Market Scout

JANUARY 9, 2024

Across Markets, Similar Investment Themes Played Out During 2023

Large-caps beat small-caps. Quality, including corporate profitability, was prized. Volatility was the enemy. In the U.S., and to some extent overseas, these themes were front and center during 2023.

DEAR INVESTORS:

Themes often drive overall investment performance. In the U.S. during 2023, a market-capitalization theme was remarkably uniform. The so-called Magnificent Seven mega-cap tech stocks led the market higher, powered by enthusiasm surrounding artificial intelligence (AI). Next came large-caps, then mid-caps, followed by small-caps—with micro-caps bringing up the rear but still providing decent positive returns.

Other themes were also evident in the U.S., although with less uniformity. Quality, including corporate profitability, was often an important threshold for stocks to perform well during 2023. The exact level of profitability was somewhat less critical. Conversely, stock-price volatility was to be avoided—as less-volatile names tended to perform better because investors sought predictability amid an uncertain economy. To be sure, these themes were most pronounced in the U.S. But they were also evident to some extent in international developed and emerging markets.

Of all our strategies, one that benefited the most from prevailing investment themes during 2023 was Wasatch U.S. Select—and we think it continues to be very well-positioned. The U.S. Select strategy can include companies of

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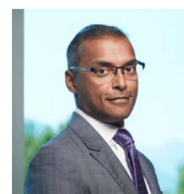

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all market capitalizations, but it focuses on mid-caps that our research team has known for years or even decades.

IN THE U.S., 2023 MARKED A SHARP REVERSAL FROM 2022

The investment environment for U.S. small-caps in 2023 was dramatically different from the environment in 2022. Last year, we provided the following bar chart—which has been updated to show 2023's reversal from 2022.

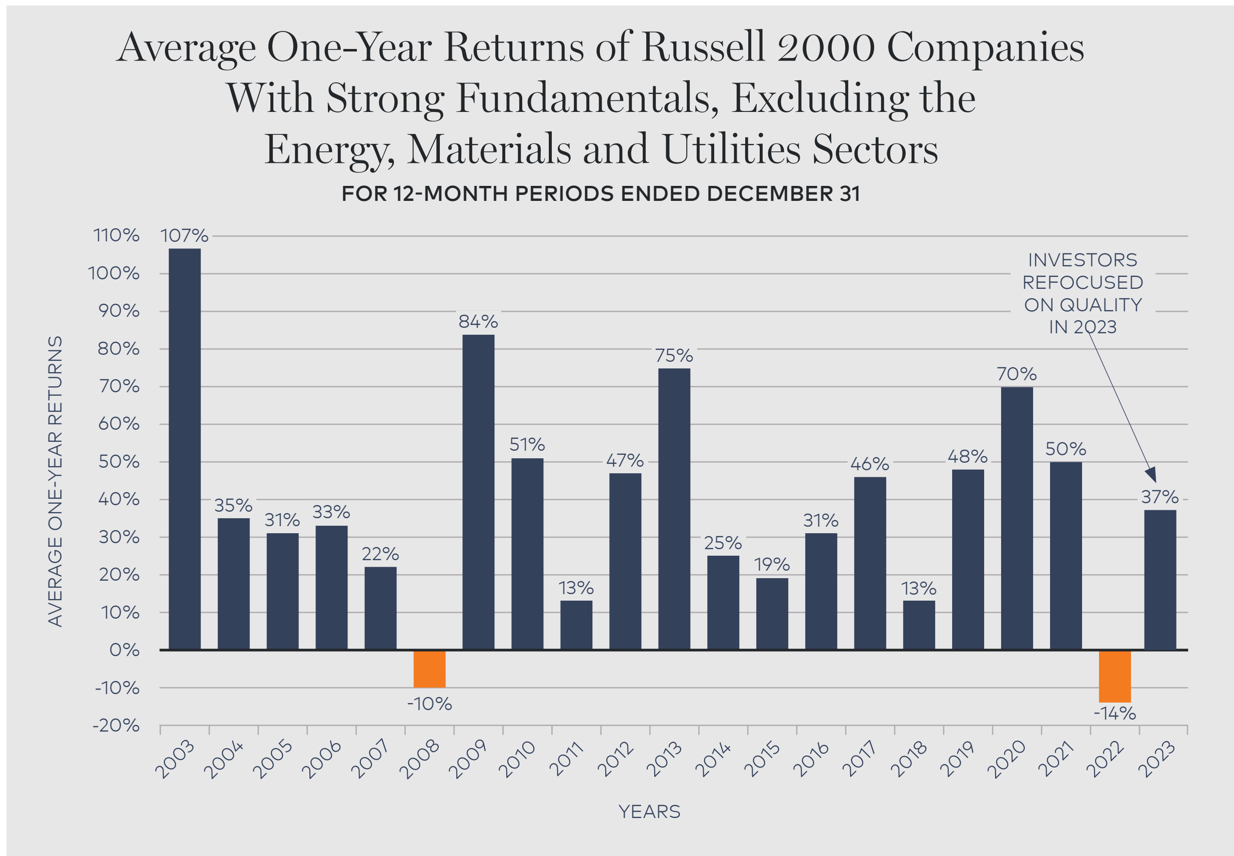
When we provided the chart last year, we noted that the macro environment in 2022 presented the most hostile set of conditions for our investment approach in over 20 years. We also said that under more normal circumstances, Wasatch-favored companies that delivered sales growth above 15% and surpassed earnings estimates were typically rewarded with higher stock prices. However, this wasn't the case in 2022 when an inflationary environment and cyclical commodities favored certain sectors that largely produced the best returns in the market.

