



## Wasatch World Innovators Fund (WAGTX)

Quarterly Comments from Lead Portfolio Manager Samuel S. Stewart, Jr., Ph.D., CFA and  
Portfolio Manager Josh Stewart

*Open to all investors*

### Average Annual Total Returns For Periods Ended September 30, 2015

	Quarter*	1 Year	3 Years	5 Years	10 Years
<b>World Innovators Fund</b>	-5.92%	0.32%	8.74%	11.81%	7.91%
<b>MSCI AC World IMI**</b>	-9.59%	-6.21%	7.20%	6.99%	4.84%

*\*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 [www.WasatchFunds.com](http://www.WasatchFunds.com). The Advisor may absorb certain Fund expenses, without which total return 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: 1.74%***

Total Annual Fund Operating Expenses include direct expenses paid to the Advisor as well as indirect expenses incurred by the Fund as a result of its investments in other investment companies (each an "Acquired Fund"), before any expense reimbursements by the Advisor. Wasatch Advisors has contractually agreed to reimburse the Fund for Total Annual Fund Operating Expenses in excess of 1.95% (excluding interest, dividend expense on short sales/interest expense, taxes, brokerage commissions, other investment related costs and extraordinary expenses in excess of such limitations) until at least January 31, 2016. See the prospectus for additional information regarding Fund expenses.

*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 or taxes, which if reflected, would reduce the performance quoted. For more complete information including charges, risks and expenses, read the prospectus carefully.*

**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.**

*This must be accompanied or preceded by a prospectus. Click [here](#) for a prospectus. Please read it carefully before investing.*

## Overview

Global equity markets moved from relative stability in the first half of the year to broad-based volatility and ultimately a moderate sell-off in the third quarter. Our global benchmark, the MSCI All Country World Investable Market Index (ACW IMI) sunk a full 13% at one point intra-quarter, only to finish the period with a loss of -9.59%. This poor performance dragged the annual change down into negative territory for the first time since 2011, putting the benchmark -6.21% lower than it was a year ago.

Meanwhile, the recent quarter and year have been periods of strong outperformance for the Fund, which was down -5.92% for the quarter but up 0.32% for the last year.

## Details of the Quarter

We think the high valuations<sup>†</sup> of many global assets are the root causes for stalling equity prices. High valuations make investors jittery and magnify every little piece of information that emanates from the U.S. Federal Reserve, China or whatever the headline du jour might be. The good news about flat and down market periods is that as long as companies execute their strategies and grow profits, then these periods mean better prices for investors.

In the Fund, we've seen dramatic improvements in the prices we're paying for our companies. Not only has our weighted-average price-to-earnings (P/E) multiple<sup>††</sup> dropped from about 27 times trailing earnings the previous quarter to 21 times, but that figure puts us below the benchmark's P/E of 22 times—which is the first time we've had a below-benchmark P/E since we implemented the World Innovators strategy. Unfortunately, some of the P/E improvements have come from falling share prices. But we've also rotated into some less-expensive stocks as we've been on red alert since about mid-2014 when international markets first started hinting at danger and investor sentiment began moving toward “risk-off,”<sup>†††</sup> defensive behavior.

Additions to the Fund and weighting changes in existing investments have favored companies that reflect classic quality characteristics—strong returns on investment, positive free cash flow and net-cash balance sheets. We continue to execute our strategy of investing in innovative companies taking market share. But recently when given the option between a rapid sales grower relying on external funding and a moderate grower chipping away market share one customer at

a time funded with internal cash flow, we've favored the latter. As a result, we're glad to report that along with better valuations, we've maintained or improved upon our quality metrics.

Our favorite quality metric is return on assets (ROA).<sup>‡</sup> The Fund and the benchmark finished the quarter with ROAs of 10% and 7%, respectively, unchanged from the prior period. However, we maintained our healthy lead in the return category while capturing faster profit growth. The Fund's EBITDA (earnings before interest, taxes, depreciation and amortization) growth as of quarter end was 7%, ahead of the benchmark's 5%—and a clear improvement over the previous period when those figures were 5% and 6%, with the Fund lagging. In terms of indebtedness, the weighted-average net debt-to-equity for the Fund was 33%, exactly half of the benchmark's 66%. Our last key metric, sales growth, did come in lower for the quarter at 10% compared to 12% for the prior period, but still outpaced the benchmark's 8%. Given decelerating global economic growth and current investor sentiment, we like the trade-off of a little less sales growth for a little more profit growth.

