

## Exploiting Market Inefficiencies For Long-Term Gains

With principal offices in Texas, First Cash Financial operates over 1,200 pawn shops in 14 U.S. states and in Mexico, El Salvador and Guatemala. Headquartered in San Diego, Bank of Internet (Bofi Holding) is an online-only bank with nearly \$8 billion in assets. Based in Israel, Caesarstone is a leading manufacturer and distributor of quartz countertops for kitchens.

None of these companies are household names. And all of them are often overlooked by investors and research analysts. They are typical, however, of the investments in the **Wasatch Micro Cap Value Fund (WAMVX)** managed by Brian Bythrow. Under his direction, the Fund invests primarily in value companies with market capitalizations of less than \$1 billion. Up to 30% of the Fund may be invested in international companies.

Brian seeks companies that he considers to be undervalued relative to their industry group and that he expects will grow faster. He works closely with the entire team of Wasatch portfolio managers and analysts to identify suitable investments for the Fund. “Sometimes my colleagues come across an interesting company that’s too small for their fund, but is an attractive fit for mine. At other times, I’ll come across a company that’s outgrown the Micro Cap Value Fund, but would be just right for a small- or mid-cap fund.”

### **SPARSE ANALYST COVERAGE CREATES OPPORTUNITIES**

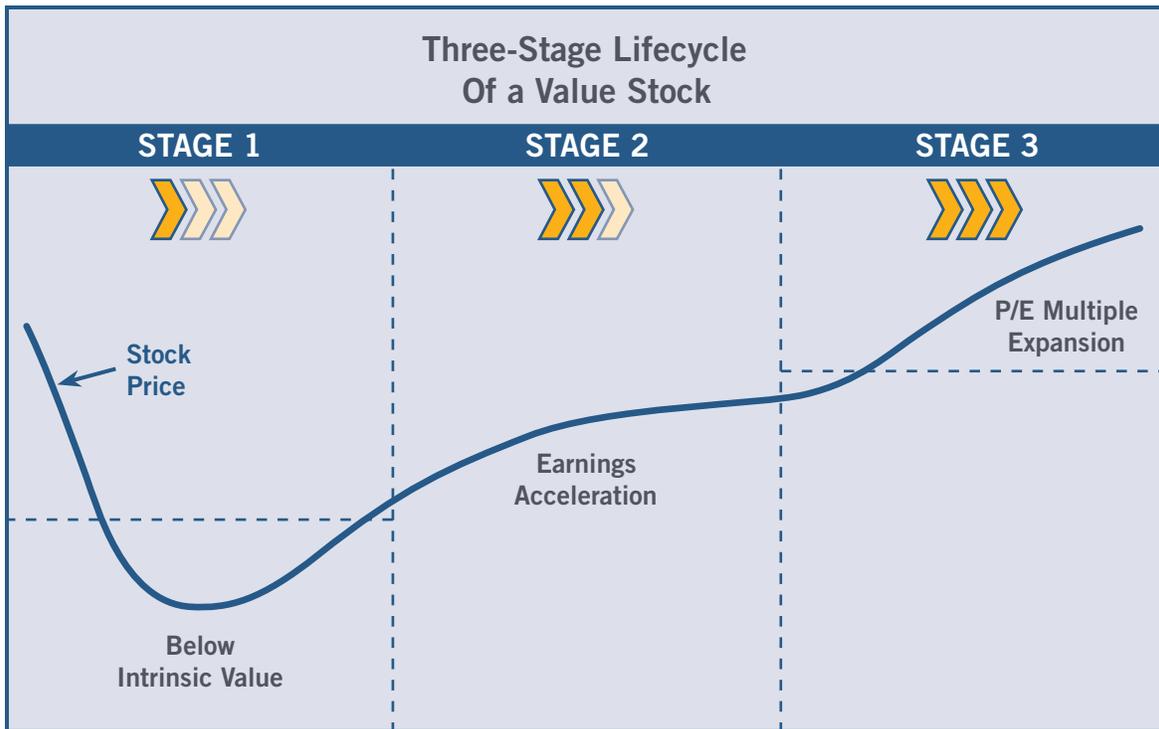
“I’m looking for companies that are modestly priced,” says Brian. “Not necessarily companies that represent

