINCE INCEPTION

As mentioned above, we employ a directional (long-biased) approach to investing for the Wasatch Long/Short Alpha Fund. The Fund's long weighting will typically range from 90% to 140% in 30 to 60 stocks, and its short weighting will span from 0% to 60% in 0 to 60 stocks. We expect

that the Fund's most common weightings will be around 130% long and 50% short.

From inception on October 1, 2021 through March 31, 2023, the Fund's average long weighting was 115%, and its average short weighting was 40%. Returns for the Fund and its benchmarks are presented in the table below.

As you can see, the Long/Short Alpha Fund's since-inception performance has exceeded our expectations. The Fund's cumulative gain was 7.60% (Institutional Class) versus the Russell 2500's -12.37% cumulative loss. Digging deeper, the Fund's long positions were down about -10%, which was better than the Russell 2500's loss. Even more important, the Fund's short positions were down approximately -39%—which was especially beneficial because negative performance in short positions translates into positive performance for the Fund.

Put another way, on a cumulative basis since inception, the Fund outperformed the Russell 2500 by a total of about 20 percentage points—and approximately three-quarters of that total came from a 40% average short weighting. The Fund's most recent performance is available on the Wasatch website at ***wasatchglobal.com/wasatch-long-short-alpha-fund-institutional/***.

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

Mick Rasmussen

Fund and Benchmark Performance

As of March 31, 2023

	FIRST-QUARTER TOTAL RETURNS	AVERAGE ANNUAL TOTAL RETURNS		CUMULATIVE TOTAL RETURNS
		One Year	Since Inception	Since Inception
Wasatch Long/Short Alpha Fund—Institutional Class	4.37%	7.17%	5.01%	7.60%
Wasatch Long/Short Alpha Fund—Investor Class	4.38%	6.87%	4.81%	7.30%
Russell 2500™ Index	3.39%	-10.39%	-8.44%	-12.37%
FTSE U.S. 3-Month Treasury Bill Index	1.12%	2.61%	1.76%	2.65%

RISKS AND DISCLOSURES

First-quarter and cumulative total returns are not annualized.

The Wasatch Long/Short Alpha Fund's inception date was October 1, 2021.

Data show past performance, which is not indicative of future performance. Current performance may be lower or higher than the data quoted. To obtain the most recent month-end performance data available, please visit wasatchglobal.com. The Advisor may absorb certain Fund expenses, without which total returns would have been lower. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. **Total Expense Ratio: Investor Class—Gross 3.14%, Net 2.41% / Institutional Class—Gross 3.10%, Net 2.20%**

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 1.75% for the Investor Class and 1.50% for the Institutional Class through at least January 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 does 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.

Equity investing involves risks, including potential loss of the principal amount invested.

Short selling incurs significant unique risks, including potentially unlimited downside risk, high short-sale related expenses, and unavailability of securities to sell short, among others, all of which could negatively impact the performance of the Fund. Additionally, the Fund may not be able to borrow the securities it intends to sell short.

Because the Fund invests in both long and short equity positions, the Fund has overall exposure to changes in the value of securities, which far exceeds the value of the Fund's assets. This may magnify gains and losses and increase the volatility of the Fund's returns. Investment in the Fund will involve market risks associated with different types of investment decisions than those made for a typical "long only" fund. There is no guarantee that the use of long and short positions will succeed in limiting the Fund's exposure to market movements, sector swings or other risk factors.

Being non-diversified, the Fund can invest a larger portion of its assets in the stocks of a limited number of companies than a diversified fund. Non-diversification increases the risk of loss to the Fund if the values of these securities decline.

Diversification does not eliminate the risk of experiencing investment losses.

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.**

The Wasatch Long/Short Alpha Fund's investment objective is long-term growth of capital.

Portfolio holdings are subject to risk and may change at any time. Securities in the Fund are generally added to the portfolio as long or short positions based upon security rankings provided by multi-factor quantitative models and on fundamental analysis of securities. The reliance on quantitative models entails unique risks, including the risk that a model may be limited or incorrect, that the data on which a model relies may be incorrect or incomplete and the risk that the Advisor may not be successful in selecting companies for investment or determining the weighting of particular stocks in the Fund's portfolio. The Advisor will generally sell a security if, among other things, the rankings provided by the quantitative models decline and/or research analysis reveals deterioration in company fundamentals.

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DEFINITIONS

Alpha is a risk-adjusted measure of the so-called "excess return" on an investment. It is a common measure of assessing an active manager's performance as it is the return in excess of a benchmark index or "risk-free" investment. The difference between the fair and actually expected rates of return on a stock is called the stock's alpha.

Beta is a quantitative measure of the volatility of a given stock relative to the overall market. A beta above one is more volatile than the overall market, while a beta below one is less volatile.

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

Long-only investing is the typical approach of buying stocks for a portfolio.

Long/short investing is an approach in which a portfolio manager buys some stocks but also sells some shares short (see short selling).

Short selling is the process in which a portfolio manager borrows shares of a stock and then sells them on the open market. If the shares then fall in price, the manager can repurchase them at the lower price and return them to the lender. That would net a profit for the portfolio manager because the manager sold the shares for more than the repurchase price. Clearly, this is the goal of short selling. But there's always the risk that the share price could rise and generate a loss for the portfolio manager.

Return on capital is a measure of how effectively a company uses the money, owned or borrowed, that has been invested in its operations.

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

The **Russell 2500 Index** *is a market-cap weighted index that includes the smallest 2,500 small- and mid-cap stocks covered in the broad-based Russell 3000 of U.S.-based listed equities.*

The **FTSE 3-Month U.S. Treasury Bill Index** *is intended to track the daily performance of 3-month U.S. Treasury bills.*

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