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1Q19 Market Scout: Great Companies Persist and Find Ways to Win Over the Long Term

(April 08, 2019)

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DEAR FELLOW SHAREHOLDERS:

For this latest quarterly message, we focus on a long-held Wasatch investment philosophy: Genuinely great companies are—as Warren Buffett wrote in 1994—"rare gems" that prevail regardless of political climates, economic conditions or market events. The same, of course, can be said of the world's leading investors.

Twenty-five years ago, in his annual letter to Berkshire Hathaway shareholders, Buffett wrote: "If we identify businesses similar to those we have purchased in the past, external surprises will have little effect on our long-term results."

Buffett, who notched 30 years at Berkshire's helm in 1994, cited a more than 23% compounded average annual return provided to shareholders since 1964—along with the "major shocks" he witnessed over the preceding three decades. The dissolution of the Soviet Union, the resignation of a U.S. president, the inordinate escalation of the Vietnam War and "Black Monday" (the one-day decline in the Dow Jones Industrial Average of -22.6%) were just some of the examples that Buffett relayed to his readers. Today, we know that not a single one of those episodes—or any global challenges that followed—made the slightest dent in Buffett's investment principles. As he wrote in his 1994 shareholder letter, "nor did they render unsound the negotiated purchases of fine businesses at sensible prices."

"GROW OR GO"

Buffett's fundamental, bottom-up approach to identifying and deploying capital to best-in-class companies with disciplined management teams has been written about by a litany of journalists and stock-market commentators. Few, however, have undertaken an extensive quantitative study of corporate growth and survivorship that spans decades. Two researchers with consulting giant McKinsey & Company, Patrick Viguerie and Sven Smit, did just that in 2008, publishing, along with former McKinsey colleague Mehrdad Baghai, the Wiley business bestseller, *The Granularity of Growth*.

In 2015, Smit revisited the book's central thesis with another McKinsey colleague, Yuval Atsmon, to determine if the book's findings still held true. Smit and Atsmon built a brand-new proprietary database to track company fundamentals across S&P 500 Index constituents over the 30-year period from 1983 to 2013. The duo published their findings in a McKinsey research report entitled *Why It's Still a World of 'Grow or Go*.' The report found:

- For the three-decade period, nearly 60% of the S&P 500 companies that lagged their peers—in terms of growth and profit margins—were acquired. It was "grow or go," and the majority of S&P 500 constituents were gone.
- More than 75% of the S&P 500 constituents that generated top-line growth and maintained or improved margins outperformed the Index over the period.
- 56% of the companies that grew slowly but also aggressively distributed cash to shareholders outperformed the Index.
- Companies with deteriorating margins underperformed, even if these companies were still growing at a significant clip. Just 27% of this last group outperformed the Index.

What Smit and Atsmon concluded in 2015 after revisiting the core tenets of *The Granularity of Growth* was that "outperforming the competition remains possible in all industries, even in sluggish economic times." They added that high-performing companies "continually seek the kind of growth that generates real and sustainable value."

Consistent with the principles described by Buffett and the McKinsey researchers, we'd like to emphasize the following points:

- We're repeatedly faced with challenges. Although just three months—and certainly not 30 years—the first quarter of 2019 presented its share of "shocks," including the longest federal government shutdown in U.S. history, the continuation of the U.S.-China trade tensions and the U.K.'s wrangling over how to exit from the European Union.
- Financial markets rebounded from sharp fourth-quarter declines, which we believe were intensified by year-end tax-loss selling and significant mutual-fund outflows. Despite the recent strong stock-market performance, we believe global economic growth is slowing.
- While we're on the lookout for potential challenges, having a large universe to pick from means we can always find high-quality, long-duration growth companies around the world and across market capitalizations.

Now that we've presented the broad themes for this quarterly message, let's move on to the economic and market conditions that we've experienced recently.

ECONOMY

In terms of economic news, we begin with the United States, the world's largest economy. Real gross domestic product (GDP) in the fourth quarter of 2018 rose at an annual rate of 2.2%, which was down from an earlier estimate of 2.6%. Like the financial markets, recently released indicators support the view that the U.S. economy has rebounded somewhat in 2019—although we believe the probabilities suggest slower growth lies ahead.