The chart shows the historical average one-year aggregate stock returns of the Russell 2000 companies that met our criteria for having strong fundamentals. But the chart excludes companies in energy, materials and utilities because Wasatch is normally underinvested in these sectors. 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 the control of management.

In 2022, the temporarily strong fundamentals in the narrow energy, materials and utilities sectors generated an aggregate gain of about +55%. As the chart shows, the comparable loss in other sectors—those typically favored by Wasatch—was approximately -14%. The stark contrast in performance between our underweighted and overweighted sectors was a substantial headwind for us throughout 2022.

Nevertheless, as we had anticipated about a year ago, conditions that characterized 2022 reversed in 2023. The gain for fundamental performers in those sectors typically favored by Wasatch (as defined above)—was approximately +37% in 2023. By contrast, we saw a significant decline in the number of companies with strong fundamentals in the energy, materials and utilities sectors (20 names in 2023, down from 119 names in 2022). So, what was a headwind for us in 2022 was appropriately rewarded in 2023.

Going forward, we believe the benefits of high-quality growth companies will remain in force, especially if the economy slows. In addition to corporate profitability, other crucial



Source: FactSet. Wasatch defines companies with strong fundamentals as those that had sales growth above 15% for the trailing 12-month period and beat their quarterly Wall Street analysts' earnings estimates from the previous year.

indicators of quality are reasonable debt levels, differentiated business models, market-share gains and management teams that can navigate inevitable challenges.

The reason we favor high-quality growth companies is that they tend to produce the levels of revenues, earnings, cash flows and returns on capital that can drive stock prices upward. When that doesn't occur, we're fortunate to have created a culture and investment process prioritizing patience as we wait for fundamentals to work in our favor. Moreover, we often use market weakness as an opportunity to buy shares of some of our favorite long-duration growth companies at depressed prices. That's what we did in 2022, and our moves largely paid off in 2023.

U.S. SMALL-CAPS RELATIVE TO LARGE-CAPS

Despite small-caps' fourth-quarter improvement, they've underperformed large-caps as described above. And we believe small-cap valuations are still quite attractive relative to large-cap valuations, especially in light of small-cap companies' robust earnings over the past two years. As a result, we think now may be a good time for investors to consider increasing their small-cap allocations.