At the company level, we had a handful of investments that made significant positive contributions to performance, including **Activision Blizzard, Inc. (ATVI)**, **Bioventix plc**, **Gamma Communications plc** and **Google, Inc. (GOOGL)**. Bioventix and Gamma deserve a few sentences because they really illustrate the benefits of having an active global manager. These two British micro-cap companies were discovered in very different ways. We were planning a trip to visit companies in the United Kingdom (U.K.) in February of this year, and as usual we were scouring our destination for companies with the best quality metrics. For our first round of research, we use a basic computerized scoring screen that just looks at the companies by the numbers and gives them quality scores over time. Surprisingly, this tiny company—Bioventix with only 30 million British pounds in market cap—made the cut in style.

Bioventix really caught our eye because, although the name sounded very much like a biotech and the company description mentioned antibodies, the financials were night-and-day different. The vast majority of small-cap biotechs don't have steady sales or profits, and about the only financial metrics one can look at are the cash-burn rate and how much cash is left on the balance sheet before the company has a serious problem. Bioventix, on the other hand, had grown sales and profits smoothly for many years. And while total sales of 3.5 million British pounds in 2014 seemed inconsequential, more than half of that revenue made it to the bottom line! Furthermore, Bioventix pays a dividend and the yield was over 5% at the time we discovered the company.

(Most biotechs do not pay dividends.) So when we contacted our local broker to set up meetings for our trip, Bioventix was on our list.

Knowing the type of companies the Fund invests in, our broker practically begged us to have a look at a recent initial public offering (IPO)<sup>††</sup> in London called Gamma Communications. He explained that Gamma was kind of like Skype, selling IP-based communication services, but to organizations rather than to individuals. We told him we'd never heard of Gamma. On the other hand, we'd spent time researching similar U.S. companies, namely Vonage, 8x8, Inc. (EGHT) and RingCentral.<sup>†††</sup> While we'd always liked the businesses—smarter communications at much lower prices than the telco dinosaurs offered—the valuations never gave us enough margin of safety to be seriously considered as investments for the Fund. The broker told us that Gamma was far and away the market leader in the U.K., and had a P/E in the teens. Since the company was newly listed, it was not well known or understood by most investors. We told him to add Gamma to our list of meetings.

Both Bioventix and Gamma blew away our expectations when we met their leaders in person. It turns out that Bioventix sells antibodies to diagnostic companies and charges a royalty fee each time a test using one of its antibodies takes place. This creates nice, steady income streams for the company. Moreover, the number of income streams builds over time, as one to two tests using Bioventix antibodies tend to be launched each year. And, to date, none of the old tests has ever been replaced and shuttered. Our favorite part of our meeting with CEO Peter Harrison was when we asked him about his growth and hiring plans. As a large shareholder himself, he said he was happy with the 11 people in the company's lab and didn't want to do anything that would risk disrupting the chemistry at Bioventix. It was this last bit of conservatism that convinced us that, despite the market cap being smaller than anything else in the Fund, Bioventix would be an ideal investment.

Gamma Communications is run by Bob Falconer, who has the perfect pedigree to disrupt the huge, stodgy telecom/datacom industry. He was a vice president at Global Crossing during the dot-com bubble,<sup>§</sup> which was a terrible experience as he describes it. However, he now knows the competition inside and out. He spent a large part of the last decade piecing together underpriced assets that were being shed by telcos at fire-sale prices—all while maintaining a key differentiator, Gamma's "Policy of One."