deep value, but those that are modestly priced. I’m looking for names that are not well-known on Wall Street or by other investors.” In fact, most micro-cap stocks have little or no analyst coverage. According to Furey Research Partners, companies with market caps below \$300 million have, on average, just a single analyst covering them. More than 60% of these same companies have absolutely no analyst coverage at all. Without sufficient analyst coverage, markets may not accurately reflect the value of a stock, creating opportunities to acquire good companies at significant discounts to their true worth. Such markets are said to be inefficient.

Starting with a universe of modestly priced and inexpensive stocks, Brian examines each company in turn. “It’s as if we’re miners. We turn over a lot of stones. Most of them are just rocks, but occasionally, we turn over something and find gold.”

Wasatch’s research process includes visits with company management. “We visit almost all the companies in the Fund eventually, though not necessarily right away. It doesn’t have to be day one, but within a year, we’ve seen them at their site, at a conference or in our office.”

Ideally, he says, the Fund will buy companies that are relatively low-priced, but will soon start, or have already begun, growing earnings. “If we latch onto something really special, we think that with time other investors and portfolio managers will discover it. If everything works perfectly, the increased demand will lead to price-to-earnings multiple expansion along the way.”



Source: Wasatch Advisors. This is a hypothetical representation of the three-stage lifecycle of a value stock. To value investors, a stock's intrinsic value is what is believed to be its "actual" value based on examination of the company's fundamentals. There is no guarantee that a value stock's price will increase.

## UNDISCOVERED GEMS, FALLEN ANGELS AND VALUE MOMENTUM COMPANIES

**First Cash Financial**, says Brian, is illustrative of the process. One of the Fund's first portfolio holdings, the company was small, value-priced and controversial. With a market cap of about \$100 million at the time of purchase, its business was evenly split between pawn shops and payday lending. Despite growing at 15% to 20%, the regulatory risk associated with payday lending kept the stock price low. Over the years, the company successfully expanded its pawn-shop business into Mexico and began to exit the payday-loan business. As the company did that, earnings growth accelerated, and investors noted the reduced regulatory risk and began paying a higher price-to-earnings multiple for the stock.

The Fund exited its position at one point, Brian notes, when First Cash Financial "made a wrong turn" and entered the used-car business. When the company got rid of the used cars, Brian reestablished a position for the Fund until exiting again in early 2013.

When he initially purchased First Cash Financial, Brian says it was an example of an *Undiscovered Gem*, defined by Wasatch as a company with excellent growth potential that's gone unnoticed by all but relatively few investors. Although he says most of the current holdings in the

Fund were Undiscovered Gems when purchased, Brian says he also looks for *Fallen Angels* and *Value Momentum* companies. Fallen Angels are what Wasatch considers to be high-quality growth companies that have experienced a temporary setback and thus have appealing valuations relative to their long-term growth potential. Value Momentum companies have a low valuation relative to their history, but a catalyst for future growth has been identified.

Brian is especially selective when it comes to banking stocks held in the Fund, judging most banks to be more alike than different. For example, **Bank of Internet (Bofi)** piqued his interest with a unique approach. As its name implies, Bofi operates its business over the Internet. Brian believes Bofi is misunderstood and underappreciated by other investors because it's not a traditional bank.

Having started his financial career as a credit analyst, Brian was interested to see how Bofi stacked up against the four Cs of credit, the guideposts used to analyze the creditworthiness of a borrower. The four Cs of credit are:

- Character of the borrower
- Cash flow/capacity of the borrower to repay
- Capital assets of the borrower
- Collateral pledged by the borrower

According to Brian, local brick-and-mortar banks have an advantage relative to Bofi when it comes to assessing

