

Africa: A Bright Outlook For the Dark Continent

In his book *Through the Dark Continent*, journalist and explorer Henry Morton Stanley was among the first to designate Africa “The Dark Continent.” This romantic name reflected the fact that, despite its proximity to Europe, Africa was a largely unknown and mysterious area of the world to 19th-century Europeans.

Perceptions of Africa as a backward, undeveloped land of harsh terrain and dim prospects have been slow to change. The truth is that Africa has made significant advancements in recent years, and each incremental improvement unlocks the potential for future improvement. In stark contrast to the notion of a dark continent, Africa today is home to millions of bright, motivated people whose primary goal is to seek better lives for themselves and their families.

Outdated attitudes and perceptions about Africa frequently overshadow the continent’s attractiveness for investment. However, the disconnect between perception and reality has created significant opportunities for investors willing to roll up their sleeves and put boots on the ground.

THE CONTINENT

Africa is the second-most populated continent, and the African people account for about 15% of the world’s total inhabitants. Between 1975 and 2000, Africa’s population expanded from 416 million to 811 million. And the continent’s population is now well over one billion, of which 355 million are already considered middle class. Most projections indicate that this population expansion will continue. Furthermore, according to economic data from the World Bank, Africa includes seven of the top 10 fastest-growing countries globally. Regarding resources, the continent has 12% of the world’s oil reserves and 42% of its gold.

When describing Africa, the continent is often divided into two broad regions: North Africa and sub-Saharan Africa. North Africa is generally considered to consist of Algeria, Egypt, Libya, Morocco, Tunisia and Western Sahara. Sub-Saharan Africa includes all of the other 48 African countries, which roughly sit below the Sahara Desert. And while it is located in the sub-Saharan region, South Africa is clearly more developed than the other sub-Saharan countries. At Wasatch Advisors, most of our investments are concentrated in the sub-Saharan region—including South Africa—for the reasons described below.

SUB-SAHARAN AFRICA — A REGION RICH IN POTENTIAL

Frontier markets and emerging small countries comprise what many consider to be a subset of emerging markets. This subset is usually less-developed and faster-growing than emerging markets in general. Moreover, sub-Saharan Africa is home to what we believe are some of the most-attractive frontier markets and emerging small countries throughout the world. For example, according to the World Bank, real GDP growth in sub-Saharan

Africa has averaged greater than 5% per year since 2001. And growth is expected to be even more robust in the years ahead. The International Monetary Fund (IMF) predicts that 10 of the 21 quickest-growing countries (based on real GDP) in the next five years will be in sub-Saharan Africa. As a whole, sub-Saharan Africa is the second-fastest growing region in the world, after Asia.

Even the relatively more-developed country of South Africa is benefiting from the sub-Saharan growth trajectory because many South African companies serve as conduits for the broad region. To some extent, companies in North Africa—in Morocco, for example—are also benefiting from their proximity to the sub-Saharan region.

Drivers for economic growth in sub-Saharan Africa include:

- Young, expanding populations
- Urbanization and nascent consumer economies
- Greater political stability and better economic policies
- Advancements in education
- New investment by South African companies, multinational corporations and foreign governments
- Gradually improving infrastructure and power-sector reform
- Low levels of debt among consumers, corporations and governments