The release of January's retail-sales report (published by the U.S. Department of Commerce) was, like most government activities in early 2019, delayed by the longest federal-government shutdown in U.S. history—which ran 35 days from December 22nd until January 25th. Finally released on March 11th, the report downwardly revised December's percentage decline from -1.2% to -1.6%, further accentuating the worst month for retail sales since the global financial crisis. After this downward revision, however, better news followed when it was reported that U.S. retail sales for January 2019 rebounded from December 2018 and posted a significant 2.3% year-over-year increase.

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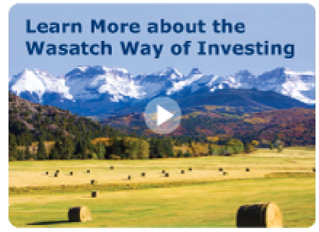

The U.S. Consumer Price Index also edged up recently, but a temporary drop in energy prices helped to hold down the Index on a year-over-year basis. With core inflation running at about a 2.1% annualized pace, the underlying trend remains in line with the Federal Reserve's target of 2.0%.

In early March, the Institute for Supply Management (ISM) delivered one of its more noteworthy reports—with a striking divergence. ISM's nonmanufacturing index, otherwise known as America's service economy, posted a 3.0% increase month-over-month in February 2019. Simultaneously, ISM's core manufacturing index fell -2.4% during the same period. While the strength of U.S. services—the country's largest economic grouping—suggests the potential for a Fed rate hike in the second half of 2019, the state of U.S. manufacturing, exacerbated by the absence of a U.S. trade deal with China, supports the exact opposite. As a result of mixed signals like these, policy recommendations from economists are all over the board.

Regarding China, the world's second-largest economy, early data indicate continued deceleration in 2019. Nevertheless, China's February retail sales rose more than 8% year-over-year, which was in line with forecasts. What's more important to us, however, is that the selection of high-quality Chinese companies has doubled in the past three years. And we continue to devote significant on-the-ground due diligence in an effort to identify the emerging leaders in various industries. This research includes a focus on the A-share market, which consists of approximately 1,400 companies incorporated in mainland China.

We turn now to Japan, the world's third-largest economy and home to what we believe is one of the most exciting small-cap markets globally. Despite being supported by easy monetary policy, many macroeconomic indicators such as GDP growth are uninspiring. However, there are positive factors—such as Japan's unemployment rate sitting at a multi-decade low and second only to Singapore (among developed countries) in terms of putting citizens to work. Japan's jobs-to-applicant ratio remains stubbornly high at 1.63 as the country faces a labor shortage. Not surprisingly, we're seeing some wage inflation in Japan, which can act as a tailwind for the domestic consumer. The tight labor market is also creating opportunities for companies that look to enable businesses to become more efficient and improve productivity.

Wrapping up this quarter's review of developed nations, we land next on the United Kingdom, which remains in upheaval over Brexit. Prime Minister Theresa May is now faced with exiting the European Union (EU) without any deal whatsoever. In March, she requested a three-month extension from the European Council, attempting to secure a stay in the EU until June 30th. With British Parliament having rejected Mrs. May's Brexit plan on March 29th for the third time, the EU bloc's other 27 governments must all agree to postpone the U.K.'s departure. The uncertainty of Brexit has been clouding the British economy and markets since the referendum in 2016, and this haze is likely to persist until we know the outcome.

Among emerging markets, we see attractive company valuations coupled with bureaucratic reforms and stimulative government initiatives. In addition, investor sentiment has improved due to low inflation and reduced concerns over monetary policies in developed nations. These factors have also enhanced the prospects for emerging-market currency valuations. Moreover, country balance sheets have strengthened, as have international fund flows into emerging markets.

Beyond China, which is discussed above, we believe Latin America may offer good investment opportunities because the region's political situation (although still highly imperfect) has become somewhat more stable, and the economic recovery seems to be getting back on track. In Brazil, we saw signs of improving consumer sentiment, and we think the country will make progress regarding deficit reduction and reining in corruption.

As for India, pro-business priorities and structural government-policy changes that have been implemented over the past several years should pay economic dividends beyond the next decade. These priorities and policy changes—along with attractive demographics and a still rapidly growing economy—help make the country one of our most-fertile grounds for finding promising emerging-market investments.

