Market Scout

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Shenzhen, China

Our Take on China and India

Investors need to understand the differences between Chinese capitalism and Western capitalism in order to properly assess the opportunities in China. Meanwhile, norms in India more closely resemble those in the United States—but India has dramatically larger headroom for growth.

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DEAR INVESTORS:

Recent clampdowns by Chinese regulators in areas such as technology and private education have caused some investors to rethink their China allocations. These government actions came in the wake of a broader push aimed at curbing monopolistic behavior in the so-called platform economy. Investors began to ponder the implications in November 2020 when regulators suspended the initial public offering (IPO) of Ant Group, a financial-technology (fintech) firm whose chairman and majority shareholder is renowned tech titan Jack Ma. This year, a flurry of additional restrictions announced during the summer rattled financial markets. Pundits in the press and elsewhere have even begun to question the Chinese government's commitment to capitalism.

CHINESE CAPITALISM VERSUS WESTERN CAPITALISM

In assessing these concerns, it must first be recognized that Chinese capitalism isn't the same as the capitalism practiced in the West. Western capitalism in its modern form rests largely on the free-market principles laid out by eighteenth-century philosopher and economist Adam Smith. In *The Theory of Moral Sentiments*, Smith introduced the concept of the "Invisible Hand"

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Wasatch Launches New Long/Short Alpha Fund

to describe the unintended social good brought about by individuals acting in their own self-interest. With an almost religious zeal, Smith viewed the workings of the free market as manifestations of something akin to divine providence.

The Chinese reject Smith's formulation. They believe capital allocation driven by self-interest and greed inevitably leads to inequality, exploitation and the dangerous accumulation of power by large corporations. Because all of these things undermine the Chinese Communist Party's (CCP's) objectives of common prosperity and social cohesion, capitalism in the Chinese model must be kept on a tight leash. In what one might characterize as "guided capitalism" or "directed capitalism," Adam Smith's Invisible Hand is replaced by the not-so-invisible and sometimes-heavy hand of the Chinese government.

IMPLICATIONS FOR RETURNS ON CAPITAL: A COMPARISON TO INDIA

Primarily as a result of heightened competition, returns on capital have generally been less sustainable in China than in some Western-style economies. In India, for example, competitive advantages such as proprietary technologies, barriers to entry and economies of scale have tended to be more enduring. Additionally, the coalition led by Prime Minister Narendra Modi has enacted a series of business-friendly reforms in India that have allowed long-running investment themes to play out more fully and with less regulatory interference than might otherwise have been the case. For these reasons, our emerging markets strategies and funds at Wasatch have typically been structurally overweight in India and underweight in China compared to their respective benchmarks.

To the extent that recent events in China foreshadow a more activist role for the government in determining how businesses are run, returns on capital may become compressed somewhat further—perhaps both in amplitude as well as duration. However, we believe companies will still be permitted reasonable levels of profitability. Capitalism has enabled China to bring hundreds of millions of its citizens out of abject poverty. With much work still remaining, the government clearly understands the profit motive's essential role in spurring the innovation necessary for China's continued growth and development.

THE NEED FOR A COMMON-SENSE APPROACH TO INVESTING IN CHINA

As painful as they've been for investors, regulatory shifts in China have followed a certain logic and rationale as the government seeks to blunt what it considers excesses of the free market. In the booming after-school education industry, for example, an influx of foreign capital helped fuel the rapid expansion of classes on nights, weekends and during vacation periods. Parents who didn't want their children to participate risked seeing them fall behind in the competitive race for college admissions. Equally important was growing resentment among poor families that couldn't afford such costly private tutoring.

Social cohesion is important in a country of 1.4 billion people. We think the government's willingness to flex its regulatory muscle in pursuit of its policy goals makes it more important than ever to take a pragmatic approach to investing in China. When evaluating a Chinese company for purchase, the impacts of the firm's products and services on the broader social good must be carefully considered. Certain consumer-facing businesses may be especially at risk of finding themselves at odds with the government. Among these are companies such as payment and social-media platforms that collect large amounts of proprietary data on Chinese citizens and companies that may be perceived as failing to promote socially responsible behavior. Also at risk are firms that the government deems important to the country's competitiveness and may therefore be less able to operate freely.