**Wasatch Micro Cap Value Fund**  
**Top 10 Holdings**  
As of March 31, 2016

Holding	Sector	Country	% of Net Assets
Fabrinet	Information Technology	United States	1.5%
LGI Homes, Inc.	Consumer Discretionary	United States	1.3%
Ebix, Inc.	Information Technology	United States	1.3%
Atlas Financial Holdings, Inc.	Financials	United States	1.2%
Customers Bancorp, Inc.	Financials	United States	1.2%
John B. Sanfilippo & Son, Inc.	Consumer Staples	United States	1.2%
NV5 Global, Inc.	Industrials	United States	1.2%
Chefs' Warehouse, Inc. (The)	Consumer Staples	United States	1.1%
Turk Tuborg Bira ve Malt Sanayii A.S.	Consumer Staples	Turkey	1.1%
Blue Hills Bancorp, Inc.	Financials	United States	1.1%
<b>Total</b>			<b>12.1%</b>

Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Fund or its Advisor. Current and future holdings are subject to risk.

the first two bullet points, as they are more likely to know their customers. To compensate for lack of personal contact with the customer, BofI has to do a better job of getting collateral than the average community bank. Compared to a 70% to 80% loan-to-value ratio for a typical lender, BofI's loan-to-value ratio is in the 50% to 60% range on the jumbo mortgage loans it predominantly makes. Few borrowers would walk away from a loan with that much of their own capital at stake. BofI's expertise in this area was evident during the Global Financial Crisis. In the midst of the downturn, many banks suffered losses because they underestimated how bad things could get and found they weren't holding enough collateral. In contrast, BofI's losses were much lower than those of traditional banks.

BofI has had tremendous growth over the past 10 years. Today, Brian continues to like the business model and believes the management team is executing well. He sees the stock as attractively valued and the company's growth prospects as strong.

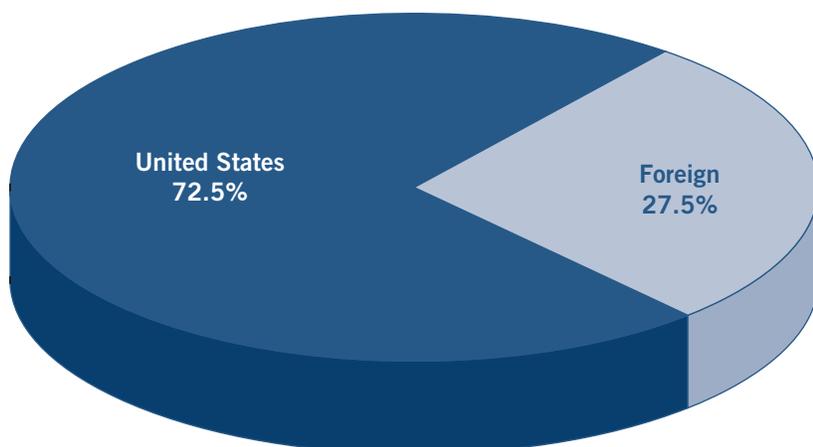
Quartz-countertop producer **Caesarstone** is an example of both a Value Momentum and an international holding in the Fund. Brian says he first took notice of the company as it was preparing for its initial public offering

(IPO). "We look at companies that are coming public, but they tend to be these really growthy and expensive IPOs and we pass on them. Still, we like to look because there might be an opportunity if they miss earnings expectations. In this case, Caesarstone was going public and not many investors wanted it."

The company showed potential, Brian explains. "The valuation was low, homeowners were still buying granite countertops and I thought, 'These guys are underappreciated.'" Quartz countertops were just starting to make inroads into the market at the time, it looked like a decent business and Brian decided to buy. Since then, quartz has taken more than 80% of the market in Israel and 30% in Australia. Several years ago, Caesarstone entered the U.S. market, which now accounts for about 40% of its sales.

"This stock was inexpensive. When I invested, I liked the earnings trend and I saw the company continuing to take market share," Brian says. Improvement in the housing market has provided a bit of a tailwind, he says, but mainly he believes this is a way to take advantage of home remodeling activity with Caesarstone gaining market share from companies offering granite and other forms of countertops.

## Wasatch Micro Cap Value Fund Country Weights



Source: Wasatch Funds, as of March 31, 2016.

