

# Wasatch: Finding the World's Innovative Companies



The **Wasatch World Innovators Fund (WAGTX)** was honored on March 14, 2013 with a Lipper Award for Excellence, achieving the #1 ranking for the three-year and five-year periods ended December 31, 2012 among 144 and 72 global multi-cap growth funds, respectively. Lipper Awards recognize mutual funds that, relative to peers, have delivered consistently strong risk-adjusted performance whereby smaller downside losses are given even more importance than larger upside gains.



Overall Rating



## Wasatch World Innovators Fund

(out of 764 world stock funds as of September 30, 2013)

Total Return Percentile Rankings (9/30/2013)	1 YEAR	3 YEAR	5 YEAR	10 YEAR
<b>World Innovators Fund</b> WAGTX (World Stock)	<b>Top 25%</b> (1,016 funds)	<b>Top 1%</b> (5 stars/764 funds)	<b>Top 1%</b> (5 stars/601 funds)	<b>Top 26%</b> (3 stars/306 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.

## SPOTTING AN INNOVATOR

Originally incorporated under the name **Cadabra**, the company began selling books online in 1995. Within months, it was selling books in all 50 states and in 45 countries. Unlike conventional bricks-and-mortar booksellers that maintained inventories of up to 200,000 titles, its inventory was several times larger and growing. Though it wouldn't turn a profit for years, the company quickly attracted the attention—and wrath—of conventional competitors.

In less than 20 years, the company expanded its offerings into a broad array of consumer and retail goods, digital content and computer services. It created a platform enabling small retailers to use its services. And it built a high-tech warehouse and distribution system to satisfy customer demand for rapid fulfillment.

The company's impact on conventional retailing has been nothing short of staggering, even delivering a knockout blow to a major bookstore chain, which failed to adapt to an increasingly digital world. The concept of “creative destruction” could not have a better modern-day example than **Amazon.com**.

## SCHUMPETER'S GALE

Innovation is the force that sustains economic growth, said economist Joseph Schumpeter. In his 1943 book *Capitalism, Socialism and Democracy*, Schumpeter developed and popularized the concept of “**creative destruction**,” the process through which existing economic order is disrupted to clear the way for future growth.

“The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates,” Schumpeter wrote. “This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in.”

Innovation is like a persistent, gale-force wind, according to Schumpeter's view. Companies will either harness it in a positive way or ultimately be destroyed by it. Innovative companies are important benefits of a free society. They provide the foundation for improving our standard of living.

While Schumpeter hailed innovation as a defining advantage of capitalism over socialism, we prefer to see innovation as the advantage that entrepreneurs have over “organization men.” Innovations seldom result from a grand compromise among experts. Compromises tend toward the safe and familiar, and the “experts” usually think they know best. Innovations, however, are more likely to flow from small changes made by those who are deeply immersed in an actual process. Innovations result from tens, possibly hundreds or even thousands of tiny adjustments.

The Japanese word *kaizen* embodies the innovator's philosophy of setting and achieving ever-higher standards—even if the current operation is not broken. In business, *kaizen* refers to a process of gradual and unending improvement. This process is exemplified by the transformation of Japanese industry to *flexible manufacturing* in which workers and managers can quickly adapt to changing customer needs and market conditions.

## MISSION OF THE WORLD INNOVATORS FUND

We believe many innovative companies are especially well-positioned for rapid market-share gains and earnings growth. The **Wasatch World Innovators Fund (WAGTX)** buys innovative companies in an effort to harness the attractive stock-market returns that are often generated by these companies. The Fund seeks to provide long-term capital growth by investing primarily in companies around the globe that we believe are innovators in their respective sectors or industries. The focus on dynamic, innovative companies often leads to large portfolio weightings in information technology and health care. But we also find innovative companies in other sectors, including consumer goods and services, financials and industrials.

The Fund is co-managed by Sam Stewart and Josh Stewart. Sam, the Founder and Chairman of Wasatch Advisors, President of Wasatch Funds and Lead Portfolio Manager of the Wasatch Strategic Income Fund, took over management of the World Innovators Fund in 2008. Josh, who worked at Wasatch in the 1990s, rejoined the firm in 2006 as an analyst on the international research team focused primarily on the health-care and information-technology sectors. He became a Portfolio Manager of the World Innovators Fund in 2012.