Because China's economy has matured to the point of becoming self-sustaining, exports and capital from overseas are no longer vital to its survival. As a result, companies are encouraged to emulate the CCP's vision of what their business models should look like. The government, in turn, now has additional scope to regulate industries without having to fear the consequences of alienating international investors. China's nascent semiconductor industry is a notable exception—and for that reason has become the subject of intense government efforts to promote its development.

CHINESE VARIABLE INTEREST ENTITIES (VIEs), EVERGRANDE GROUP AND THE DELTA VARIANT OF COVID-19

Other concerns relevant to China are the developments stemming from variable interest entities (VIEs), China Evergrande Group and the Delta variant of Covid-19.

VIEs are companies controlled through contracts designed to mimic the rights and economic interests of direct ownership. Because VIEs are used to circumvent restrictions on foreign investment in China, we think VIEs that are traded in the form of depositary receipts are the most likely to draw the ire of Chinese regulators. Rather than providing clear commentary on the legality of the VIE structure, recent legislation simply doesn't mention VIEs.

In view of what appears to be a deliberately gray area of Chinese law, no Wasatch strategy or fund has more than a modest exposure to VIEs—and we don't own VIEs listed on stock exchanges outside Hong Kong and mainland China.

A deepening liquidity crisis at real-estate development firm China Evergrande Group also captured headlines during the third quarter. Although it seemed likely that Chinese authorities would be able to limit the amount of spillover into other segments of the economy, Evergrande's massive size made it a potential source of systemic risk. Investors feared that even if a worst-case scenario could be avoided, a slowdown in China's real-estate sector might cause the country's growth to sputter, impacting the global economy as well. With no clear signals from Chinese policy makers, a growing sense of uncertainty sparked volatility in world financial markets.

Making matters worse, the emergence of the Delta variant of Covid-19 has raised strong doubts about whether China's attempts to tightly contain the virus can be sustained. Sudden lockdowns of entire cities and the mass testing of millions of people in response to a few dozen cases have imposed enormous economic and quality-of-life costs. Even so, it seems unlikely that the government will abandon its zero-Covid approach until after the Winter Olympics in Beijing—and perhaps not until the National Party Congress of the Chinese Communist Party meets in October of next year. In the meantime, virus containment and regulatory crackdowns will continue to pose short-term headwinds for China, with the situation at Evergrande an additional wild card whose impact is yet to be fully determined.

Once the regulatory dust has settled, we believe China's health-care sector will present additional investment opportunities. We're much less optimistic about Chinese financial companies, however. In addition to being subject to government control, Chinese financials lack transparency and tend to be highly leveraged. Because this combination of traits makes risks difficult to assess, we expect our exposure to Chinese financial stocks to remain somewhat limited.

LONG-TERM OPPORTUNITIES IN CHINA REMAIN INTACT

Despite sensationalistic headlines declaring that China has abandoned capitalism, we believe the long-term opportunities there remain intact. China's self-sustaining economy and relatively stable currency provide advantages found in few other emerging markets. Measured in terms of the number of IPOs, the rate of capital formation in Greater China (China, Hong Kong and Taiwan) is the highest in the world.

That said, investing in China has become more complex. Besides evaluating a company's underlying fundamentals, investors must now weigh the extent to which business practices align with the policy objectives of the Chinese government. We think this extra dimension creates opportunities for actively managed strategies and funds to outperform. We also believe our legacy in small-cap investing provides Wasatch with an additional advantage, as smaller companies may be better-positioned to grow for longer periods without attracting unwanted attention from the government.

Kolkata, West Bengal, India

TIME AND AGAIN, INDIA FINDS WAYS TO IMPRESS US

Our unenthusiastic position toward Chinese financials stands in stark contrast to our optimism about financial firms in India. In our view, Indian financials offer more attractive long-term growth prospects with significantly less uncertainty than their Chinese counterparts. The financialization of India has been one of our long-running investment themes, which we expect will continue as an upswell of IPOs boosts awareness and adds new names to the space.