Big telco competitors like BT Group and Vodafone Group are actually “Frankenstein” companies built via acquisition.<sup>†††</sup> The companies constantly suffer from slow speed to market and service challenges because their people, equipment and software have never been integrated under one umbrella. Gamma, on the other hand, developed all its software in-house. And while there have been acquisitions to obtain infrastructure (fiber, servers, switches, etc.), the services that run on top of the network are all internally developed. Gamma is extremely agile compared to its competitors and looks like it will be gobbling up market share with no end in sight for decades. Best of all was the reasonable share valuation. Despite the stock price being up about 50% since our best buys, Gamma is valued at approximately 25 times this year’s earnings. Gamma’s U.S. counterpart 8x8 trades for about 64 times earnings. And RingCentral, well that will cost you about 100 times estimated earnings for 2017.

Aside from providing a nice introduction to a couple of the best new companies we’ve found for our shareholders, we’d like to point out that there’s no algorithm to replace the type of bottom-up research we provide, at least not yet, and certainly this is not something an inexpensive exchange-traded fund (ETF)<sup>§§</sup> can offer.

Naturally, with global equity markets down during the quarter, we had several stocks detract from Fund performance. **Kroton Educacional S.A.** and **CBS Corp. (CBS)** were the most notable weak spots. Kroton, the largest private for-profit school operator in Brazil, made progress integrating the recently acquired second-largest player Anhanguera Educacional.<sup>†††</sup> But the country’s well-reported economic problems overwhelmed Kroton’s integration progress as investors became concerned about reductions in government support for education. There were no particular business developments behind the drop in CBS’s stock price. But many investors consider CBS to be a cyclical, bull-market<sup>§§§</sup> stock. As a result, the price was weak during the third quarter’s risk-off environment. (*Current and future holdings are subject to risk.*)

## Outlook

As always, we remain aware of macro themes that cause swings in investor sentiment. But above all, we spend our time focused on uncovering what we believe are the best companies—big and small—from around the world. And we invest the Fund’s assets in the ones we think the market has temporarily underpriced. We’re extremely pleased both as managers and shareholders that our strategy has delivered on Wasatch’s long-term goal to outperform in tough markets.

Finally, thank you for the opportunity you've given us to manage your savings, which we'll do our best to protect and grow.

Sincerely,

Sam Stewart and Josh Stewart

*\*\*The MSCI AC World IMI (All Country World Investable Market Index) is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of large, mid, and small cap companies across developed and emerging markets throughout the world. You cannot invest directly in this or any index.*

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*The Wasatch World Innovators Fund's investment objective is long-term growth of capital.*

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

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

*††† "Risk-off" is when investors become more cautious and take money out of the market, not being willing to risk it, thus risk off.*

*‡ 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.*

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

*‡‡‡ As of September 30, 2015, the Wasatch World Innovators Fund was not invested in Vonage Holdings Corp., 8x8, Inc., RingCentral, Inc., BT Group plc, Vodafone Group plc or Anhanguera Educacional Participacoes S.A.*

*§ The dot-com bubble, also referred to as the Internet bubble, was a rapid rise in the equity markets fueled by investments in Internet-based companies. During the dot-com bubble of the late 1990s, the value of equity markets grew exponentially, with the technology-dominated Nasdaq Composite Index rising from under 1,000 to 5,000 between 1995 and 2000.*

*§§ An Exchange-Traded Fund (ETF) is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on a securities exchange. ETFs experience price changes throughout the day as they are bought and sold.*

*§§§ A bull market is defined as a prolonged period in which investment prices rise faster than their historical average. Bull markets can happen as the result of an economic recovery, an economic boom, or investor psychology.*

<b>World Innovators Fund Top 10 Holdings as of June 30, 2015<sup>#</sup></b>	<b>Percent of Net Assets</b>
<b>Security Name</b>	
Abcam plc (United Kingdom)	4.2%
Mekonomen AB (Sweden)	3.7%
Capital One Financial Corp.	3.2%
Discover Financial Services	3.2%
Cognizant Technology Solutions Corp., Class A	2.8%
Advanced Medical Solutions Group plc (United Kingdom)	2.5%
Computer Programs and Systems, Inc.	2.5%
Take-Two Interactive Software, Inc.	2.5%
Valeant Pharmaceuticals International, Inc. (Canada)	2.2%
MasterCard, Inc., Class A	2.2%
Total	28.8%

<sup>#</sup>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.

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WAS003865 1/30/2016