DEAR FELLOW SHAREHOLDERS:
Over many years, I’ve faithfully written quarterly messages about the current state of the economy and
the financial markets in the U.S. and abroad. In every message, I’ve attempted to provide fresh insights
into events that seem to be moving the markets.

In spite of the many short-term market-moving events I’ve discussed over the past five years, however,
the underlying economy has remained largely unchanged. But while stocks were reasonably priced five
years ago, more recent valuations have been on the high side.

The topics I have discussed in these quarterly messages have included the Japanese earthquake and
tsunami, threats of default on sovereign debt in Europe, the U.S. budget standoff, strange-sounding
experiments in monetary policy by the Federal Reserve (Fed), and the economic deceleration in China
along with the related commodities meltdown.

Each crisis has passed without the more pessimistic predictions becoming reality. And the global
economy has continued to be stuck in low gear regardless of the unprecedented amount of central-
bank stimulus—whether that stimulus has been quantitative easing, operation twist or negative interest
rates. So from my perspective, we’ve been witnessing the wisdom of that old adage, “The more things
change, the more they stay the same.”

Other than Brexit—which I discuss in the Markets section below—many investors believe the U.S.
presidential race is the most significant event facing us today. Here’s my take on the candidates: Both
Donald Trump and Hillary Clinton have very large unfavorable ratings. As a result, emotions are
running high due to fear that the election of the “wrong” candidate would have dire consequences. I’m
more optimistic, however.

Notwithstanding major ideological differences between Trump and Clinton, I expect that either
candidate would have trouble implementing his/her more extreme policy initiatives. The reality is—given
the U.S. political structure that divides power among the executive, legislative and judicial branches—there are relatively few degrees of freedom within which the president can operate.

Regarding the financial markets, stocks have generally risen over time irrespective of who’s been in the White House. And I don’t anticipate that either Trump or Clinton would do anything that would cause the economy to veer from its slow-growth path.

**ECONOMY**

As I’ve discussed in prior messages, despite the use of previously unimagined monetary-policy tools, central bankers around the world may have approached the limit of their ability to meaningfully influence the economy. Sluggish economic growth is being exacerbated by widespread disinflationary forces and by demographic shifts—specifically the aging of populations in developed-market countries, which are the major sources of global demand for products and services. Older people generally need fewer products and services than younger people.

Other gating factors on economic growth have been the mixed messages being sent to commercial bankers. On the one hand, commercial bankers ostensibly have been encouraged to lend by the low rates on their overnight reserves held at the central bank. On the other hand, commercial bankers have felt the pressure of regulators to avoid any practice that could be viewed as imprudent with the perspective of 20/20 hindsight.

The result has been the reemergence of the old complaint that bankers are only willing to lend to those who don’t need the money. It seems history has been rewritten to blame the entire Global Financial Crisis on loans made to credit-stretched subprime borrowers and to gloss over the actions of those in business and government who encouraged such loans to be made. With this revised view of history, bankers and regulators have resolved that “never again” will credit be supplied to marginal borrowers.

Although such an attitude might ensure that most loans will be repaid, I think the attitude is wholly inconsistent with the need to supply capital to the entrepreneurial sectors of the economy. In other words, in the name of prudence, bankers and regulators have conspired to choke off credit. This means that inflation-adjusted gross domestic product (GDP) growth in the U.S. seems confined to the vicinity of 2%—with many other developed countries growing even more slowly.

Given this slow-growth environment, I’m frequently asked about the actions of the U.S. Fed, which raised the target for the federal-funds rate by a quarter of a percentage point on December 16, 2015. This was the Fed’s first interest-rate increase in nearly a decade. On December 16th, the Fed also signaled that more rate increases were likely in 2016—although the Brexit vote and some disappointing economic reports in the U.S. now seem to have taken such increases off the table.

While I’ve often said that today’s extremely low interest rates don’t encourage a healthy lending environment, I’m sympathetic to the Fed’s predicament. The U.S. economy is only lukewarm at best, but the Fed also has to consider the monetary environments overseas. For example, the European Central Bank and the Bank of Japan have implemented negative rates for overnight reserves held at the central bank. And 10-year government bond yields have even dropped to negative levels in several countries.
If the Fed were to raise interest rates considerably, I believe other countries would have an even more extreme mismatch versus the U.S., where rates are already comparably high. That would probably lead to a substantial increase in the value of the dollar, which could be very detrimental to U.S. exporters and therefore to U.S. jobs. It would also be disastrous to the many foreign companies that have debt denominated in U.S. dollars.

