Wasatch Core Growth Fund Q1 2022 Commentary

May 25, 2022 10:56 AM ET | **Wasatch Core Growth Fund No Load (WGROX)**, **WIGRX** | HLLY, HLNE, HQY...

Fund Letters

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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.
- If we don't perceive macro events as impacting long-term company fundamentals, our response is to stay the course.
- During the first quarter of 2022, the Wasatch Core Growth Fund— Investor Class dropped -15.92%.

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OVERVIEW

During the first quarter of 2022, the benchmark Russell 2000® Index fell -7.53% while the Russell 2000 Growth Index declined -12.63%. Underperforming its benchmark, the Wasatch Core Growth Fund— Investor Class dropped -15.92%.

At a broad level, we think there were three main reasons for the Fund's underperformance during the quarter. First, most of our stocks had such strong gains over the preceding several years—so an eventual period of consolidation was to be expected. Second, the prospect of continually rising interest rates was perceived to be especially detrimental to long-duration growth companies whose earnings and cash flows are more heavily weighted further into the future. Third, the war in Ukraine boosted commodity prices and general inflationary pressures— which were detrimental in the short term because the Fund typically avoids undifferentiated energy and materials companies, as described below.

INTEREST RATES, INFLATION, WAR, SUPPLY CHAINS AND RECESSION

We're continually asked how we've responded to the macro environment in which there have been threats related to interest rates, inflation, war, supply chains and recession. The short answer is that if a macro event hasn't changed our three- to five-year outlook for a company, we don't respond much…if at all. Having said that, we do use stock dislocations created by macro events to trim overpriced holdings such as information-technology companies about a year ago—and to round up on unfairly punished, underpriced health-care companies more recently.

To further explain our view regarding the macro environment, consider the following scenarios and hypothetical responses:

- Interest rates are low. Buy fast-growing companies!
- Interest rates and inflation are rising. Sell growth stocks. Buy value names like banks.
- War is breaking out, and inflation is accelerating. Buy deep value companies such as commodity producers.
- Supply chains are increasingly disrupted. Sell companies relying on parts sourced internationally.
- The yield curve is inverting. Sell value names like banks.
- The economy is entering a recession, causing interest rates and inflation to turn down. Sell deep value companies such as commodity producers. Buy fast-growing companies—again!

Does this sound like a good way to invest? We don't think so either.

While we're being overly simplistic in the hypothetical responses outlined above, they're not far off from what many market traders attempt to do. For our part, we act and think very differently.

- First, we've always focused on long-duration growth companies.
- Second, we think other investors can be successful with alternative styles.
- But third, we don't change our process in an effort to "time" a rotation in styles because we don't believe timing moves can be executed effectively.

WE INVEST AT THE COMPANY LEVEL, AND WE MANAGE RISK AT THE PORTFOLIO LEVEL

As we employ our process, we make most of our investment calls on individual companies. We don't usually make calls on macro risks. This doesn't mean macro risks are unimportant. It's just that they generally don't change our long-term views on company fundamentals.

In this regard, consider receiving two equally convincing arguments that in five years oil will:

1. Exceed $150 per barrel.
2. Drop below $50 per barrel.

But the fact is that no one knows for sure. And there's risk in both directions. So, the way we manage this risk is by having, for example, only reasonable portfolio exposure to energy-sensitive companies like travel-related names. The same logic applies to interest-rate risk for banks, regulatory risk for health-care companies, labor cost risk for retailers, supply-chain risk for semiconductor-equipment manufacturers, etc.

A FOCUS ON INFLATION

Although we've already touched on inflation, it deserves further consideration in the current environment. Many investors believe the best way to protect and grow capital amid high inflation is to own a large allocation of energy and materials companies that are perceived to have strong pricing power. But most of these companies only have strong pricing power in the short term as commodity costs are spiking. Over the long term, we've found that most energy and materials companies operate with low pricing power because they have poor business models and few competitive advantages. Moreover, we refuse to invest in such companies based on macro events for which we have no unique insights.

We think a better way to invest amid inflation is to own high-quality, well-managed companies that have an edge and that are taking share in expanding markets over the long term. After all, the best employees will be attracted to such companies—and customers will be agreeable to paying premium prices for premium products and services. But unlike energy and materials companies that may have pricing power in the short term, high-quality growth companies may not have — or may not use — pricing power each and every quarter. This means there will periodically be excessive volatility in earnings and share prices even if a company is a great investment over time. And, as mentioned above, we attempt to use temporary share-price volatility for the Fund's long-run advantage.

DETAILS OF THE QUARTER

Trex Co., Inc. (TREX)

The greatest detractor from Fund performance for the first quarter was Trex Co., Inc., a manufacturer of high-performance composite (non-wood) decking and accessories. The company has continued to take market share in composite decking and from traditional suppliers of wood products, which have shorter lifespans and require extra upkeep compared to composites.