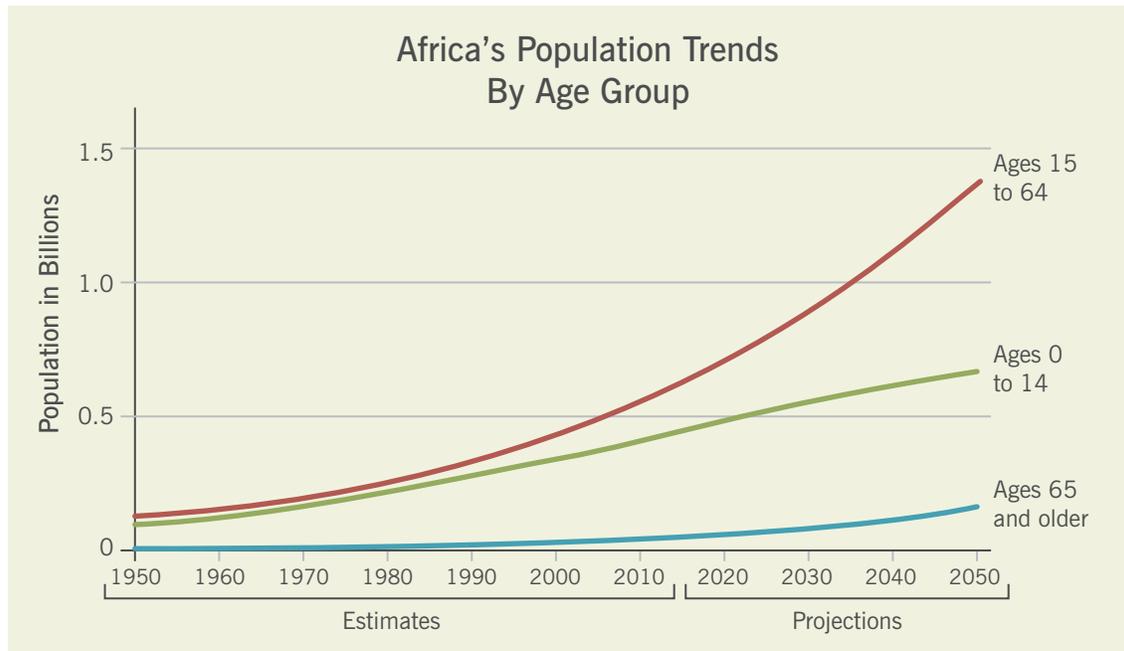
At Wasatch Advisors, we believe sub-Saharan Africa has made significant social and economic progress, and is now poised for a new wave of economic development that can fully unlock the potential of its attractive demographics and rich natural resources. In fact, we think certain sub-Saharan countries have the type of potential today that China had about a decade ago.

In addition to the drivers for economic growth, sub-Saharan Africa offers investors the following advantages:

- A healthy business environment with a rapidly improving communications network, which helps companies expand more quickly
- Comparatively low analyst coverage, which means that stocks are often less efficiently priced
- Smaller investments from the passive emerging-markets index funds that tend to cause more-volatile stock prices due to their unpredictable cash flows
- High levels of stock ownership by corporate insiders and by local pension funds
- Rising trading volumes on the local stock exchanges, which improve liquidity
- Relatively low correlations between countries and companies, which help diversify an investor's portfolio

A FAVORABLE DEMOGRAPHIC WINDOW

In developing countries like those in Africa, mortality rates fall as health, nutrition and incomes improve. Families respond by having fewer children, because the importance of children as wage earners diminishes relative to the financial costs of raising them. So, ultimately, fertility rates decline along with falling mortality rates. However, the long lag between the drop in mortality and the drop in fertility creates a population explosion in which the number of young people increases rapidly. In fact, the average African is currently only 19 years old. And by 2050, the population of Africa will approximately double to about two billion people. The favorable demographic trends can be seen in the graph below.



Source: United Nations, Department of Economic and Social Affairs, Population Division (2011): World Population Prospects: The 2010 Revision. UN estimates for 1950 to 2010. UN projections based on medium-fertility variant for 2015 to 2050.

