

Micro Cap Value: Exploiting Market Inefficiencies For Long-Term Gains

With principal offices in Texas, First Cash Financial operates over 275 pawn shops in 12 states and 550 more in Mexico. Based in Israel, Caesarstone is a leading manufacturer and distributor of quartz countertops for kitchens. Headquartered in San Diego, BofI Holding (Bank of Internet) is an online-only bank with nearly \$3 billion in assets.

None of these companies is a household name. 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 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/earnings multiple expansion along the way.”

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, 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/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 first 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.

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, most 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. A few years ago, Caesarstone entered the U.S. market, which now accounts for about 40% of its sales.

“This is not a great long-term growth stock, but it was inexpensive, I like the earnings trend and I see them 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 taking market share from companies offering granite and other forms of countertops.

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 looking mainly for pure 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 are trying to find a good little 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 a recent 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."

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 September 30, 2013 of 7.30% since 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 3.06%. Source: Morningstar.*

Average Annual Total Returns

For Periods Ended September 30, 2013

	1 Year	3 Years	5 Years	10 Years	Since Inception 7/28/2003
Wasatch Micro Cap Value Fund	33.92%	17.05%	16.32%	12.42%	12.68%
Russell Microcap® Index	32.12%	19.66%	11.12%	7.55%	8.21%
Russell 2000® Index	30.06%	18.29%	11.15%	9.64%	9.91%

Source: Wasatch Funds.

Data shows past performance. Past performance is not indicative of future performance, and current performance may be lower or higher than the performance quoted. For the most recent month-end performance data, visit www.WasatchFunds.com. Investment returns and principal value will fluctuate; and shares, when redeemed, may be worth more or less than their original cost. The Advisor may absorb certain Fund expenses, leading to higher shareholder returns. Expense Ratio—Gross: 2.32% / Net: 2.26%. The Advisor has contractually agreed to limit expenses to 2.25% through at least January 31, 2014.

Wasatch Funds will deduct a 2.00% redemption proceeds fee on Fund shares held 60 days or less. Performance data does not reflect the deduction of fees, including sales charges, or the taxes you would pay on fund distributions or the redemption of fund shares. These fees and taxes, if reflected, would reduce the performance quoted. Wasatch does not charge any sales fees. For more complete information, including charges, risks and expenses, read the prospectus carefully.



Overall Rating



Wasatch Micro Cap Value Fund

(out of 615 small growth funds as of September 30, 2013)

Total Return Percentile Rankings (9/30/2013)	1 YEAR	3 YEAR	5 YEAR	10 YEAR
Micro Cap Value Fund WAMVX (Small Growth)	Top 19% (695 funds)	Top 76% (3 stars/615 funds)	Top 15% (4 stars/546 funds)	Top 4% (5 stars/359 funds)

For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of the funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.)

Morningstar percentile rankings are based on a comparison of a fund's total return performance against its peers over the stated time period. Past performance is no guarantee of future results. © 2013 Morningstar, Inc. All rights reserved. The information contained herein (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete, or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

ABOUT WASATCH ADVISORS®

Wasatch Advisors is the investment manager to Wasatch Funds,® a family of no-load mutual funds, as well as 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 \$17.9 billion in assets under management as of September 30, 2013. Wasatch Advisors, Inc. is registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940.

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RISKS

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. 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 or call 800.551.1700. Please read it carefully before investing.

*Information in this report regarding market or economic trends or the factors influencing historical or future performance reflects the opinions of management as of the date of this report. 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 investment objective of the Wasatch Micro Cap Value Fund is long-term growth of capital. The primary investment objective of the Wasatch Small Cap Value and Wasatch Ultra Growth Funds is long-term growth of capital. Income is a secondary objective, but only when consistent with long-term growth of capital.

DEFINITIONS

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

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.

The **Price-to-Earnings or 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.

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.

As of September 30, 2013, the Wasatch Micro Cap Value Fund held 1.9% of its net assets in Caesarstone Sdot-Yam Ltd. (Israel) and 1.9% of its net assets in Bofl Holding, Inc. The Fund did not hold a position in First Cash Financial Services, Inc. or Electromagnetic Geoservices ASA (Norway) as of September 30, 2013.

As of September 30, 2013, the Wasatch Small Cap Value Fund held 1.3% of its net assets in Bofl Holding, Inc. and did not hold any of the other companies mentioned in this document.

As of September 30, 2013, the Wasatch Ultra Growth Fund did not hold any of the companies mentioned in this document.

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.