I don’t think most people outside the investment community understand these interest-rate dynamics. The concept of negative rates is especially perplexing. To illustrate just how ludicrous the situation is, according to an April 14, 2016 Wall Street Journal article, “Negative Rates Around the World,” some homeowners in Denmark are actually being paid money back on their mortgages via negative interest rates.

So with central bankers approaching the limit of their effectiveness, with demographics trending unfavorably and with regulations leading to tight credit, we may simply have to accept slow economic growth in the U.S. and other developed countries. To do better than this tortoise pace, I think politicians would have to take the handoff from central bankers and begin to prioritize our infrastructure needs. That would probably produce the added benefits of rising wages, increased labor-force participation, lower unemployment, more equitable wealth distribution and the knock-on effects of greater innovation.

MARKETS
Beyond the usual hand-wringing over Fed policies, Britain’s referendum regarding the country’s possible exit from the European Union (EU) dominated market psychology during much of the second quarter. On June 24th and June 27th, the first two trading days after the Brexit referendum, global stock markets fell hard in response to the shock that Britons actually voted to leave the EU.

But in the final three trading days of the quarter, markets recouped much of their losses. And for the June quarter as a whole, the S&P 500® Index of large caps actually rose 2.46%, which was the third-straight quarterly gain for the Index. Similarly, the Russell 2000® Index of small caps moved up 3.79%. International stocks weren’t so resilient, as indicated by the -1.05% fall in the MSCI World Ex-U.S.A. Index.

Meanwhile, high-quality bonds performed well during the second quarter. The intermediate-term Barclays Capital U.S. Aggregate Bond Index returned 2.21%. Similarly, the long-term Barclays U.S. 20+ Year Treasury Bond Index gained 6.76% for the quarter.

While the Brexit referendum initially created turmoil in the financial markets, many investors now seem to believe that there may be some sort of workaround to Britain’s desired exit from the EU. If Brexit does actually go through, however, there are genuine concerns that a situation in which other countries also want to exit could lead to the demise of the EU and could create barriers to free trade. While these are remote possibilities at this point, future developments should not be ignored.

At Wasatch Advisors, we had reduced our U.K. exposure in some of our international portfolios earlier this year as a risk-control measure related to Brexit uncertainties. Currently, we’re looking to increase our holdings in high-dividend payers and companies that may benefit from recent currency movements—the weaker British pound and the stronger Japanese yen, for example.
Similarly, the stronger U.S. dollar may help keep a lid on energy prices, which are mostly denominated in dollars. This trend could continue to work in favor of our longstanding strategy to overweight domestically oriented companies in those particular emerging markets that benefit from low energy costs.

The quick digestion of the Brexit news seems to be an indication that markets are less likely to stay down based on events that are manageable in the long term—even if they seem like crises in the short term. And I continue to believe that in a slow-growth, low-interest-rate environment—with many companies that are less capital-intensive than a generation ago—investors have become more accustomed to higher stock valuations. The main risk in such an environment, however, is that low interest rates and higher valuations leave less margin for error when periodic disappointments occur.

With sincere thanks for your continued investment and for your trust,
Sam Stewart

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Mutual-fund investing involves risks, and the loss of principal is possible. Investing in small-cap funds will be more volatile, and the 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 unstable currencies, highly volatile securities markets, and political and social instability, which are described in more detail in the prospectus.

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DEFINITIONS
The European Union (EU) is a politico-economic union of 28 member states that are located primarily in Europe.

The financial crisis of 2007-09, also known as the Global Financial Crisis (GFC) and 2008 financial crisis, is considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s.

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.

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

**Operation twist** is the name given to a Federal Reserve monetary policy operation that involves the purchase and sale of short-term and long-term bonds depending on the policy objective.

**Quantitative easing** is a government monetary policy used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity. **QE1** is the nickname for the first round of quantitative easing.

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

The **S&P 500 Index** includes 500 of the United States’ largest stocks from a broad variety of industries. The Index is unmanaged, but is a commonly used measure of common stock total-return performance.

The MSCI World Ex-U.S.A. Index captures large and mid cap representation across 22 of large and mid cap representation across 22 of 23 Developed Market (DM) countries—excluding the United States. With 1,004 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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The **Russell 2000 Index** is an unmanaged total-return index of the smallest 2,000 companies in the Russell 3000 Index, as ranked by total market capitalization. The Russell 2000 is widely used in the industry to measure the performance of small-company stocks. Russell Investment Group is the
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The **Barclays Capital U.S. Aggregate Bond Index** covers the U.S. investment grade fixed rate bond market, including government and corporate securities, agency mortgage pass-through securities, and asset-backed securities.

The **Barclays U.S. 20+ Year Treasury Bond Index** measures the performance of U.S. Treasury securities that have remaining maturities of 20 or more years.

You cannot invest directly in these or any indices.

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