MARKETS

We recently heard a great adage about investing: "The stock market is the only market where people head for the exit when things go on sale." And considering what followed 2018's stock-market rout, heading for the exit certainly wasn't a wise move. As long-term investors, we prefer to use overall market weakness as an opportunity to increase our positions in exceptional businesses.

During the first quarter of 2019, the U.S. large-cap S&P 500® Index advanced 13.65%. The technology-heavy Nasdaq Composite Index gained 16.81%. The Russell 2000® Index of small caps rose 14.58%. And growth-oriented small caps performed extremely well, with the Russell 2000 Growth Index up 17.14%. Value-oriented small caps in the Russell 2000 Value Index were up 11.93%, as value stocks—including those across larger market capitalizations—generally trailed growth stocks. The outperformance of growth stocks relative to value names was a continuation of a trend we've seen for a number of years.

For the most part, international stocks also performed very well but generally lagged those in the U.S. The MSCI World ex USA Index rose 10.45% and the MSCI Emerging Markets Index gained 9.92% for the first quarter.

Intermediate- and long-term bond yields fell during the quarter as the inversion of the yield curve signaled subdued inflationary expectations. Because bond prices move in the opposite direction of yields, bond indexes posted positive returns. The Bloomberg Barclays US Aggregate Bond Index increased 2.94%. And the Bloomberg Barclays US 20+ Year Treasury Bond Index was up a solid 4.73%. One of the best-performing bond indexes was the ICE BofAML US High Yield Index, which gained 7.40%. We believe the strong showing by high-yield bonds was yet another indication of increased risk appetite among investors.

While we don't generally focus on commodities in our messages, it's interesting to note that the Morningstar Long-Only Commodity Index rose 10.40% during the first quarter. Moreover, Brent crude oil was up about 25%.

Wasatch

At Wasatch, we think the returns for stocks, bonds and commodities during the first quarter of 2019 were reminders of the difficulty—or as some would say, the futility—of using macro events to try to predict asset prices. It appeared to us that the first-quarter rebound was triggered by investors feeling relieved by the pause in tightening of U.S. monetary policy and the outright accommodative monetary policies in Europe and Asia.

Stock investors seemed to ignore the inverted yield curve and the signs of slowing economic growth around the world. For our part, we believe it's important to note that economic slowdowns and recessions aren't all bad, as they can help correct excesses that build up during economic expansions. This underscores the importance of owning high-quality companies that are able to maneuver through challenging times. The truly exceptional companies focus on the long term—which provides the potential for investors like us to benefit from the power of compounding returns.

As we've said, forecasting macro events and how those events might affect stock prices over the short term isn't our game. But we do recognize that macro events will sometimes create a tailwind for us, while at other times the wind will be in our faces. Through it all, we remain steadfastly focused on the long-term potential of individual stocks. In 2018, our investment team visited companies in 23 countries. Over the past two years, we've had over 1,500 face-to-face meetings with management teams and made over 800 on-site company visits. We believe that interactions with such a broad array of companies, combined with our bottom-up quantitative screens, provide an even more robust view of business conditions and competitive dynamics.

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

Ken Applegate and Linda Lasater

PORTFOLIO MANAGER BIOS

Ken Applegate, CFA, CMT—Portfolio Manager

Ken Applegate joined Wasatch Advisors in 2014 and is the Lead Portfolio Manager for the Wasatch International Growth Fund. He is also a Portfolio Manager for the Wasatch Global Opportunities Fund. His more than 20 years of investment experience has focused exclusively on small cap growth investing.

Mr. Applegate's career began in 1994 in London, where he served as a financial analyst and later as a co-manager of a foreign exchange hedge portfolio for Refco. In 1996, he moved to the U.S. where he spent 11 years specializing in small cap investing for RCM and then Berkeley Capital Management. Later, he returned to his native New Zealand to join Fisher Funds as a senior portfolio manager, and was integral in launching and managing international small cap funds. In 2012, he moved back to the U.S. to launch the Pacific View Asset Management international small cap strategy.

Mr. Applegate completed his Bachelor of Management studies at the University of Waikato in New Zealand. He is also a CFA charterholder and a Certified Market Technician (CMT).

Ken enjoys traveling, sports, outdoor activities, and spending time with his wife and two children.

Linda Lasater, CFA—Portfolio Manager

Linda Lasater is the Lead Portfolio Manager for the Wasatch International Opportunities Fund. She is also a Portfolio Manager for the Wasatch International Growth Fund. She joined Wasatch Advisors in 2006 as a Senior Equities Analyst on the international research team. She also completed a successful research internship with Wasatch during the summer of 2005.