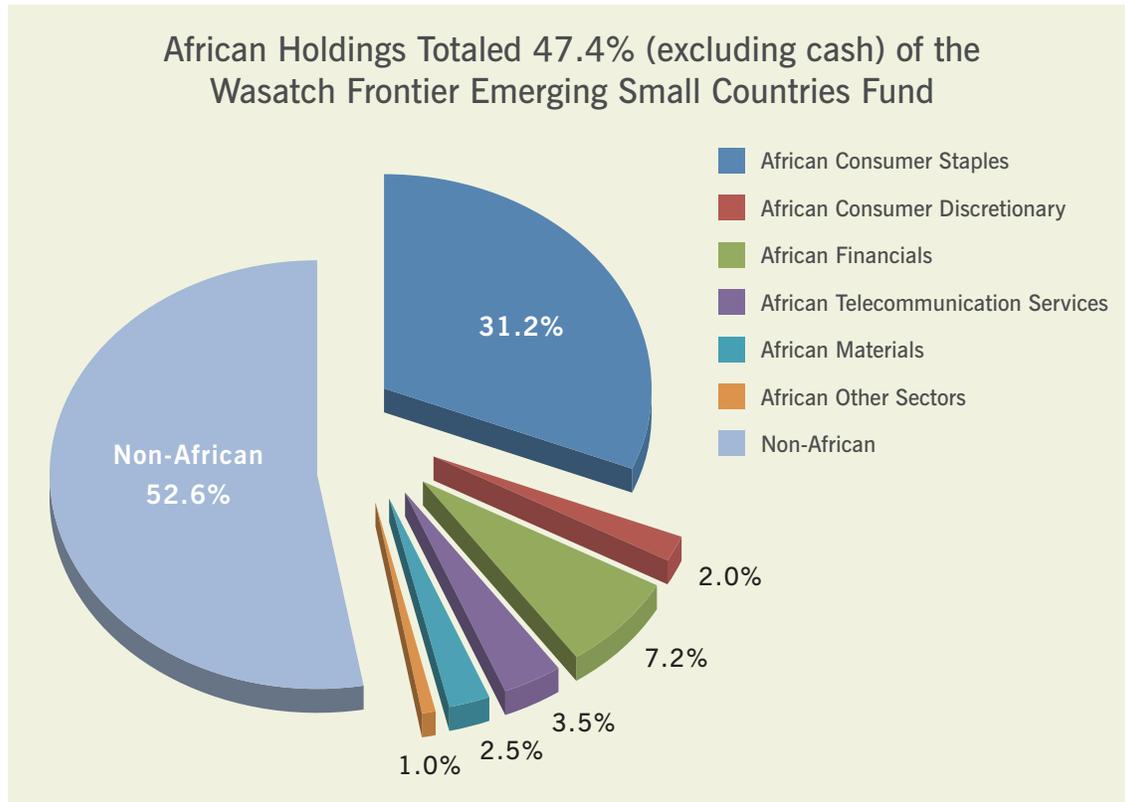
The most-obvious benefit is a burgeoning labor force from which businesses can draw without putting upward pressure on wages. An important spin-off effect is an increase in per-capita GDP resulting from the higher percentage of working individuals in the population relative to dependents (children and those over 65). The falling ratio of dependents per worker also boosts savings and investment.

Greater levels of productive investment in facilities and equipment—especially when combined with an expanding labor pool—act as a high-powered fuel to drive a developing economy for decades into the future. Regarding Africa’s education system, secondary school enrollment increased by almost 50% between 2000 and 2008. As a result, Africa has a **growing, increasingly well-educated population** with relatively **few older people depending on young workers** and an environment of **rising productivity**. This is a powerful combination that’s not found in many areas of the world.

Another important factor is that the level of debt in Africa is remarkably low, which is one less impediment to future growth. So while much of the developed world has entered a period of slower growth and is struggling to pay off its debt, Africa is **relatively unburdened by debt** and is in the early stages of what’s likely to be a multi-decade period of rapid economic expansion. Foreigners have begun to recognize this economic potential. From 2000 to 2012, foreign direct investment in Africa went from about \$9 billion to more than \$80 billion.

AFRICAN HOLDINGS IN SELECT WASATCH FUNDS

As displayed in the following pie chart, the **Wasatch Frontier Emerging Small Countries Fund (WAFMX)** has substantial African holdings that include **consumer-related** companies positioned to hopefully benefit from **urbanization** and growing **domestic (home-country) demand**.



Source: State Street, as of June 30, 2013. 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 table below shows the smaller, but still substantial, weightings (excluding cash) in African holdings for the **Wasatch Emerging Markets Select Fund (WAESX)** and the **Wasatch International Opportunities Fund (WAIIX)**. Also included in the table are the top three sector weightings represented by the funds' African holdings.