## BETTER, FASTER, CHEAPER

One of the hallmarks of innovative companies is that they tend to gain market share because they are constantly seeking ways to manage their businesses more efficiently. “Better, faster, cheaper” is their mantra. True to the kaizen philosophy, innovative companies examine their processes from top to bottom. Inventories, production, marketing and administration are just some of the areas in which innovation may improve a company’s top-line and bottom-line results. For example, innovative human-resources management can enhance productivity and lower payroll expenses. Reduced production costs can drive earnings higher, or may be used to cut prices and gain market share. Smoother, more-efficient internal operations can produce a more-pleasurable customer experience, increase sales and result in better customer retention.

In a competitive environment, innovation is a necessity rather than a luxury. Successful innovators create a virtuous circle as they take market share, grow cash flows, and use this cash to reinvest in their businesses. Entrenched legacy competitors may find themselves suddenly ceding ground to innovators in the race for competitive advantage.

## WHY INNOVATIVE COMPANIES DO WELL IN THE STOCK MARKET

Innovative companies are disruptive. They change the way things are done, the way products are sold, the way we live our lives. They change perceptions. If consumers come to prefer the new, the innovator will acquire market share at the expense of the old. We believe there are five main reasons why innovative companies perform well and reward their shareholders over time.

First, market-share gains imply revenue growth. The more enthusiastically customers react, the greater the revenues will be. Second, revenue growth often leads to margin growth due to scale economies. Third, disproportionately high earnings-per-share (EPS) growth is generally the result of rising revenues and margins. Fourth, in the long run, we believe EPS growth drives stock prices. Fifth, price-to-earnings (P/E) ratios often expand as the market becomes aware of corporate innovations.

## EXAMPLES OF INNOVATIVE COMPANIES

Innovation takes many forms. Ask most people to name an innovative company and they'll likely mention one with a new high-tech computer—or Internet-based device or service. With its iPod, iPhone and iPad, **Apple** is a frequently cited example. And that's fascinating because Apple didn't invent the first MP3 music player, cell phone or tablet computer.

What Apple did do, however, is arguably create the *best* MP3 music player, cell phone and tablet computer. The company's products redefined these categories and raised the bar for competitors. Apple took significant market share as its products' sleek styling, advanced features and highly refined user interfaces generated overwhelming consumer demand.

Indeed, we consider Apple to be an innovator of the first order. That said, we think innovation is about much more than creating new products. We believe innovative companies can be found in every area of the economy, not just high-technology. In addition to products, companies can innovate through design, distribution, operations and branding.

In managing the Wasatch World Innovators Fund, we look for companies that are engaged in and benefiting from the process of creative destruction, no matter what form it takes. While Apple is known for its products, Amazon.com's most-significant innovation has been in distribution, where it has permanently changed the way many products are marketed, bought, sold and delivered. Although some may look at the stock-market valuation of Amazon as being too high, it is worth noting that the company's valuation is high in no small part due to the massive amount of reinvestment that Amazon makes to constantly improve its distribution system and develop new products such as the Kindle. This becomes apparent when comparing Amazon's price-to-earnings ratio and its price-to-sales ratio. Based on price to earnings, the company appears expensive. Looking at price to sales, the company's valuation is more attractive.

Amazon.com's willingness to reinvest in its business dates back to its early years. When this reinvestment for growth allowed **Amazon** to proclaim itself the "world's largest bookstore" in 1997, Barnes & Noble cried foul and filed suit, complaining that Amazon was nothing more than a book broker, not a *bookstore*. The suit was settled out of court and Amazon maintained its claim. More importantly, it seems that the larger point was lost on Barnes & Noble: It made no difference what you called it; Amazon had forever changed the bookselling business. For that matter, it wouldn't be long before it became clear that Amazon had forever changed sales and distribution for many businesses.

Amazon's example influenced Abcam's business model. While maintaining little inventory of its own, U.K.-based **Abcam** has created a sophisticated online market that matches buyers and sellers of antibodies, proteins and other materials for medical researchers. This market is supported by an offline distribution system, which even enables same-day delivery by bicycle messengers in some locations.