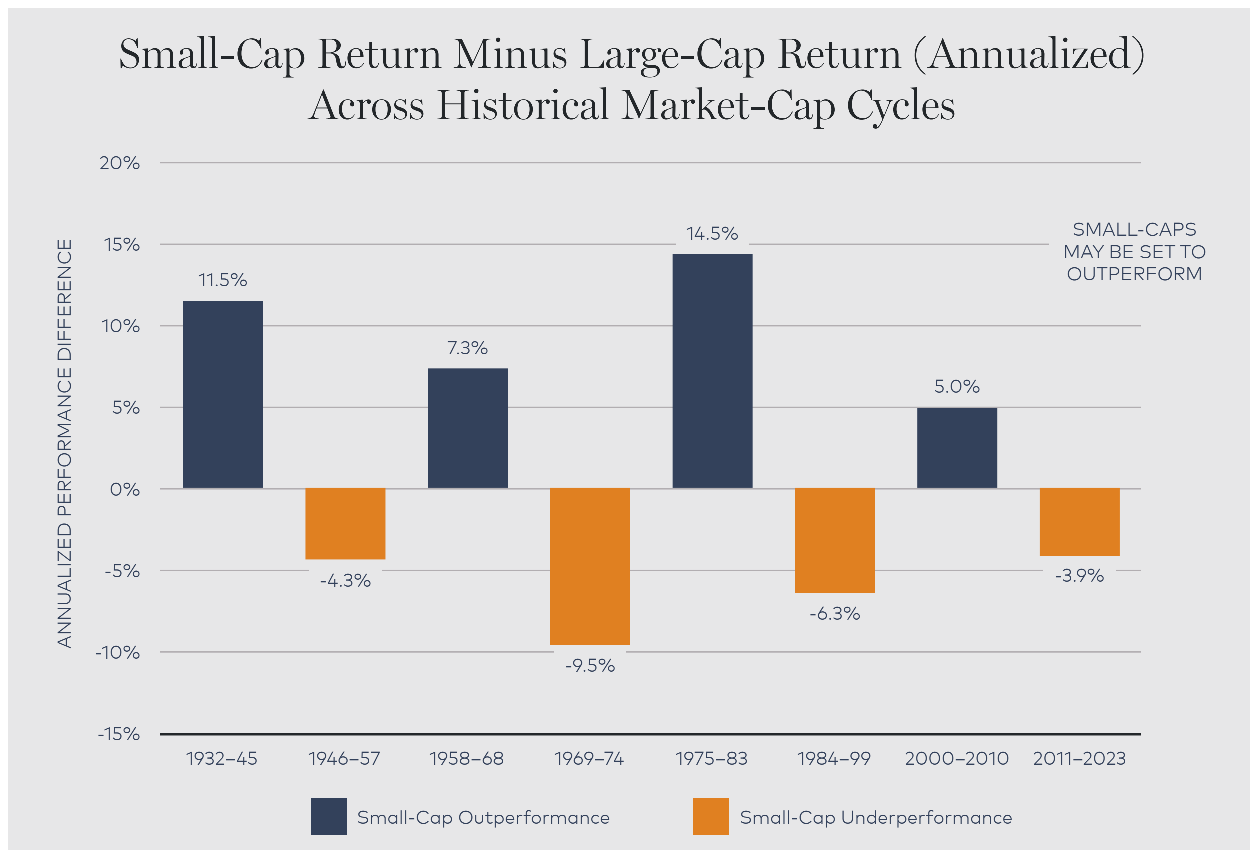
Small- and large-cap stocks can go through long cycles of outperformance and underperformance. Small-caps' current run of underperformance has stretched for more than a decade. The following bar chart, provided with data from Furey Research Partners, shows some of the dominant periods of both market-cap segments and the levels of relative performance.

