Wasatch Small Cap Value Fund Q1 2022 Commentary

May 25, 2022 10:26 AM ET | **Wasatch Small Cap Value Fund Institutional Class Shares Inst (WICVX)**, **WMCVX** | AIMC, ENSG, HQY... | 1 Like

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Summary

- Wasatch Global Investors is a comprehensive small-cap equity manager singularly focused on delivering superior risk-adjusted returns for our clients.
- Our focus on “growthier” value companies faced headwinds during the quarter.
- The Wasatch Small Cap Value Fund—Investor Class fell -9.88% and underperformed the value benchmark in the quarter.

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OVERVIEW

U.S. equities moved lower in the first quarter, during which a litany of adverse developments led to heightened investor uncertainty. The markets faced headwinds from Russia's invasion of Ukraine, together with ongoing supply-chain disruptions and surging energy prices. In addition, it became apparent that the U.S. Federal Reserve intends to hike interest rates aggressively in order to stave off inflation. These issues led to underperformance for smaller companies in general. While the Fund's benchmark, the Russell 2000® Value Index, declined -2.40%, the decline was much less than the -12.63% loss of the Russell 2000 Growth Index.

The Wasatch Small Cap Value Fund—Investor Class fell -9.88% and underperformed the value benchmark in the quarter. Our approach tends to place the Fund at the "growthier" end of the value category, which was a positive for much of 2020–21 but proved to be a headwind in the first three months of 2022. Our "growthier" style was reflected in the Fund's sector positioning. We had a sizable underweight in energy, the best-performing sector in the benchmark with a gain of over 43% driven by surging prices for oil and natural gas. Our overweight positions in the industrials and consumer-discretionary sectors also created higher vulnerability to the macroeconomic headwinds that drove market performance in the first quarter.

In our 20-plus years of managing the Fund, we have witnessed many other occasions when news events have led to wide divergences in performance among the various segments of the market. During these times, we have always maintained a consistent approach on the belief that good companies with attractive valuations are likely to outperform over time. Conversely, we believe a strategy that seeks to make large, frequent changes to positioning in an effort to chase short term returns is destined to underperform. We think our steady, bottom-up approach is a key factor in the Fund's outperformance of the Russell 2000 Value Index over the five-year, 10-year and since inception periods ended March 31, 2022.

DETAILS OF THE QUARTER

The underperformance of our holdings in the industrials and consumer-discretionary sectors illustrated the impact of macroeconomic factors in the first three months of the year. With investors ratcheting up expectations for the number of rate hikes likely to occur before year-end, stocks with higher interest-rate sensitivity generally lagged.

This weighed on the stocks of our homebuilders— LGI Homes, Inc. (LGIH), Skyline Champion Corp. (SKY) and Toll Brothers, Inc. (TOL). Producers of building products, such as Trex Co., Inc. (TREX), were similarly affected by concerns about a slowdown in housing construction. We maintained these positions. When we remain confident in a company's fundamentals, we believe holding on for the long term, rather than selling into weakness, is the best course of action.

Trex, a manufacturer of high-performance composite (non-wood) decking and accessories, offers a prime example of the merits of patience in volatile markets. We view Trex, which features accelerating business trends and an impressive degree of pricing power, as one of the highest quality stocks in the Fund. The company raised prices by 15% in 2021, yet customer demand remained firm.

Companies with international exposure in terms of both sourcing and customers were hurt by increased supply-chain disruptions. Fund holdings Altra Industrial Motion Corp. (AIMC) felt some of these pressures in the first quarter, as did Janus International Group, Inc. (JBI). We maintained holdings in both companies on the view that they are well-positioned to grow once shorter-term issues have dissipated.

Elsewhere in the Fund, we lost some ground from positions in non-bank financials. Companies with above-average sensitivity to activity in capital markets were notable laggards due to market volatility and geopolitical tensions.

On the positive side, energy-sector holdings— Cactus, Inc. (WHD) and Magnolia Oil & Gas Corp. (MGY)—were two of our top contributors for the quarter. We had maintained a low or zero weighting in energy for some time coming into 2020, but the pronounced downturn in the sector led us to establish positions in these higher-quality companies at compelling prices. This decision has paid off, as both companies have performed very well since we added them to the Fund. Our approach to

the energy sector isn't to try to predict the direction of oil prices. Instead, we focus on owning well positioned companies with sound balance sheets and skilled management teams that we believe are capable of navigating both positive and negative oil-price movements.