Prior to joining Wasatch Advisors, Ms. Lasater worked as a project lead and systems analyst in the portfolio analytics group at AIM Investments, where she developed tools that enabled portfolio managers and analysts to make informed investment decisions.

Ms. Lasater earned a Master of Business Administration from the Tuck School of Business at Dartmouth. Earlier, she received a Bachelor of Business Administration in Management Information Systems from the University of Texas. She is also a CFA charterholder.

Linda is fluent in Vietnamese. She enjoys biking, reading and spending time with her family.

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DEFINITIONS

China **A-shares***, along with B-shares, are sold on mainland China's two stock exchanges, which are in Shanghai and Shenzhen. The key difference between A-shares and B-shares is that A-shares are denominated in mainland China's currency, the renminbi, and B-shares are denominated in foreign currency (U.S. dollars in Shanghai and Hong Kong dollars in Shenzhen).*

Brexit *is an abbreviation for "British exit," which refers to the June 23, 2016 referendum whereby British citizens voted to exit the European Union. The referendum roiled global markets, including currencies, causing the British pound to fall to its lowest level in decades.*

The **U.S. Consumer Price Index (CPI)***, also called the cost-of-living index, is an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. The CPI is published monthly. The headline CPI includes volatile food and energy prices, while the core CPI excludes food and energy.*

The **Dow Jones Industrial Average** *is the most widely used indicator of the overall condition of the U.S. stock market. It is a price-weighted average of 30 blue chip stocks, primarily industrial stocks, traded on the New York Stock Exchange. The stocks are chosen by the editors of the Wall Street Journal, which is published by Dow Jones & Company.*

The **global financial crisis***, also known as the financial crisis of 2007-09 and 2008 financial crisis, is considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s.*

Gross domestic product (GDP) *is a basic measure of a country's economic performance and is the market value of all final goods and services made within the borders of a country in a year.*

The **ICE BofAML US High Yield Index** *tracks the performance of U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P. These issues are below investment grade, but are not in default. You cannot invest directly in this or any index.*

The **Morningstar Long-Only Commodity Index** *is a fully collateralized commodity futures index that is long all eligible commodities. You cannot invest directly in this or any index.*

Real gross domestic product (GDP) *is a macroeconomic measure of the value of economic output adjusted for price changes (i.e., inflation or deflation). This adjustment transforms the money-value measure, nominal GDP, into an index for quantity of total output.*

Return on assets (ROA) *measures a company's profitability by showing how many dollars of earnings a company derives from each dollar of assets it controls.*

The **Shanghai Stock Exchange** *is the largest stock exchange in mainland China. It is a non-profit organization run by the China Securities Regulatory Commission (CSRC).*

The **Shenzhen Stock Exchange***, based in Shenzhen, Guangdong, is one of China's three stock exchanges. The other two are the Shanghai Stock Exchange and the Hong Kong Stock Exchange.*

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

The **yield curve** *is a line on a graph that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares three-month, two-year, five-year and 30-year U.S. Treasury securities. This yield curve is used as a benchmark for other interest rates, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.*

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 **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 Value Index** *measures the performance of Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.*

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The **Nasdaq Composite** *is a market-capitalization weighted index of the more than 3,000 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks. The Nasdaq was created by the National Association of Securities Dealers (NASD) to enable investors to trade securities on a computerized, speedy and transparent system, and commenced operations on February 8, 1971.*

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 **MSCI Emerging Markets Index** *captures large and mid cap representation across 24 emerging market countries. With 1,136 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.*

The **MSCI World ex USA Index** *captures large and mid cap representation across 22 of 23 developed market countries—excluding the United States. With 1,012 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.*

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The **Bloomberg Barclays US Aggregate Bond Index** *is a broad-based flagship benchmark that measures the investment grade, US dollar denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities (MBS) (agency fixed-rate and hybrid adjustable-rate mortgage [ARM] pass-throughs), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) (agency and non-agency).*

The **Bloomberg Barclays US 20+ Year Treasury Bond Index** *measures the performance of U.S. Treasury securities that have remaining maturities of 20 or more years.*

You cannot invest directly in these or any indexes.

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