As Abcam demonstrates, not all innovators are as obvious as Apple and Amazon.com. Although much of financial services and banking is viewed as a commodity—e.g., Where can I find the lowest-cost checking account?—there are some companies engaged in meaningful innovation. While the payment systems in developed countries are considered mature, that is hardly the case in emerging-markets countries, where much of the population has little or no access to banking services. In these regions, both **MasterCard** and **Visa** are developing electronic-payment systems that will create significant opportunities for commercial use. Though often written off as stodgy behemoths, we think these companies have tremendous potential because most of the transactions

in the world are still done with cash. We think MasterCard and Visa will experience significant growth for years to come resulting from movement away from cash and toward electronic transactions.

We found another unexpected source of innovation in **Walgreens**. With its 2012 partial acquisition of European pharmacy chain Alliance Boots, Walgreens is creating a global drugstore chain with more than 11,000 stores in 12 countries including China. The immediate benefit is greater purchasing power, particularly with pharmaceutical companies, that has now accrued to the chain. In some markets, Walgreens is also experimenting with in-store clinics.

Sometimes innovation is found in the way products are manufactured. A classic example is the introduction of the Model T in 1908. Henry Ford didn't invent the automobile, but he did create the moving assembly line. As he refined the process, the car's price dropped from \$825 to \$575 four years later. Assembly time was slashed from more than 12 hours to less than six. By 1914, Ford had a 48% market share. Henry Ford had achieved his goal to produce a car at a price that his own workers could afford. The moving assembly line had transformed a product for the wealthy into a mass-market vehicle within the reach of many ordinary Americans.

## PROCESS OF FINDING INNOVATIVE COMPANIES

Determining which companies are innovative is more of an art than a science. For the Wasatch World Innovators Fund, we often start our search with a bottom-up process of fundamental analysis similar to that used for other Wasatch funds. We typically screen financial databases for companies that we think are high-quality and have the potential to grow earnings for long periods of time.

In these screens, we usually look for:

- Market-share gains and revenue growth
- Margin growth due to scale economies
- Rising return-on-assets (ROA) trends, which may indicate attractive operating leverage
- High ROA levels versus peers
- Improving cash flows
- Positive inflections in income-statement and balance-sheet metrics

While such screens will often reveal interesting companies, finding true innovators requires more effort. We also employ deep due diligence because screens alone will not detect company management teams that embrace the kaizen philosophy of setting and achieving ever-higher standards.

The reason we focus on market share is that when a company is able to rapidly take share away from competitors—preferably in good times and bad, as Amazon.com did with bookstores—it's a strong indicator that the company is doing something innovative. The key, though, is to ensure that the company and the market potential match up well. At the time, Amazon was a small company and the market for books was large enough to give Amazon ample room to grow. If the market had been small, it wouldn't have mattered how much share Amazon took; it would not have provided enough room for growth.

We also try to identify innovators by looking for companies with large research and development (R&D) budgets. This can be tricky, however, because innovation is different from invention. The hallmark of invention is discovering something new. Inventions often result in the issuing of patents as a means of certifying that the discovery is indeed original.

In contrast, innovation often has more to do with the unique application of existing ideas. Take Apple for example, which many regard as the poster child for innovation. Although the company's R&D budget is large on an absolute basis, the budget is small as a percentage of gross profit compared to that of a tech company such as Intel. Apple's R&D expenses amount to 5% of gross profit, while Intel's amount to 30% of gross profit.

Before investing, we also build earnings models to analyze a company's key growth drivers. Models enable us to create projections of a company's potential earnings growth and what we believe to be a fair price for the stock. We look closely at a company's valuation—e.g., price to earnings (P/E), enterprise value to EBITDA, price to book value, etc.—to assess the potential return and the risk/reward trade-off of each stock.

One metric we've paid special attention to over the years is the P/E to growth rate, also known as the PEG ratio. For example, if a company's P/E ratio were 20 and its annualized earnings growth rate were 25%, the PEG ratio would be 0.8 (20 divided by 25). While there's no magic number that constitutes an attractive PEG ratio, we find it to be a useful metric to compare companies in similar industries and to remind us to always look at a company's valuation relative to its growth rate.