Foreign Country	% of Net Assets
United Kingdom	5.0%
Japan	3.8%
India	2.2%
Sweden	2.2%
France	1.9%
Israel	1.9%
Germany	1.8%
China	1.5%
Turkey	1.3%
Malaysia	1.2%
Singapore	1.1%
Australia	0.9%
Philippines	0.8%
Argentina	0.6%
Canada	0.5%
Taiwan	0.5%
Korea	0.3%

### FOREIGN COMPANIES ADD QUALITY

An international business, Caesarstone has lots of company in the Fund's portfolio. Typically, Brian maintains about a 25% allocation to international stocks, though he occasionally takes this up to 30%, the Fund's ceiling. These stocks have performed well over the long term, Brian says, often contributing as much as a third of the return. "They've definitely proved their worth," he says. "They've carried their weight and then some."

Brian says the foreign companies tend to be of better quality than the micro caps found in the U.S., where he often sees low return on equity, low inside ownership and little or no dividend. In contrast, he says, foreign micro-cap companies typically have a dividend, significant inside ownership and a stellar balance sheet. "The quality level is a notch higher," says Brian. "If I found the same company in the U.S., it might be twice the price."

To uncover investments overseas, Brian relies on and often travels with the Wasatch international team. As he does in the U.S., he'll target a particular area, run screens for companies that meet his criteria and call on management. "With the international names, I'm searching mainly for undiscovered growth that looks like it has a good runway ahead of it," he says.

Foreign companies can be a little tougher to trade, he says, adding that he views this as a positive. "If you're right on your thesis that people will want to own the name because the company is doing something special,

illiquidity now will pay off later when the stock is more liquid."

Brian also notes that with international investments, you have to live with currency fluctuations and political noise. "We're not going into a foreign stock to make a bet on a particular market or country. We're trying to find a good, undiscovered micro-cap growth company at a reasonable price. With time, the rest usually works out."

### A THREE-PRONGED SELL DISCIPLINE

If an investment is successful, it will eventually grow out of the micro-cap space. To maintain the Fund's median market capitalization at around \$500 million, Brian will begin selling a company when it reaches a market cap of approximately \$1.5 billion and totally exit a position by the time it reaches about \$2 billion. Those limits are somewhat higher today than they were several years ago. "We realized that we were selling companies too early. In a perfect world, if the stock is doing well and it's not too expensive, we'll just leave it alone and see if we can capture some excess return for shareholders."

In some cases, a holding may transition from one Wasatch fund to another. A company that has become too big for the Micro Cap Value Fund may still have considerable growth potential. In that case, the **Wasatch Small Cap Value Fund (WMCVX)** or the **Wasatch Ultra Growth Fund (WAMCX)** may find it attractive and initiate a position. This is an example of Wasatch's collaborative process.

A second reason that Brian will sell is valuation. While it often takes years for a company's market capitalization to grow from say \$500 million to \$1.5 billion, occasionally the stock will make a sudden move and become expensive. Rather than risk an equally sudden decline, he'll usually sell. At some point, if the price falls and he still likes the company, he may buy it back.

A third reason to sell is when it becomes apparent that an investment simply isn't succeeding. When that happens, Brian says he'll reevaluate the company and he may decide to move on. "You just know that a certain percentage of these names aren't going to work out. That's simply the reality of it. So we'll sell and redeploy the capital to what we think is a better name."