African Holdings and Top Three Sector Weightings (excluding cash)

| Fund | % of Fund in African Holdings | Top Three Sectors Represented by African Holdings | |
|---|-------------------------------|---|------|
| Wasatch Emerging Markets Select Fund | 12.7% | Consumer Staples | 3.4% |
| | | Health Care | 3.3% |
| | | Consumer Discretionary | 3.1% |
| Wasatch International Opportunities Fund | 9.2% | Consumer Discretionary | 5.7% |
| | | Information Technology | 1.6% |
| | | Industrials | 1.3% |

Source: State Street, as of June 30, 2013. 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.

While the three Wasatch funds presented here have exposure to Africa, it's important to note that the exposure in each of these funds is driven strictly by the investment potential that we see currently. Over time, the exposures will vary with our assessment of valuations and our outlook for future conditions.

COMPLEMENTARY FUNDS WITHIN AN INVESTOR'S DIVERSIFIED PORTFOLIO

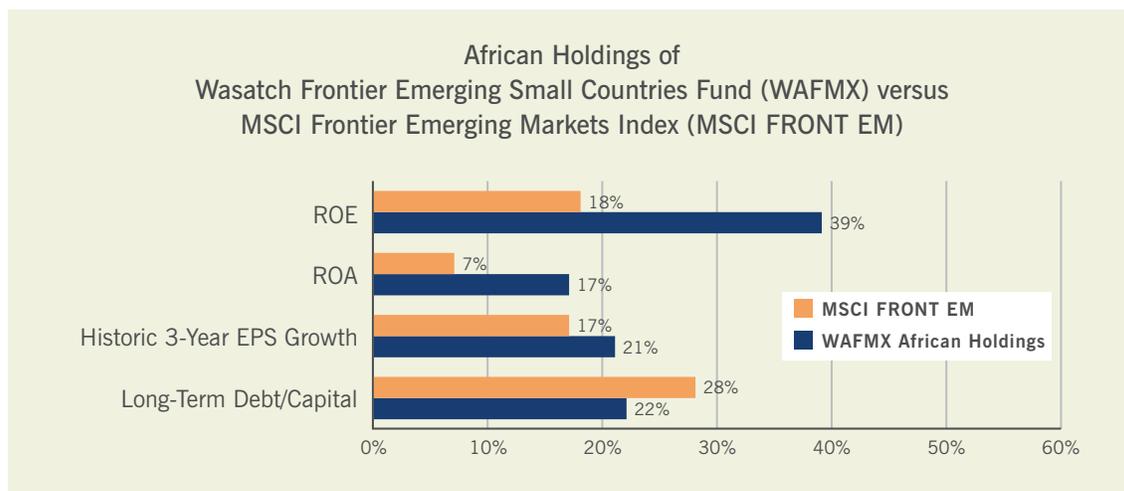
As would be expected, compared to the other two Wasatch funds, the Frontier Emerging Small Countries Fund has the largest weighting in Africa. Nevertheless, while the African holdings in the Emerging Markets Select Fund and the International Opportunities Fund are much more modest, the weightings still indicate our positive outlook for the continent considering the broader benchmarks of these funds.

An additional point is that the *overall* overlap among the holdings in these three Wasatch funds is usually very low (under 10% as of June 30, 2013). This means that the funds complement each other and that an investor can use one or more of these funds to bring frontier, emerging-markets and/or broad international diversification to a portfolio that's lacking in these areas.

RISKS AND OPPORTUNITIES

Despite recent strides, investing in Africa still entails significant risks that include political instability and unreliable power and water supplies. But we believe these risks also come with significant investment opportunities. In fact, the presence of these greater risks and opportunities is often what separates frontier markets and emerging small countries from the more-developed emerging markets.