During the third quarter, investors—encouraged by record-low interest rates, hopes for a pickup in consumer demand and an improved outlook for manufacturing—drove India's major stock averages to new all-time highs. Inflationary pressures from food and housing have eased in recent months, providing India's central bankers with additional scope to keep interest rates low in support of economic growth. According to a report from the Statistics Ministry, consumer prices rose 5.3% in August from a year earlier—less than expected and the smallest increase since April's 4.2%.

Fallout from India's second outbreak of Covid-19 has been less significant than had been feared. High-frequency indicators of business and consumer activity have recovered lost ground more rapidly than they did during the first wave of the virus. Gross domestic product rose 20.1% in the three months to June 30 versus the same period last year—helped by rising factory orders, robust demand from overseas and a rebound in the services sector. The record year-on-year expansion of India's economy also reflected favorable comparisons to 2020, when Prime Minister Modi imposed one of the world's strictest lockdowns.

Declining Covid-19 caseloads and strong inflows of foreign capital underpinned support for Indian equities during the third quarter. Moreover, managers of emerging-market portfolios world-wide have been increasing their allocations to India.

INDIAN IPOs SIGNAL A HEALTHY ENVIRONMENT

As mentioned above, India's market for IPOs is perking up. Robust demand from retail, institutional and foreign investors is encouraging Indian firms to go public at a record pace in what's shaping up to be the best year ever for local IPOs. The surge of new listings is expected to add about $400 billion of new capital to India's equity market over the coming two to three years. And based on recent announcements, the IPO pipeline is likely to remain strong for at least the next year or so.

Besides the large number and size of India's recent IPOs, their nature is also quite remarkable. Compared to past periods when the IPO calendar consisted almost exclusively of traditional businesses, this time around there's better representation from new-economy industries such as e-commerce, software and financial technology (fintech). Examples include Zomato Ltd., an online restaurant guide and food-delivery company that went public in July, and digital-payments startup Paytm, which has filed to raise as much as $2.2 billion. These listings are in addition to firms such as Freshworks, Inc., which in September became the first Indian software-as-a-service (SaaS) company to go public in the United States.

Although IPO participation isn't a major part of our investment process, we believe our fundamental approach naturally lends itself to the analysis of companies seeking to go public. Moreover, we believe a healthy IPO calendar filled with new-economy businesses helps to sustain investor enthusiasm and increase the flow of international capital into India's financial markets.

With sincere thanks for your continuing investment and for your trust,

Ajay Krishnan and Dan Chace

INTRODUCING THE WASATCH LONG/SHORT ALPHA FUND

Mick Rasmussen, CFA

Portfolio Manager and Quantitative Analyst

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YEARS AT WASATCH

As a learning organization for over 45 years, Wasatch continually strives to improve investment decisions for all of our strategies and funds. Moreover, when we start a new fund, we only do so if we'd want to put our own money in it and we already have the resources necessary to manage it properly. With that as background, we're extremely excited about the launch of the Long/Short Alpha Fund—which uses an approach developed solely by Wasatch.

Part of our process of continual improvement is to research and develop quantitative methods that might enhance performance. Although we select companies based mainly on bottom-up, fundamental analysis, we've found that multi-factor quantitative methods can help with decision-support for tasks like entering and exiting positions, sizing portfolio weights, achieving proper diversification and placing trades efficiently.

Having developed quantitative methods to enhance performance generated by stocks held in our existing strategies and funds, we realized these same methods—with additional refinements—could be used to pick candidates for short sales. These short sales are specifically selected to reduce risk and complement stocks purchased on the long side.

That's why we launched the Wasatch Long/Short Alpha Fund. Mick Rasmussen, the Fund's Lead Portfolio Manager, has been with our firm since 2014. And he's supported by all of the Wasatch research teams. The core of Mick's investment philosophy can be summarized as follows: "Because attractive returns generally aren't possible without some level of risk, our goal is to *optimize* risk-reduction—rather than to *maximize* risk-reduction."