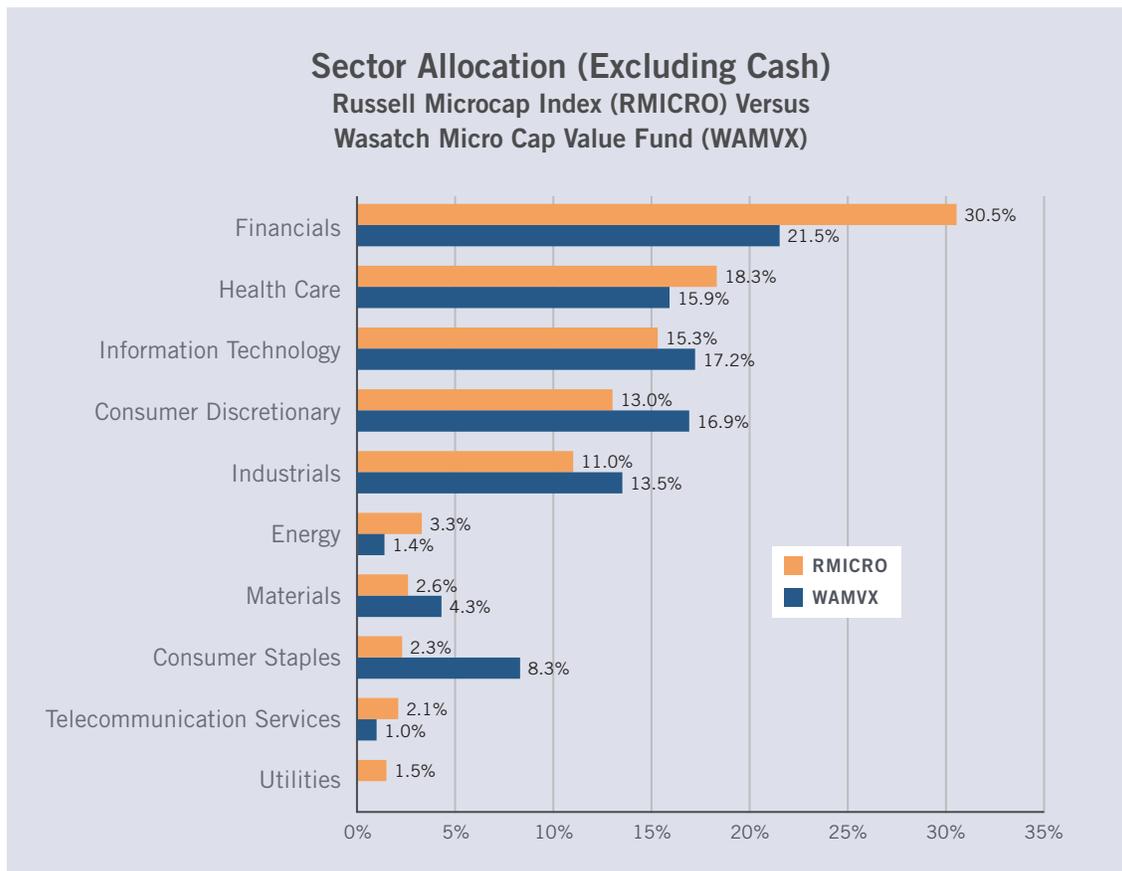
**Electromagnetic Geoservices**, a Norwegian company, is an example of an investment that didn't pan out. Brian says the company appeared to have attractive technology that enhanced seismic data used in oil exploration. The company had good sales and earnings growth, but wasn't well-known. After Brian invested, its business partially dried up. It seems that the company had a lot of trial orders that weren't renewed. To some customers,

the technology is apparently not worth what it costs, says Brian. The Fund took a loss on that one, Brian acknowledges, but it's more often the case that an unsuccessful stock pick is relatively stagnant or moves up very slowly.