Although higher energy and logistics costs squeezed margins in the company's most recently reported quarter, Trex was able to raise prices with little impact on demand. We believe the company's leading position in its product category leaves Trex well-positioned to pass along future cost increases as well. Moreover, higher oil prices aren't likely to significantly affect costs for the recycled plastic from which the company's products are made.

Despite these positives, the stock was down during the quarter based on what we think were two headwinds.

- First, there was nervousness surrounding companies like Trex that had thrived during the pandemic when homebound Americans chose to upgrade their living spaces.

- Second, fears of rising interest rates disproportionately impacted higher-growth and housing-related companies.

From our perspective, however, we continued to be impressed with the company's strong cash flows and we added to our position. In other words, we ran into the headwinds as other investors were running away.

Hamilton Lane, Inc. (HLNE)

Hamilton Lane, Inc., a traditional investment firm with approximately $850 billion in assets under management/supervision, was also a large detractor. The firm's financial data platform, Global Evergreen, has seen promising growth. Hamilton Lane recently reported that the platform accounted for nearly $1.6 billion in assets under management in just over two years since its launch. The success of Global Evergreen is indicative of why we like Hamilton Lane. And we expect this well-run firm will continue to expand quickly. But during the quarter, the stock pulled back on fears of higher interest rates and a temporarily deteriorating environment for raising assets.

Medpace Holdings, Inc. (MEDP)

Another significant detractor was Medpace Holdings, Inc., which provides clinical research services for biotechnology companies. The stock was weak because, despite strong fourth- quarter results, Medpace indicated that request-for-proposal (RFP) volume was down in January. Some investors interpreted this as meaning new bookings could be weak in the coming months. For our part, we have seen such concerns before and know that Medpace's pipeline can be volatile. Moreover, RFP volume isn't even a standard reporting metric because it's unreliable.

Based on other metrics and our company-specific research, we continue to have a positive outlook for Medpace. In addition to admiring the company's business model, management team and solid balance sheet, we like the fact that Medpace serves small biotechnology firms and gives us some exposure to biotech without the often "all or nothing" nature of the industry. Therefore, we increased our position size amid weakness in the stock price.

HealthEquity, Inc. (HQY)

The top contributor to Fund performance for the first quarter was HealthEquity, Inc. The company is the largest U.S. non-bank custodian for health-savings accounts (HSAs). Account holders have online access to their tax-advantaged HSAs and can compare treatment options, pay medical bills, earn wellness incentives, and receive personalized benefit and clinical information. HealthEquity reported strong growth in its HSA business, with total HSA assets increasing 37% year-over-year and the number of HSAs on the company's platform up 25% from a year ago. Management's upwardly revised forecasts for revenues and earnings in the current fiscal year also cheered investors. We believe HealthEquity is largely insulated from supply-chain constraints and rising materials costs, and is well-situated for an environment of higher interest rates.

Intra-Cellular Therapies, Inc. (ITCI)

Intra-Cellular Therapies, Inc. was also a contributor. The company develops therapeutics for disorders of the central nervous system. Intra-Cellular reported robust prescription growth for Caplyta, which recently was approved for the treatment of bipolar depression in adults. Previously labeled only for schizophrenia, the drug's appeal for treating bipolar depression is significantly enhanced by its favorable safety and tolerability profile. Intra-Cellular remains focused on maximizing Caplyta's potential, seeking to expand its approval to other areas that include major depressive disorder, certain neurologically based sleep disorders and Parkinson's disease. A post-Covid environment in which patients are less hesitant to attend in-person consultations with their health-care providers should also support prescriptions. And now that Intra-Cellular has proven the efficacy of its intellectual property, we view the company as a developing pharmaceutical business rather than as a biotech "lottery ticket."

Holley, Inc. (HLLY)

Another contributor was Holley, Inc., which designs, manufactures and sells high-performance automotive parts for car and truck enthusiasts. The company's loyal customer base, healthy margins and specialized product offerings have enabled it to pass along higher costs and better withstand the impacts of inflation— especially compared to other businesses that lack the same pricing power. Investors reacted positively to Holley's most recent round of acquisitions, which are expected to help unlock new and large markets of strategic importance to the company. Holley's latest earnings report confirmed its organic growth profile, further underpinning confidence in the company's future prospects. Holley is a former special-purpose acquisition company (SPAC), and there have been general concerns over SPACs because they usually issue warrants (options to purchase stock at a fixed price) that can dilute shareholder ownership down the road. For our part, we factor potential dilution into our analysis whenever we invest in a former SPAC. Regarding Holley specifically, last year we maintained our positive outlook for the company and we were rewarded in the first quarter of 2022. *(Current and future holdings are subject to risk.)*

OUTLOOK AND POSITIONING

Like investors everywhere, we at Wasatch often engage in elaborate discussions about world-wide events. These discussions, however, rarely lead to specific views on the road ahead. Conversely, we can always explain our evaluations of individual companies —and whether we should buy, sell or hold. That's why we usually confine our investment decisions to company fundamentals. But as described above, we also apply a risk-management overlay at the portfolio level.