Each bar represents the annualized returns of small-caps minus the annualized returns of large-caps over the respective period. (Blue bars represent periods in which small-caps outperformed, and orange bars represent periods in which large-caps outperformed.) The cycles start at the beginning of the respective calendar year. Small-cap returns are represented by the Russell 2000® Index from 1979 to 2023 and, before that, by the CRSP 6-8 Decile Index. Large-cap returns are represented by the S&P 500® Index.

Although no one can time a market-cap cycle with certainty, we think small-caps' underperformance for over a decade and their attractive valuations put the odds in their favor.

INTERNATIONAL DEVELOPED MARKETS

While we at Wasatch have generally been rewarded for our patience in U.S. small-caps, stock prices have been slower to turn in our favor among international names. The main reason has had to do with the lagging performance of our Japanese holdings.



Source: Furey Research Partners as of December 31, 2023. Annualized small-cap performance is represented by the Russell 2000 Index from 1979 to July 31, 2023, and by the CRSP 6-8 Decile Index before 1979. Annualized large-cap performance is represented by the S&P 500 Index for all periods. Past performance is no guarantee of future results.

Our lackluster stock returns in Japan notwithstanding, our companies have generally continued to demonstrate solid fundamentals. Our companies were growing earnings per share (EPS) at rates in the high teens at the end of 2022, and that growth rate has remained steady—or in many cases edged a bit higher—since then. But three market factors have worked against our stocks during the past year.

First, in the wake of Japan's reopening from the Covid-19 pandemic, investors have tended to favor "middling" Japanese companies whose fundamentals have improved because of the reopening. Looking across Japan's micro- and small-cap names during the past year, the top performers have often exhibited below-average earnings growth. Many of the top performers also have a return on equity (ROE) that's near or only slightly above the average level in Japan, which suggests they're mediocre in terms of business quality.

Most of the companies in the middling group have EPS growth rates and ROEs that are substantially lower than the corresponding metrics for our holdings. But the stocks in the middling group have been rewarded for having fairly big improvements in fundamentals due to the reopening being a tailwind. Meanwhile, our names have been underperformers despite maintaining—or in some cases seeing slight improvements in—their strong fundamentals.

The second factor working against us arose when investors began anticipating that the Bank of Japan would raise interest rates. This has resulted in a market rotation from growth-oriented companies to value-oriented names. In the past year, Japanese stocks with the lowest valuations have experienced some of the best returns. For example, in 2023, the most value-oriented quintile of Japanese stocks *outperformed* the least value-oriented quintile by about +34%. And the most growth-oriented quintile *underperformed* the least growth-oriented quintile by approximately -11%. These figures are based on style analysis by the Wasatch quantitative team.

The third factor has stemmed from the Tokyo Stock Exchange embarking on a series of initiatives designed to spur greater capital efficiency among Japanese businesses. Amid the initiatives, investor capital has flowed toward lower-quality companies that could be forced to improve their fundamentals.

The strong-performing names in the middling and value groups aren't generally the types of businesses in which we invest. At Wasatch, we invest in high-quality growth companies. We tend to focus on strong balance sheets, high ROEs, healthy free cash flows and less economically sensitive business models that allow companies to continue growing earnings throughout economic cycles.

For the most part, our companies in Japan have delivered on these metrics. And we think it's just a matter of time before their strong fundamentals are fully reflected in their market prices. Recently, this has started to occur with improved fourth-quarter performance. Further improvement has come from larger companies strategically acquiring

Tokyo, Japan

high-growth smaller businesses, bidding up stock prices in the process. We think acquisition activity will continue for quite some time because it improves productivity, which is especially important in Japan's tepid economic environment with an aging population.

EMERGING MARKETS

Like many other small-caps around the world, emerging markets small-caps experienced a strong rebound in 2023 coming off the lows of 2022. Overall, we were pleased with improvements in our companies' fundamentals (e.g., the earnings growth captured in our strategies) and our 2023 investment performance. But we're always looking for ways to do better—for example, by making fewer errors of commission (holdings that performed poorly) and fewer errors of omission (missed opportunities).