Health care was another area of strength for the Fund. The sector tends to have lower sensitivity to macroeconomic trends than the market as a whole, so company-level developments are more likely to be reflected in performance. HealthEquity, Inc. (HQY), a custodian of health-savings accounts, was a top performer. We bought the stock at what we considered an attractive price during a stretch of poor performance in 2021. The stock has since rebounded on strength in HealthEquity's core business and anticipation of higher yields on its cash holdings. Intra-Cellular Therapies, Inc. (ITCI) and Ensign Group, Inc. (ENSG) were also key contributors in health care.

Supermarket chain Sprouts Farmers Markets, Inc. (SFM) was another holding that benefited from company-specific performance drivers. The stock slumped in 2021 when the company's efforts to win new customers caused a hit to profit margins. We bought the stock on weakness, and it has bounced back following management's decision to refocus on margins. We continue to view Sprouts as inexpensive, and we have maintained the position. *(Current and future holdings are subject to risk.)*

Consistent with our steady, longer-term approach, we avoided making broad portfolio shifts. During times of rapid changes in the macroeconomic outlook, we seek to reconfirm the reasons why we hold each individual position. This process gave us confidence that our holdings have strong fundamentals across the board, with most meeting or exceeding our expectations. At the same time, however, we are acutely aware of how larger trends can affect the fortunes of the companies represented in the Fund. We therefore trimmed or sold some positions that may remain challenged over the next several quarters, while modestly increasing our exposure to the more value-oriented side of our investment universe.

OUTLOOK

Our discussions with management teams suggest that company fundamentals remain solid, but there is an increasing level of caution regarding the economic backdrop. While our portfolio companies continue to demonstrate healthy fundamentals, their management teams are being conservative as they assess the outlook for the remainder of the year. Amid this uncertainty, we remain focused on using market weakness as an opportunity to purchase shares of companies we wouldn't typically expect to find in value territory. We believe using bottom-up research to identify companies whose stock prices have become disconnected from their fundamentals remains a prudent approach in both up and down markets.

Thank you for the opportunity to manage your assets.

Sincerely,

Jim Larkins and Austin Bone

AVERAGE ANNUAL TOTAL RETURNS FOR PERIODS ENDED MARCH 31, 2022

	Quarter*	1 Year	3 Years	5 Years	10 Years
Small Cap Value Fund—Investor	-9.88%	-2.10%	12.07%	10.69%	12.19%
Small Cap Value Fund—Institutional	-9.79%	-1.98%	12.23%	10.86%	12.32%
Russell 2000® Value Index**	-2.40%	3.32%	12.73%	8.57%	10.54%
Russell 2000® Index†	-7.53%	-5.79%	11.74%	9.74%	11.04%

SMALL CAP VALUE FUND — TOP 10 HOLDINGS AS OF DECEMBER 31, 2021

	Percent of Net Assets
Kadant, Inc.	3.8%
Fabrinet	3.2%
Axos Financial, Inc.	3.1%
Bank OZK	3.0%
Altra Industrial Motion Corp.	3.0%
Skyline Champion Corp.	2.7%
Ensign Group, Inc.	2.6%
Webster Financial Corp.	2.5%
National Storage Affiliates Trust	2.4%
Valvoline, Inc.	2.4%
	28.8%

Original Post

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*Returns less than one year are not annualized.

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— 1.16% / Institutional Class—Gross: 1.06%, Net:1.05%

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 1/31/2023. 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.

Performance for the Institutional Class prior to 1/31/2012 is based on the performance of the Investor Class. Performance of the Fund's Institutional Class prior to 1/31/2012 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. Investments in value stocks can perform differently from the market as a whole and from other types of stocks and can continue to be undervalued by the market for long periods of time. 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 Russell 2000 Value Index measures the performance of Russell 2000 Index companies with lower price-to-book ratios and lower 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 3000 Index is an unmanaged total return index of the largest 3,000 U.S. companies based on total market

capitalization. The Russell 2000 Index is widely used in the industry to measure the performance of small company stocks. You cannot invest directly in these or any indexes.
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The Wasatch Small Cap Value Fund's investment objective is long-term growth of capital. Income is a secondary objective, but only when consistent with long-term growth of capital.

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