Furthermore, we think the risks are manageable, especially in light of the **high growth rates, compelling valuations** and **quality metrics** to be found in selected countries. For example, as of June 30, 2013, the Wasatch Frontier Emerging Small Countries Fund's African holdings had a weighted average **dividend yield of 3.10%**, which is very attractive for growth-oriented companies. Other key quality metrics are shown in the chart below.

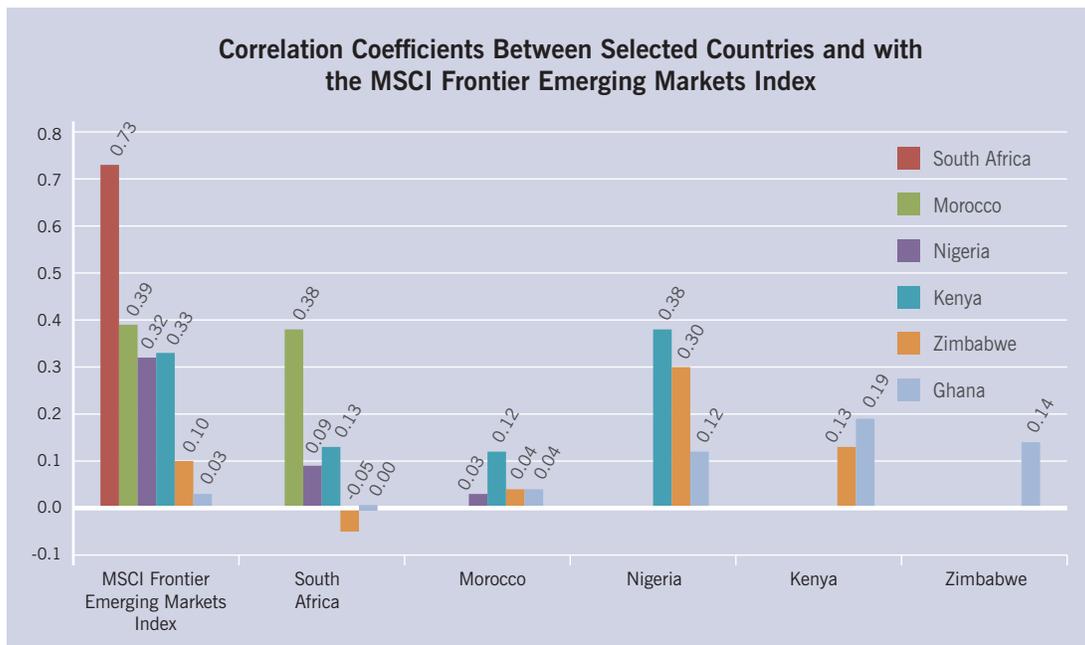


Sources: FactSet and Wasatch Advisors, as of June 30, 2013. Past performance is not indicative of future results. Quality metrics are subject to change. Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Fund or its Advisor. Current and future holdings are subject to risk.

Additional factors that mitigate some of the investment risks in Africa are high levels of stock ownership by corporate insiders and pension funds, and **improved liquidity on local stock exchanges**. For example, from 2011 to the present, trading volume is up more than 60% in Nigeria and about 200% in Kenya. Also, Zimbabwe is expected to have an electronic trading exchange in the near future.

EACH AFRICAN COUNTRY IS UNIQUE — LOW CORRELATIONS AND PORTFOLIO DIVERSIFICATION

What’s surprising to many investors is that African equity markets tend to be local in character, driven largely by the country’s own economic and political development and less subject to whims of the global economy. The chart below compares the correlation coefficients between selected countries and with the MSCI Frontier Emerging Markets Index. (For clarity and to avoid redundancy, only one bar is shown for each country-index or country-country pair.)



Source: Bloomberg. The chart reports correlation coefficients for the three-year period ended June 30, 2013.

Of the pairings shown, South Africa and the Index have the highest correlation (0.73). That means about 53% (0.73^2) of the variation in the South African stock market can be explained by movements in the Index. Between countries themselves, the highest correlations shown are 0.38 for South Africa-Morocco and 0.38 for Nigeria-Kenya. In these instances, movements in each country of the pair explain only about 14% (0.38^2) of the variation in the other. For the remaining pairs, the correlations are even weaker.

