In today’s global economy, many of the most attractive investing opportunities lie beyond the U.S. borders. Emerging markets offer some of the most promising prospects in our opinion, particularly smaller companies in these markets with great growth potential and lower valuations.

Yet because small cap emerging market stocks constitute an asset class thinly covered by Wall Street analysts, they are almost unrepresented in most emerging market portfolios. Consequently, investors miss out, perhaps unknowingly, on what we believe to be one of the best equity investment opportunities in the world. In this paper we examine what makes emerging market small cap stocks particularly compelling, including why:

- **Emerging markets offer some of the best global growth opportunities**—with burgeoning consumer populations and high growth economies.

- **Emerging markets are more developed and more stable than commonly perceived**—with improving infrastructure and controls to reduce investment risk.

- **Small caps are a relatively undiscovered frontier of emerging markets**—with some of the strongest growth opportunities and most attractive valuations.

**EMERGING MARKETS ARE POISED TO CONTINUE TO OUTPERFORM**

![GDP & Total Equity Market Cap Growth 1999 - 2009](image)

Sources: International Monetary Fund (IMF); Standard & Poor’s. As of December 31, 1999 and December 31, 2009. Population and GDP are from the World Economic Outlook Database, April 2010, published by the IMF. Market capitalizations are based on the individual country market capitalizations within the S&P/Citigroup Global BMI Index. BRIC stands for Brazil, Russia, India and China.
**Economic Growth**

Much of the global economic growth in recent years has occurred in emerging markets, which account for 63% of the world’s population, and now 28% of its economic output. Many emerging countries are undergoing significant growth of the middle class, as they transition from agriculture-based economies to manufacturing and service economies. Citizens of emerging market nations are becoming more prosperous and are increasingly significant consumers themselves. In addition to economic growth via exports, many of these nations are now experiencing rapid internal growth.

This is evident in emerging markets’ growing share of global GDP growth. Real GDP in emerging countries has been growing at more than twice the rate of developed countries, and from 2009 to 2014 inflation-adjusted GDP is expected to grow 12.6% annually in emerging countries, compared to just 3.7% in developed countries. By 2019, emerging markets are expected to account for as much as 47% of global GDP.

<table>
<thead>
<tr>
<th>GDP Growth</th>
<th>2004 - 2009</th>
<th>2009 - 2014 (Projected)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Markets</td>
<td>8.7%</td>
<td>12.6%</td>
</tr>
<tr>
<td>Developed Markets</td>
<td>3.5%</td>
<td>3.7%</td>
</tr>
</tbody>
</table>

Source: International Monetary Fund, World Economic Outlook Database, April 2010. Emerging and Developed markets as defined by the IMF.

In the BRIC economies—Brazil, Russia, India, and China—the outlook for growth is particularly favorable. These four emerging countries have been booming, despite the global recession, posting five-year average annual growth rates of 8%, 11%, 9%, and 12%, respectively from 2005-2009. These markets have benefited from increasingly literate and skilled workers available at relatively low costs.

**Improving Institutional Stability**

Many emerging nations have made significant strides in improving their economic and political stability. Countries such as Brazil, Indonesia, and Mexico have embraced international accounting and trading standards, while cementing ties with neighboring countries through regional economic alliances. Latin American countries formerly dependent upon exports to the U.S. and Western Europe have forged burgeoning trading partnerships with China and other growing economies. Such globalization has helped stabilize these countries, as formerly resource dependent economies become intertwined with world markets.

Emerging markets have also been able to better control inflation through stronger monetary leadership, inflation targeting, the establishment of floating exchange rates, and prudent management of public finances. China, for example, has kept inflation in check despite its double-digit economic growth; while Brazil has managed to moderate its historically high inflation and avoid major blows such as the collapsing banking and property bubbles seen in the U.S. and Great Britain.

What’s more, business-friendly political reforms, including the privatization of government-run monopolies, have been implemented in many markets. Countries such as Indonesia, with legacies of corruption and political turmoil, have instituted higher standards of corporate governance. Though still far from perfect, the improved transparency and oversight has significantly reduced uncertainty in many emerging markets.