As for the general investment environment, it's certainly possible that a heightened level of stock- market volatility will continue based on the macro events already described and new ones that may emerge. But you should also consider that some of our best investments over long stretches were in stocks that actually spent more time with lagging results than with leading returns. In these cases, the stocks' briefer periods of outperformance more than compensated for lengthier periods of underperformance. This is why it's important for investors to avoid being shaken out of their well-researched positions.

In our experience, we're unlikely to be shaken out of a holding if the company has:

1. a large and growing addressable market;
2. a defensible competitive advantage;

3. a unique business model; and,
4. an ability to consistently boost market share.

Because we're pleased with our current holdings based on these characteristics, we haven't made many changes to the Fund's portfolio recently. In fact, with stock prices having come down and with the well-publicized gap between growth and value having narrowed, our conviction in our names has actually increased.

More specifically, we can report that our companies' 2021 sales and earnings for the fourth quarter and for the full year mostly came in above expectations. Sales and earnings for the first quarter of 2022 haven't been released yet. But going forward, we continue to expect double-digit sales growth overall because positive demand trends have shown no signs of abating. Earnings growth may be a bit weaker due to rising costs for labor and other inputs that can't be immediately offset by charging higher prices.

Finally, we'd like to emphasize that despite recent challenges, corporate growth has continued to be quite strong. In fact, this is one reason for the Federal Reserve's decision to embark on a series of interest-rate hikes. And even after these hikes are factored in, U.S. monetary policy will still be fairly accommodative. Moreover, now that businesses have been tested by obstacles like supply-chain disruptions and rising costs, we think our companies in particular may have made competitive inroads and positioned themselves for even better market-share gains. As always, our job is to find great long-duration growth companies selling at reasonable stock prices.

Thank you for the opportunity to manage your assets.

Sincerely,

JB Taylor, Paul Lambert and Mike Valentine

AVERAGE ANNUAL TOTAL RETURNS FOR PERIODS ENDED MARCH 31, 2022

	Quarter*	1 Year	3 Years	5 Years	10 Years
Core Growth Fund—Investor	-15.92%	-3.62%	17.09%	16.32%	14.23%
Core Growth Fund—Institutional	-15.90%	-3.51%	17.23%	16.47%	14.35%
Russell 2000® Index**	-7.53%	-5.79%	11.74%	9.74%	11.04%
Russell 2000® Growth Index†	-12.63%	-14.33%	9.88%	10.33%	11.21%

CORE GROWTH FUND — TOP 10 HOLDINGS AS OF DECEMBER 31, 2021

Security Name	Percent of Net Assets
Morningstar, Inc.	3.5%
Trex Co., Inc.	3.2%
Medpace Holdings, Inc.	3.2%
ICON PLC	3.0%
Bank OZK	3.0%
Hamilton Lane, Inc., Class A	2.9%
CyberArk Software Ltd.	2.8%
Balchem Corp.	2.8%
Novanta, Inc.	2.7%
Kadant, Inc.	2.7%
Total	**29.6%**

Original Post

Uncover the next wave of FAANG stocks

Amazon has stalled. Facebook may never regain its highs.

But tech insider Beth Kindig and her team have identified the **bargain-priced stocks** that will lead us into a new era of tech.

These are the companies set for **rapid growth** in a data-driven, AI/ML-centric world.

Banks, media, healthcare, tech and other industries are spending billions on AI and ML. Facebook alone will spend **at least $10 billion this year** in its pursuit of the metaverse - and it plans to keep investing heavily over the next few years.

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Editor's Note: The summary bullets for this article were chosen by Seeking Alpha editors.

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Fund Letters

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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— 1.17% / Institutional Class—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. 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 Index is an unmanaged total return index of the smallest 2,000 companies in the Russell 3000 Index. 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. You cannot invest directly in these or any indexes.

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The Wasatch Core 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.

Earnings growth is a measure of growth in a company's net income over a specific period, often one year.
Sales growth is the increase in sales over a specified period of time, not necessarily one year.

A special purpose acquisition company (SPAC), also known as a "blank check company," is a company with no commercial operations that is formed specifically to raise capital through an initial public offering for the purpose of acquiring an existing 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.

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