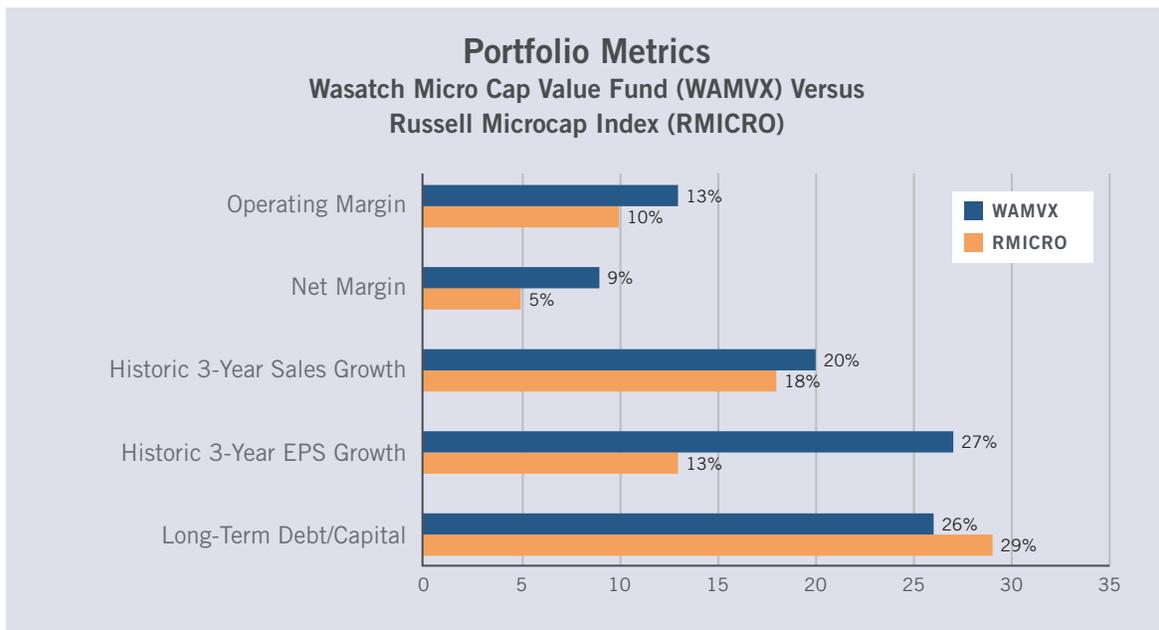
### MANAGING RISK IS CRUCIAL

Brian says that he strives to manage the portfolio's overall risk. Early in his career, he worked for another asset-management firm that posted strong results based on the performance of a number of expensive growth stocks. Over time, he says, the wheels started coming off. "One stock was down about 50% on an earnings miss; another dropped around 50% on an accounting restatement. When the time came to manage my own Fund, I decided I didn't want to own companies that had to live up to high expectations.

"If I invest in companies that are smaller, less known and less covered, then, if things don't work out, I think we're less likely to experience as steep of a decline. Hopefully, we'll be more likely to just have a stock that hasn't gone anywhere for a period of time."



Sources: Wasatch Funds and FactSet, as of March 31, 2016. Current and future holdings are subject to risk and may change at any time.



Sources: FactSet, Russell and Wasatch Advisors, as of March 31, 2016. Past performance is not indicative of future results. Portfolio metrics are subject to change.

Brian screens companies carefully using a variety of metrics including their EV (enterprise value)-to-EBITDA (earnings before interest, taxes, depreciation and amortization) or their EV-to-sales ratios. Enterprise value, an industry standard for determining the worth of a company, is calculated by taking the market value of that company, subtracting its cash and adding its debt.

When you look at micro caps as a category, Brian says, they tend to be less expensive than the overall market because they are less liquid. “So, the trick is, if you can find companies that are growing faster than the average company, eventually they’ll attract attention. When they do, the stock becomes more liquid and the price can rise significantly.”

Micro caps, he says, comprise an asset class that has historically delivered above-average returns. Brian acknowledges that there’s volatility: “When people don’t want micro caps, they might flee to large caps. But that doesn’t mean our companies aren’t performing well. And if you look at the long-term returns, you’ll see that micro caps have done better than most of the market since the Russell Microcap Index was created.”\*

*\*Micro caps, as represented by the Russell Microcap Index, had an average annual total return through March 31, 2016 of 6.27% since the inception of the Index on June 30, 2000. The market, as represented by the S&P 500® Index, had an average annual total return over the same time period of 4.24%.*

Source: Morningstar.

## ABOUT THE PORTFOLIO MANAGER



Brian Bythrow, CFA  
Lead Portfolio  
Manager

**Brian Bythrow** is the Lead Portfolio Manager for the Wasatch Micro Cap Value Fund. He joined Wasatch Advisors in 2003 and became a Portfolio Manager for the Micro Cap Value Fund at its inception later that year.

From 1998 to 2003, Mr. Bythrow was a portfolio manager for the Monogram Special Equity Fund, where he also managed separate account large-cap value portfolios. Earlier, he was an equity analyst with Parkstone Funds and a credit analyst with Shoreline Bank.