The Fund's investment objective is long-term growth of capital. Beyond that, there are a few major characteristics: (1) the Fund attempts to decrease market exposure (beta); (2) the Fund seeks to increase the portion of returns coming from stock selection (alpha); and (3) the Fund tries to preserve a high-quality, growth orientation but lessen the effects of investment styles coming in and out of favor.

For more information, please visit our website at ***wasatchglobal.com***.

GENERAL RISKS AND DISCLOSURES

Mutual-fund investing involves risks, and the loss of principal is possible. Investing in foreign securities, especially in frontier and emerging markets, entails special risks, such as currency fluctuations and political uncertainties, which are described in more detail in the prospectus. 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.

An investor should consider investment objectives, risks, charges and expenses carefully before investing. To obtain a prospectus, containing this and other information, visit wasatchglobal.com or call 800.551.1700. Please read the prospectus carefully before investing.

The Covid-19 health pandemic has negatively affected and may continue to affect the economies of many nations, individual companies, and the global securities markets. This has impacted and may continue to impact the issuers of securities held by the Fund.

Information in this document regarding market or economic trends, or the factors influencing historical or future performance, reflects the opinions of management as of the date of this document. These statements should not be relied upon for any other purpose. **Past performance is no guarantee of future results, and there is no guarantee that the market forecasts discussed will be realized.**

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As of September 30, 2021, none of the Wasatch strategies or funds were invested in China Evergrande Group, Zomato Ltd. or Freshworks, Inc. As of September 30, 2021, Ant Group and Paytm were privately held companies. Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Funds or their Advisor. Current and future holdings are subject to risk.

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LONG/SHORT ALPHA FUND RISK DISCLOSURES

Equity investing involves risks, including potential loss of the principal amount invested.

Short selling incurs significant unique risks, including potentially unlimited downside risk, high short-sale related expenses, and unavailability of securities to sell short, among others, all of which could negatively impact the performance of the Fund. Additionally, the Fund may not be able to borrow the securities it intends to sell short.

Because the Fund invests in both long and short equity positions, the Fund has overall exposure to changes in the value of securities, which far exceeds the value of the Fund's assets. This may magnify gains and losses and increase the volatility of the Fund's returns. Investment in the Fund will involve market risks associated with different types of investment decisions than those made for a typical "long only" fund. There is no guarantee that the use of long and short positions will succeed in limiting the Fund's exposure to market movements, sector swings or other risk factors.

Being non-diversified, the Fund can invest a larger portion of its assets in the stocks of a limited number of companies than a diversified fund. Non-diversification increases the risk of loss to the Fund if the values of these securities decline.

Portfolio holdings are subject to risk and may change at any time. Securities in the Fund are generally added to the portfolio as long or short positions based upon security rankings provided by multi-factor quantitative models and on fundamental analysis of securities. The reliance on quantitative models entails unique risks, including the risk that a model may be limited or incorrect, that the data on which a model relies may be incorrect or incomplete and the risk that the Advisor may not be successful in selecting companies for investment or determining the weighting of particular stocks in the Fund's portfolio. The Advisor will generally sell a security if, among other things, the rankings provided by the quantitative models decline and/or research analysis reveals deterioration in company fundamentals.

DEFINITIONS

Alpha *is a risk-adjusted measure of the so-called "excess return" on an investment. It is a common measure of assessing an active manager's performance as it is the return in excess of a benchmark index or "risk-free" investment. The difference between the fair and actually expected rates of return on a stock is called the stock's alpha.*

Beta *is a measurement of a fund's trailing return in relation to the overall market (or appropriate market index). A beta of 1 indicates the share price will typically move with the market. A beta of more than 1 indicates the share price will typically be more volatile than the market. A beta of less than 1 indicates the share price will typically be less volatile than the market.*

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.*

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

Return on capital *is a measure of how effectively a company uses the money, owned or borrowed, that has been invested in its operations.*

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