These low correlations among African countries are noteworthy because we often find that countries in different areas of the world have correlations that exceed 0.80. The U.S.-Germany correlation, for example, is 0.84. So South Africa’s correlation to the Index of only 0.73 and correlations below 0.40 between various African countries are quite remarkable. From a diversification standpoint, low correlations between the holdings in a portfolio may reduce the portfolio’s volatility because investments that are less correlated are less likely to move together in price.

We like to think of our African holdings as providing multiple levels of diversification. Within the Wasatch Frontier Emerging Small Countries Fund, the exposure to several African countries—**Nigeria, Kenya, South Africa, Zimbabwe, Morocco, Egypt, Ghana** and **Botswana**—may help reduce the volatility of the Fund itself. At another level, the Fund may help diversify other aggressive investments in an investor’s overall portfolio. In other words, to the extent that investors have aggressive investments in their portfolio, they may be more comfortable with multiple aggressive investments that are less likely to move in tandem. The Fund may also be a good diversifier for a portfolio that’s heavily weighted toward U.S. markets, developed international markets and traditional emerging markets.

Another important point is that we believe the Fund’s country diversification allows us to invest comfortably in fewer industries and sectors. This is because exposure across multiple countries within Africa seems to provide more diversification benefits than exposure across multiple industries and sectors. For example, Nigerian stocks in a variety of sectors tend to be highly correlated, while consumer-discretionary stocks throughout Africa tend not to be.

INDIVIDUAL COUNTRY EXPOSURE IN THE WASATCH FUNDS

From a country perspective, the **Wasatch Frontier Emerging Small Countries Fund’s** 47.4% exposure to Africa is comprised of Nigeria (18.3%), Kenya (11.8%), South Africa (5.0%), Morocco (5.0%), Zimbabwe (2.9%), Egypt (1.9%), Ghana (1.8%), Botswana (0.5%) and Uganda (0.2%). The **Wasatch Emerging Markets Select** and **International Opportunities Funds’** respective 12.7% and 9.2% exposures to Africa are concentrated mostly in the country of South Africa.

The reason for these differences is that the first fund targets frontier markets and emerging small countries, while the other two funds generally have exposure to somewhat more-advanced emerging markets. In terms of sector exposure, all three of these funds have the majority of their African stocks concentrated in consumer-related areas that should benefit from domestic (home-country) demand, rather than from exports to developed countries. In countries outside of Africa, this consumer focus is a broader theme for these funds, which also tend to have more country diversification and higher weights in smaller countries compared to their respective benchmarks.

One of the best examples of an African frontier market is Nigeria. Lagos, Nigeria’s center of commercial activity, recently passed Cairo to become Africa’s largest city. The population of Lagos has grown more than eightfold since 1970. Just as important, urban planning and quality of life have improved dramatically over this period. Where crime, inefficiency and crumbling infrastructure had been prevalent, the city is seeing a transformation that—while far from perfect—is dramatic nonetheless. Even foreign companies are moving into Lagos, including Shoprite, the South African supermarket chain. This is just one indication of the growing middle class and the rise of consumer spending in Africa’s urban centers.

Regarding our South African holdings, most of the companies serve the needs of consumers in South Africa or the less-developed areas elsewhere in the sub-Saharan region. Even some of the companies we own in North Africa (i.e., Morocco) do business in the sub-Saharan region, as well as serve their own local consumers in the north. One of the factors we like about many companies in South Africa and Morocco is that we often find very experienced management teams at these companies. And to the extent that they also operate in the fast-developing sub-Saharan region, we benefit from high growth *and* strong management controls—a combination that’s not always easy to find.

CONSUMER-FOCUSED INDUSTRIES AND STRONG BRAND NAMES

As described above, in the less-developed, fast-growing countries of sub-Saharan Africa we're looking to benefit from the rise of domestic (home-country) consumers—who are demanding high-quality, brand-name products and services. These products and services include **food, beverages, clothing, household/personal items, pharmaceuticals, retail, construction, home improvement, banking/finance** and **energy**. Another attractive area is **telecommunications**, due to the growth in cell phones. According to Informa Telecoms & Media, over a billion phones are expected to be in the hands of Africans by 2016.