Mr. Bythrow earned a Master of Business Administration from California State University, Sacramento and a Bachelor of Science in Social Sciences from the United States Air Force Academy, where he received the Outstanding Cadet in Social Sciences award for being the top graduate in Social Sciences. He is also a CFA charterholder.

Mr. Bythrow served as a communications/computer officer from 1989 to 1994 in the United States Air Force, where he was awarded the Meritorious Service Medal and obtained the rank of Captain. While in the Air Force, he was the leader of the United States Air Force International Rifle Shooting Team and set several individual and team records for marksmanship.

Brian is a Michigan native who enjoys spending time with his family outdoors, golfing, hiking and hunting. He is also very involved in the community — teaching free personal-finance courses in local community centers and churches, and actively supporting charities that operate orphanages and adoption services around the world.

### ABOUT WASATCH ADVISORS®

Wasatch Advisors is the investment manager to Wasatch Funds, a family of no-load mutual funds, as well as to separately managed institutional and individual portfolios. Wasatch Advisors pursues a disciplined approach to

investing, focused on bottom-up, fundamental analysis to develop a deep understanding of the investment potential of individual companies. In making investment decisions, the portfolio managers employ a uniquely collaborative process to leverage the knowledge and skill of the entire Wasatch Advisors research team.

Wasatch Advisors is an employee-owned investment advisor founded in 1975 and headquartered in Salt Lake City, Utah. The firm had \$15.9 billion in assets under management as of March 31, 2016. Wasatch Advisors, Inc. is registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940.

## Wasatch Contacts

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### RISKS AND DISCLOSURES

Investing in micro 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 [www.WasatchFunds.com](http://www.WasatchFunds.com) or call 800.551.1700. Please read it carefully before investing.***

*Information in this document regarding market or economic trends or the factors influencing historical or future performance reflects 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 Micro Cap Value Fund's investment objective is long-term growth of capital.*

*As of March 31, 2016, the Wasatch Micro Cap Value Fund held 1.0% of its net assets in BofI Holding, Inc. and 0.8% of its net assets in Caesarstone Sdot-Yam Ltd. (Israel). The Fund did not hold a position in First Cash Financial Services, Inc. or Electromagnetic Geoservices ASA as of March 31, 2016.*

*Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Funds or their Advisor. Current and future holdings are subject to risk.*

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### DEFINITIONS

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

**Earnings-per-share or EPS** is the portion of a company's profit allocated to each outstanding share of common stock. EPS growth rates help investors identify companies that are increasing or decreasing in profitability.

**Enterprise value (EV)** is an industry standard for determining the worth of a company, and is calculated by taking the market value of that company, subtracting its cash and adding its debt.

**The EV (enterprise value)-to-EBITDA (earnings before interest, taxes, depreciation and amortization) ratio** is enterprise value, as defined above, divided by annual EBITDA. **The EV (enterprise value)-to-sales ratio** is enterprise value, as defined above, divided by annual sales. Each ratio is a measure of a company's expensiveness.

An **initial public offering (IPO)** is a company's first sale of stock to the public.

**Long-term debt to capital** is a company's debt as a percentage of its total capital. Debt includes all short-term and long-term obligations. Total capital includes the company's debt and shareholders' equity, which includes common stock, preferred stock, minority interest and net debt.

**Net margin**, also known as the profit margin, is a measure of a company's profitability and an indicator of a company's pricing policies and its ability to control costs. It is calculated by dividing revenue into the company's net profit after taxes.

**Operating margin** equals operating income divided by revenues, expressed as a percentage.

The **price-to-earnings (P/E) multiple**, also known as the P/E ratio, is the price of a stock divided by its earnings per share.

**Return on equity (ROE)** measures a company's efficiency at generating profits from shareholders' equity.

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

The **Russell Microcap Index** is an unmanaged total return index of the smallest 1,000 securities in the small cap Russell 2000 Index plus the next smallest 1,000 securities, based on a ranking of all U.S. equities by market capitalization. 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.

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The **S&P 500 Index** represents 500 of the United States' largest stocks from a broad variety of industries.

You cannot invest directly in these or any indices.