Ultimately, there is no substitute for doing the deep due diligence that is a hallmark of the Wasatch investment process. This includes ongoing investigative calls and frequent travel for on-site, face-to-face meetings. We study each company, its management, competitors, customers and its industry. We also consult with the other Wasatch portfolio managers and analysts to leverage the knowledge and perspective of our investment team. Perhaps the most-important aspect of our research process boils down to, "What do we know that others don't?"

**SodaStream**, for example, is an Israel-based company that designs in-home soda makers. Consumers replace the old habit of driving to the store to buy cases of soda and sparkling water, and instead use the device with its refillable CO<sub>2</sub> canisters to make fresh sparkling beverages at home and in the process save time, money and the environment. The main source of all of SodaStream's benefits is routing around the inherent inefficiency of traditional soda distribution. At-home soda eliminates the majority of the costs involved in: the manufacture and filling of billions of soda containers that by the way create mountains of trash as an output; the trucks, the diesel fuel and the maintenance it takes to transport heavy cargo from factory to grocery store; and the rents, salaries and utilities paid to warehouse inventories and sell the products at retail locations. SodaStream's products are riding some meaningful cultural trends—health consciousness and environmental awareness—as well as the classic consumer desire for better value and convenience.

What sets the company apart, and makes it difficult for others to compete, in our opinion, are the brand name the company has built up as the first in the space to gain scale and go global and the distribution network that SodaStream's management established for carbon dioxide refills. Rather than purchase new CO<sub>2</sub> canisters, consumers can save money by exchanging their empty ones at a wide variety of nearby retail stores. We think it would be difficult for a competitor to enter the market now and set up a parallel distribution network. Perhaps the most-important factor from an investment perspective is that the growth potential is phenomenal because the market for carbonated beverages is massive.

**iRobot**, best known for its Roomba line of vacuum cleaning robots, is another innovative company with a promising future. The company has expanded its home-cleaning products to include floor-washing, surface-cleaning and pool-cleaning robots. It also has lines of industrial and police/military robots, all of which result in sufficient cash flow to give us confidence in the company's ability to sustain profitability and invest in the robotic products of the future. What makes iRobot an attractive investment, in our view, is the potential for significant growth as the company adds new applications and as consumer acceptance increases from a relatively small base.

Not all of our investments have been successful, of course. We invested in **Netflix** as it was beginning to transition from a DVD rental/subscription model to an online-streaming model. At the time, we thought Netflix was a super innovator that was rapidly growing its business. Looking back, we can see that we did not anticipate the degree to which existing customers would drop their subscriptions to protest the changes Netflix implemented.

Nor did we foresee the disruption to the company's cash flows caused by the new business model. The DVD rental business afforded Netflix a great deal of operating leverage. A single DVD could be rented out hundreds of times, all for the cost of that single DVD. Online streaming fundamentally changed the dynamic, requiring that substantial payments be negotiated with the studios for each title.

## HOW WE CONSTRUCT THE PORTFOLIO

In building the Fund's portfolio, we attempt to balance many factors, including company size, sector, industry, geography, risk and correlations with the price movements of other securities. We believe that diversification of these factors will lead to attractive returns over time with less volatility. For example, we've often found that stocks in the financials sector have low or negative correlations with stocks in the information-technology sector. If we're able to select stocks in both sectors that perform well over time, the correlation characteristics of these stocks should enhance the Fund's risk-adjusted performance.

Traditionally, we have looked at each company's likelihood of success and its potential payoff. Usually there is a give-and-take between the two. So we try to find those companies with a higher-than-average likelihood of success and an average payoff, or those companies with an average likelihood of success and an above-average payoff.

Valuation is a key component of payoff. When high-likelihood companies have lower valuations, their potential payoffs will be greater than normal, which tends to favor large-cap companies. As the relative valuations of large caps rise, the reverse will generally be true, favoring smaller companies that—due to their size—have the potential to grow more quickly (if we properly recognize the truly innovative companies).

Currently, we're finding more attractive investment opportunities among mid- and large-cap stocks than we normally find. In particular, we think many big-cap technology companies are amazingly inexpensive. Some of these have growth rates that exceed their P/E ratios *and* offer substantial dividend yields. In the past, we've generally had good success with stocks bought at such reasonable valuations.