An interesting anecdote regarding the importance of branding in Africa is that even an industrial product like cement is marketed and advertised under a strong retail brand name. With the support of a **strong brand name**, companies that deliver **high-quality** products and services are able to create customer loyalty, which gives them some level of pricing power. Through on-the-ground research, we find many **local companies** with strong name recognition that also meet our investment criteria.

In addition, we often find **multinational corporations** to be very attractive. Such multinationals give us the benefits of in-country labor and management teams—with the financial backing, global brand and strong corporate governance of a larger parent company. For example, our current African holdings include multinational subsidiaries that are household names: **Barclays Bank, Cadbury, GlaxoSmithKline, Guinness, Nestlé, Shoprite** and **Unilever**. Another interesting point regarding our enthusiasm for multinational corporations is that this is a departure from our traditional focus on smaller companies. But we believe our ability to invest in the local-country divisions of these corporations gives us the targeted regional exposures we want, plus an added margin of safety that's attractive especially in countries where the overall risks are higher.

AN "ACTIVE MANAGER'S DREAM"

As active portfolio managers, our philosophy at Wasatch Advisors has always been to focus on areas where we believe we can add value relative to a passive investment approach. This philosophy led us first to small- and micro-cap investing in the United States, and then to smaller companies in foreign developed and less-developed markets. We think the companies operating in the emerging markets, frontier markets and emerging small countries of Africa offer some of the next great investment opportunities. Due to this enormous potential we see in Africa, we're frankly surprised that African countries are not more heavily weighted in the frontier emerging markets indices.

As discussed above, the reasons for our favorable outlook on Africa include what we believe to be attractive demographics, low debt levels (among consumers, corporations and governments), a healthy business environment for companies that are expanding quickly, low analyst coverage of many stocks, less attention from passive emerging-markets index funds, rising trading volumes on the local stock exchanges, and the diversification benefits of relatively low correlations between countries and companies. As we analyze individual companies, we are most interested in finding:

- Healthy balance sheets and cash-flow statements
- High revenue and earnings growth rates or projected growth rates
- Reasonable stock valuations relative to their growth rates
- High returns on capital
- Attractive dividend yields in many cases
- Substantial levels of insider ownership among corporate executives

- Sustainable competitive advantages
- Experienced, proven management teams

In Africa, the potential rewards we encounter also come with the investment risks inherent in less-developed countries and smaller companies. This balance of potential rewards and risks is why we describe the region as an “active manager’s dream.” It’s also why on-the-ground research — meeting with the people and visiting the companies — is more important than ever. In fact, Laura Geritz, Lead Portfolio Manager of the Wasatch Frontier Emerging Small Countries Fund, estimates that in less than two years since the Fund’s launch she has flown over 150,000 miles in her search for the best growth companies around the world.

THE WASATCH ADVANTAGE

We believe Wasatch is uniquely positioned to exploit opportunities in emerging and frontier markets, both present and future. We’re willing to dig deep to find them. And we have a proven track record of doing so. Past performance is not indicative of future results.

Wasatch Advisors, investment advisor for Wasatch Funds, was founded in 1975 as a small-cap-growth investment boutique. The firm has spent nearly 40 years developing unique expertise in the small- and micro-cap space. We launched our first international product in 2000 and have continued to build our international team over the past 13 years.

Deep Due Diligence

To take full advantage of the inefficiencies and opportunities available in emerging and frontier markets, analysts must be willing to roll up their sleeves and travel in order to gain a true understanding of the companies and their markets. A Wasatch cornerstone has always been the deep due diligence applied to each investment we make. The international team regularly travels the world to meet with management teams, who sometimes mention just how rare it is for them to actually get a visit from an analyst.