In India, equity prices were particularly robust during 2023. This rising tide generally lifted lower-quality, less-expensive stocks to a greater extent than higher-quality, more-expensive names. We weren't surprised by such price action because rebounds off the bottom often favor the former group. Since we don't chase short-term trends and we always focus on high-quality growth businesses, the environment during 2023 was a minor headwind for our relative performance even though our absolute performance was quite good.

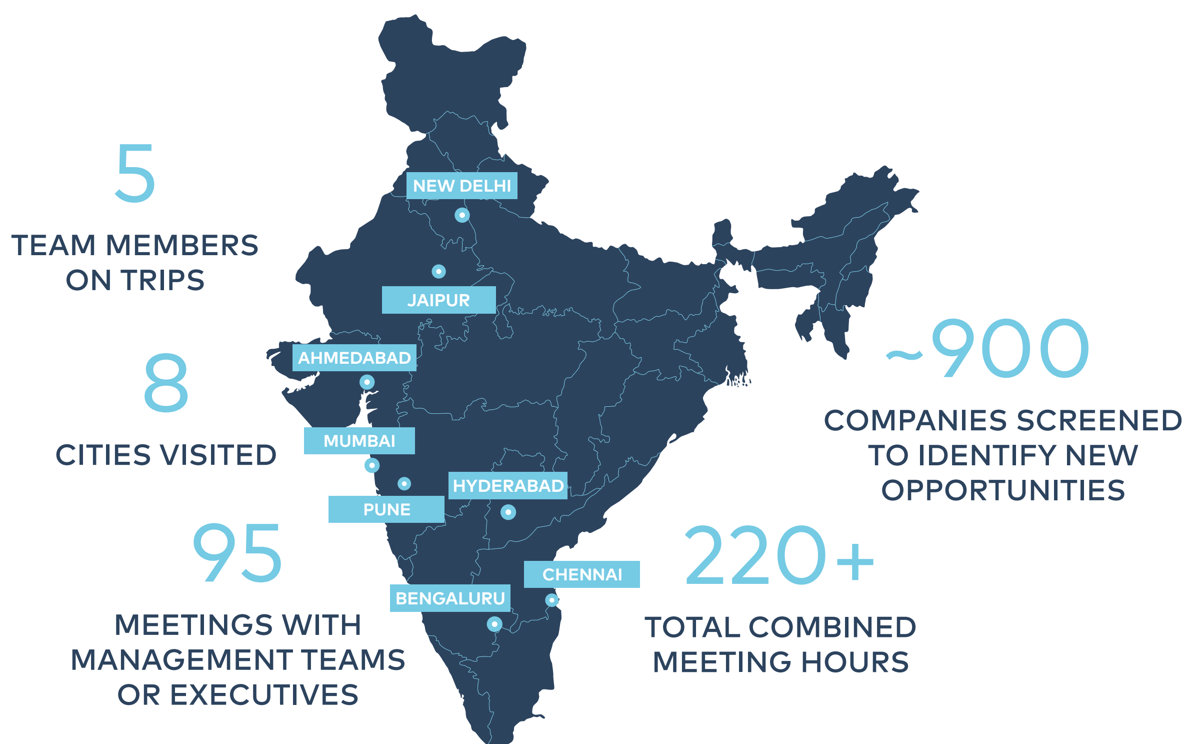
Regarding what we did well and what we did poorly, our Indian stock selections in information technology and consumer discretionary were excellent, but we made some errors of commission in financials and some errors of omission in industrials. We take comfort in our long-term success with Indian financials, many of which should directly benefit from the Reserve Bank of India's (RBI's) latest actions encouraging fiscal responsibility.

However, we need to do better with Indian industrials—which have been high on our agenda when we visit companies. One challenge with industrials is that we must pay close attention to capacity utilization. We generally want to own companies with rising capacity utilization and, if possible, with the ability to add capacity in a modular fashion as needed. The illustration below shows the intensity of our 2023 research trips to India.