## CROSS-TEAM COLLABORATION

A key element of our approach is cross-team collaboration. In our search for high-quality, innovative growth companies, the World Innovators Fund has the entire Wasatch research team behind it. With so much investment research going on across the firm, it's not unusual for an analyst to come across an interesting company that doesn't fit the specific style of his or her portfolio. Our *Multiple Eyes*® approach makes it easy for that analyst to pass such an investment idea on to colleagues for appropriate consideration.

Sam Stewart founded Wasatch Advisors in 1975 and served as Chief Executive Officer until 2009. Dr. Stewart has also been the Lead Portfolio Manager of the Wasatch Strategic Income Fund since its inception in 2006 and took the lead of the Wasatch World Innovators Fund in 2008.



Sam Stewart, CFA  
 Founder and Chairman of  
 Wasatch Advisors  
 Lead Portfolio Manager

Josh Stewart joined Wasatch Advisors in 2006 as an analyst on the international research team. He was also employed by Wasatch as a research associate from 1990 until 1996.



Josh Stewart  
 Portfolio Manager

Wasatch's domestic and international research teams consist of 25 portfolio managers and securities analysts. 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](http://www.WasatchFunds.com)), had \$17.9 billion in assets under management as of September 30, 2013.

Average Annual Total Returns					
For Periods Ended September 30, 2013					
	1 Year	3 Years	5 Years	10 Years	Since Inception 12/19/2000
Wasatch World Innovators Fund	24.80%	19.25%	17.59%	9.64%	8.24%
MSCI AC World Investable Market Index	18.65%	10.53%	8.29%	8.28%	4.86%

Source: Wasatch Funds.

*Data shows past performance which is not indicative of future results. Current performance may be lower or higher than the performance quoted. For month-end performance, please visit [www.WasatchFunds.com](http://www.WasatchFunds.com). Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. **Total Expense Ratio—1.87%**.*

*Wasatch Funds deducts a fee of 2% from redemption proceeds 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.*

## Wasatch Contacts

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 Institutional Investors: 801.983.4119 • Retirement Plan Solutions: 801.415.5524

### RISKS

Investing in concentrated funds will be more volatile and loss of principal could be greater than investing in 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](http://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 World Innovators Fund is long-term growth of capital.*

*As of September 30, 2013, the Wasatch World Innovators Fund held the following percentages of its net assets in the following companies: 2.8% in Abcam plc, 2.4% in Amazon.com, 3.2% in Apple, Inc., 0.9% in iRobot Corp., 2.2% in MasterCard, Inc., 1.1% in SodaStream International Ltd., 2.6% in Visa, Inc., and 1.3% in Walgreen Co. As of September 30, 2013, the Wasatch World Innovators Fund was not invested in Alliance Boots GmbH, Barnes & Noble, Inc., Ford Motor Co., Intel Corp. or Netflix, Inc.*

*The **Lipper Fund Awards** program honors funds that have excelled in delivering consistently strong risk-adjusted performance relative to peers. Lipper designates award-winning funds in most individual classifications for the three-, five- and 10-year periods. Please visit the **Awards for Excellence** website for more details about the Lipper Fund Awards. Lipper Award designations are not intended to constitute investment advice or predict future results, and Lipper does not guarantee the accuracy of this information. In addition to periods of positive returns, the Wasatch World Innovators Fund experienced some periods of negative returns during the award time frames. Past performance is not indicative of future results.*

### 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.

**Enterprise Value (EV)** is a measure of a company's value calculated as market capitalization plus debt, minority interest and preferred shares, minus total cash and cash equivalents. The **EV (enterprise value)-to-EBITDA (earnings before interest, taxes, depreciation and amortization) Ratio** is enterprise value, as defined above, divided by annual EBITDA.

**Multiple Eyes** is a Wasatch term used to describe the firm's collaborative culture and research process.

**Operating Leverage** is the percentage of fixed costs in a company's cost structure. Generally, the higher the operating leverage the more the company's income is affected by fluctuation in sales volume.

The **Price-to-Book Ratio** is used to compare a company's book value to its current market price.

The **Price-to-Earnings or P/E Ratio** is the price of a stock divided by its earnings per share.

The **Price-To-Sales Ratio** is a stock's capitalization divided by the company's sales over the trailing 12 months. The value is the same whether the calculation is done for the whole company or on a per-share basis.

**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.

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

The MSCI 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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