Wasatch believes its deep due diligence can better determine a company’s growth potential, financial stability and management quality. The Wasatch heritage is “bottom-up,” which means analyzing the investment potential of individual companies. All of Wasatch’s international funds employ this same approach.

Cross-Team Collaboration

Another key element of Wasatch’s approach is cross-team collaboration. For example, we don’t send one person to Nigeria to determine the best companies in that country. We send a team of members with different backgrounds in order to get a more-robust understanding of each company. This team gets together with analysts who have been trekking through other parts of the world, as well as with the U.S. team, to compare companies from around the globe to help select investments that appear to have the best potential.

Wasatch’s research team consists of 23 portfolio managers and securities analysts, which includes three portfolio managers and seven analysts focused specifically on investing internationally. Each team member is dedicated to the collaborative, hands-on research process the firm employs in managing its mutual funds and institutional separate accounts.

Wasatch Advisors, investment advisor for Wasatch Funds (www.WasatchFunds.com), had \$16.5 billion in assets under management as of June 30, 2013.

Wasatch Contacts

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RISKS

In addition to the risks of investing in foreign securities in general, the risks of investing in the securities of companies domiciled in frontier and emerging markets countries include increased political or social instability, economies based on only a few industries, unstable currencies, runaway inflation, highly volatile securities markets, unpredictable shifts in policies relating to foreign investments, lack of protection for investors against parties that fail to complete transactions, and the potential for government seizure of assets or nationalization of companies.

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.

Being non-diversified, the Wasatch Frontier Emerging Small Countries and Wasatch Emerging Markets Select Funds can invest a larger portion of their assets in the stocks of a limited number of companies than diversified funds. Non-diversification increases the risk of loss to these Funds if the values of these securities decline.

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 Frontier Emerging Small Countries, Wasatch Emerging Markets Select, and Wasatch International Opportunities Funds is long-term growth of capital.

As of June 30, 2013, of the companies mentioned in this report, the following were held by the Wasatch Frontier Emerging Small Countries Fund: 0.2% of net assets in Barclays Bank of Kenya Ltd. (Kenya), 2.3% of net assets in Cadbury Nigeria plc (Nigeria), 0.2% of net assets in GlaxoSmithKline Consumer Nigeria plc (Nigeria), 0.3% of net assets in GlaxoSmithKline Pakistan Ltd. (Pakistan), 0.3% of net assets in Guinness Anchor Berhad (Malaysia), 1.7% of net assets in Guinness Nigeria plc (Nigeria), 0.5% of net assets in Nestlé Lanka plc (Sri Lanka), 0.3% of net assets in Nestlé Malaysia Berhad (Malaysia), 4.0% of net assets in Nestlé Nigeria plc (Nigeria), 0.1% of net assets in Nestlé Pakistan Ltd. (Pakistan), 2.2% of net assets in Shoprite Holdings Ltd. (South Africa), 1.1% of net assets in Unilever Ghana Ltd. (Ghana), and 1.7% of net assets in Unilever Nigeria plc (Nigeria).

As of June 30, 2013, of the companies mentioned in this report, the following was held by the Wasatch Emerging Markets Select Fund: 3.2% of net assets in Shoprite Holdings Ltd. (South Africa). None of the other companies were held by the Fund.

As of June 30, 2013, the Wasatch International Opportunities Fund did not hold any of the companies mentioned in this report.

DEFINITIONS

Correlation, in the financial world, is a statistical measure of how asset classes, securities, markets, or countries move in relation to each other.

Dividend Yield is a company's annual dividend payments divided by its market capitalization, or the dividend per share divided by the price per share. For example, a company whose stock sells for \$30 per share that pays an annual dividend of \$3 per share has a dividend yield of 10%.

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.

Gross Domestic Product (*GDP*) is a basic measure of a country's economic performance and is the market value of all final goods and services made within the borders of a country in a year.

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.

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.

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 MSCI Frontier Emerging Markets Index is a free float-adjusted market capitalization index designed to measure equity market performance in the global frontier and emerging markets. You cannot invest in this or any index.

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