As for Taiwan, our stocks generated positive returns but lagged the benchmarks' positions. We mostly made errors of omission by being underinvested in companies benefiting from optimism surrounding AI. While AI largely drove the Taiwanese stock market, our tech companies in the country were more closely linked to consumer electronics, automotive

India Research Trips in 2023

At Wasatch, we take a deliberate approach to our research trips so that we can visit as many current holdings as possible and explore specific new opportunities. We set our own agenda and don't passively meet companies at conferences. Rather, we home in on the potential new ideas first by rigorously screening our investable universe. This helps us identify companies that meet our specific investment criteria and candidates for further due diligence. From there we choose companies of interest and take trips to companies' headquarters or other facilities to meet with management one-on-one and learn more about operations.



manufacturing and economic activity in China. That said, we think AI exuberance may have gotten overdone, and the areas in which our companies specialize may be poised to grow.

Although we look for errors of omission to understand what opportunities we missed, sometimes we intentionally underweight an area in which, regardless of the outcome, we wouldn't consider our decision to be an error. That was the case for us in China because we saw better opportunities elsewhere. But even we were surprised, along with much of the investment community, that China didn't experience much of a post-pandemic economic rebound. As a result, stock returns were mostly negative.

Instead of resuming normal activities, Chinese consumers remained reluctant to spend. And the real-estate market continued to be in disarray. Additionally, the Chinese government showed a lack of leadership by failing to set appropriate priorities. While we think China is too big to ignore and the country will eventually offer incredible investment opportunities, we expect to stay underweighted in Chinese stocks until signs of improvement in the economy and the equity markets are more definitive.

Latin America was another source of strength for us. In this region, we own consumer, financial and industrial companies—some of which benefited from the trend to diversify manufacturing capabilities beyond China. From a macro perspective in Latin America, we note that Brazil's central bank (like the RBI in India) sets a good example with sensible monetary policies that help promote a supportive environment for businesses and investors alike.

POSITIONING FOR THE ENVIRONMENT AHEAD

When asset managers assess their results, they often refer to *relative performance* and *absolute performance*. Relative performance is determined by how much a portfolio outperforms or underperforms a pre-established benchmark index. Absolute performance is a reflection of the positive or negative magnitude of returns regardless of benchmark results.

Beyond company fundamentals, we think three possible economic scenarios could affect our relative and absolute performance going forward: (1) the economy goes into a recession; (2) growth stalls, but the economy muddles along; or (3) economic growth gains momentum.

In the U.S. during the upcoming year, we think we're especially well-positioned on a relative basis for scenarios 1 and 2 because our profitable, growth-oriented companies could be in favor amid a slower economic environment with declining interest rates. We might do less well on a relative basis under scenario 3 because less-profitable, value-oriented names could receive a boost amid an accelerating economic expansion.

Over the longer term, which is what we really care about, we have a high degree of confidence in the earnings power of our companies regardless of the economic environment. Moreover, we think our companies are reasonably priced—which should set us up for strong relative and absolute performance.

In international developed markets and emerging markets, our assessments are roughly the same. But we think a boost to value-oriented names is somewhat less likely because value stocks have already been bid up, as described above.

Finally, we'd like to re-emphasize that we think small-caps' attractiveness compared to large-caps is a world-wide condition. If we're correct, our small-cap strategies focused on the U.S., international developed markets and emerging markets could all receive a tailwind for absolute performance. As for relative performance, that will be determined by our stock-picking skills.

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

Mike Valentine, Ken Applegate and Ajay Krishnan

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DEFINITIONS

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.*

The **S&P 500 Index** *includes 500 of the United States' largest stocks from a broad variety of industries. The Index is unmanaged and is a commonly used measure of common stock total return performance.*

The **CRSP 6-8 Decile Index** *is a small-cap index created and maintained by the Center for Research in Security Prices (CRSP) at the University of Chicago's Graduate School of Business. CRSP capitalization-based indexes include common stocks listed on the NYSE, AMEX, and the NASDAQ National Market.*

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