Historical Outperformance

Emerging markets have outperformed the U.S. and developed countries over the 1-, 5-, 10-, and 20-year periods ended December 31, 2009. During the infamous lost decade of 2000 to 2009 when the S&P 500 was down -1.0%, emerging market stocks actually gained an annualized 10.0%. Note: it is particularly important for emerging market investors to have a long-term perspective since these markets still experience higher volatility.

Emerging Markets Comparative Performance

<table>
<thead>
<tr>
<th></th>
<th>1 Year</th>
<th></th>
<th>5 Year</th>
<th></th>
<th>10 Year</th>
<th></th>
<th>20 Year</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Markets</td>
<td>79.0%</td>
<td>27.8%</td>
<td>15.9%</td>
<td>28.0%</td>
<td>10.0%</td>
<td>24.9%</td>
<td>10.6%</td>
<td>24.3%</td>
</tr>
<tr>
<td>Developed (non-U.S.)</td>
<td>32.5%</td>
<td>24.9%</td>
<td>4.0%</td>
<td>19.7%</td>
<td>1.6%</td>
<td>17.9%</td>
<td>4.4%</td>
<td>17.5%</td>
</tr>
<tr>
<td>U.S.</td>
<td>26.5%</td>
<td>21.4%</td>
<td>0.4%</td>
<td>16.0%</td>
<td>-1.0%</td>
<td>16.1%</td>
<td>8.2%</td>
<td>15.0%</td>
</tr>
</tbody>
</table>

Sources: As of 12/31/09. MSCI; Standard & Poor’s. Total returns. Standard deviation is a measure of volatility. Emerging markets represented by MSCI EM Index; Developed markets (non-U.S.) by MSCI EAFE Index; U.S. markets by the S&P 500 Index. Past performance is not indicative of future returns.
Smart Diversification

Despite their volatility, emerging market stocks have also historically acted as an effective portfolio diversifier—measured by correlation with the U.S. equity market. Correlation gauges how closely returns of one investment track another. A value of 1 indicates perfect correlation (i.e. that returns of the two move in lockstep).

For the 20 years ended December 31, 2009, emerging market stocks showed a correlation of just 0.42 with the U.S. equity market, suggesting that emerging market stocks have provided nice diversification to domestic U.S. stock portfolios. As a point of comparison, non-U.S. developed country stocks had a 0.72 correlation with the U.S. equity market over the same period.

THE SMALL CAP ADVANTAGE IN EMERGING MARKETS

In U.S. markets, it’s no secret that small cap stocks have outperformed large caps over the long-term. In fact, U.S. small caps have outperformed large caps during the 5-, 10-, 20-, and 30-year periods ended December 31, 2009. Since 1926, small caps have shown an average total return of 11.5%, compared with 9.9% for large caps.

The factors that have brought about small cap outperformance apply equally to domestic and international small cap companies: higher earnings growth potential, leaner operations, and the ability to respond more quickly to changing market dynamics.

While the historical data on emerging market sub-segments is limited, and many emerging market small cap stocks are still relatively undiscovered by investors, results over the last five years show a similar trend potentially developing in emerging markets.

### Comparative Recent Performance

<table>
<thead>
<tr>
<th></th>
<th>Small Cap</th>
<th>Mid/Large Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005 - 2009</td>
<td>17.1%</td>
<td>15.9%</td>
</tr>
</tbody>
</table>

Sources: As of 12/31/09. MSCI Emerging Market Small Caps represented by the MSCI EM Index, small cap segment; emerging market large cap and mid cap stocks represented by the MSCI EM Index, large cap and mid cap segments.

Earnings Growth

Earnings growth, as the long-term driver of stock prices, plays a pivotal role in small cap outperformance. For the 10 years ended December 31, 2009, emerging market small cap stocks produced annualized earnings growth of 7.9%, compared with 5.2% for large caps (and just 1.6% for all U.S. stocks). For 2010, average per share earnings of emerging market small cap companies are estimated to grow 36.1%, according to MSCI.
**Larger Selection**

The small cap universe offers a far greater pool of stocks from which to choose. The MSCI Emerging Markets Index, the most commonly used benchmark for most emerging market funds, contains just 413 securities. This compares to the emerging small cap universe of 1,775 companies in the MSCI Emerging Markets Small Cap Index, plus micro cap companies and planned initial public offerings which are not yet included in the Index.  

**Less Analyst Coverage**

It takes a lot of work to analyze this expansive small cap universe, and there is limited market capitalization in these companies. Consequently, small cap stocks are typically overlooked by emerging and international fund managers, as well as by Wall Street analysts.  

According to Bloomberg, 36% of small cap companies in the MSCI Emerging Markets Small Cap Index have no more than two analysts covering them, and 18% have no analyst coverage at all. On average, 3.5 times more analysts cover each stock in the MSCI Emerging Markets Index than the stocks in the MSCI Emerging Markets Small Cap Index. This lack of small cap coverage poses a great opportunity for investment managers who have the commitment and skill to take advantage of such market inefficiencies.  

**Lower Valuation**

Because emerging market small cap stocks are generally less followed and less liquid than large cap stocks, they currently carry lower valuations. As of April 2010, emerging market small cap stocks traded at a substantial valuation discount to emerging market large caps, fetching only 7.1 times 2010 estimated earnings per share, versus 13.3 for large caps and 15.5 for all U.S. stocks. This presents an additional investment opportunity since the P/E ratios between emerging large and small cap stocks are likely to converge over time, or even flip, as smaller companies garner growing investor attention.
More Exposure to the Actual Emerging Market

Many emerging market fund investors may not realize that they are primarily invested in large cap stocks, some of which are actually multi-national companies. As such, the financial/business exposure of these companies may actually be in developed, as well as emerging, countries. The emerging large cap universe is also heavily weighted toward the energy, materials, and financial sectors.

A potential benefit of emerging market small cap investing is purer exposure to the internal economies of the rapidly growing emerging markets themselves, including direct domestic exposure to high-growth sectors and niche markets that may not be captured by large emerging market companies.

High Insider Ownership

Small cap companies typically have higher rates of insider ownership, leading to stronger incentives for managers to profitably grow their company. Among the stocks in the MSCI Emerging Markets Small Cap Index, the average company has only 55% of its stock available to the public, giving the private holders (typically management and insiders) a clear and compelling motivation to succeed. 8

Conclusion

The advantages that currently exist for small cap emerging market stocks are remarkable in the world of global investing. They present a uniquely compelling opportunity to invest in solid, high growth companies trading at low valuations, and can also provide portfolio diversification. Although emerging market stocks are not without their risks, their potential for long-term outperformance is clear.

THE WASATCH ADVANTAGE IN EMERGING MARKETS SMALL CAP INVESTING

Small Cap Specialists

Wasatch was founded in 1975 as a Small Cap Growth shop. We have spent 35 years developing a unique expertise in the small and micro cap space. We launched our first international product in 2000, and we have continued to build our international team over the past decade.

In October 2007, we launched the Wasatch Emerging Markets Small Cap Fund (WAEMX)—one of just a few actively managed emerging market funds focused specifically on small cap stocks. Our research team was already in these countries looking at small companies for other Wasatch funds. In comparing the opportunities in these markets to those in developed countries, we saw a huge opportunity being overlooked by most emerging market funds and analysts who are focused on large cap companies and missing what we believe is the most exciting part of the emerging opportunity—small caps—where growth prospects are higher and valuations lower.
Deep Due Diligence

To take full advantage of the opportunity and inefficiencies in the emerging markets small cap space, analysts have to be willing to roll up their sleeves and travel through the countries to gain a true understanding of the companies and their markets. A Wasatch cornerstone has always been deep due diligence around each investment we make. Our team is regularly traveling the world, getting off the beaten path in emerging markets, and frequently meeting with management teams that mention to us just how rare it is for them to actually get a visit from an analyst.

It is through our deep due diligence that we believe we can better determine a company’s growth potential, financial stability, and management quality. After studying smaller companies for 35 years, we have a strong framework from which to begin and compare our evaluation.

Cross-Team Collaboration

Another key element of the Wasatch approach is cross-team collaboration. We don't send one person to Indonesia and ask them to determine the best small companies in that country. We send a team to Indonesia with different backgrounds in order to get a more robust understanding of each company there. Then we bring those analysts together with analysts who have been trekking through other parts of the world (as well as our U.S. team), to compare companies from around the globe to help us select the emerging market investments that we believe to have the most potential.

Seasoned Portfolio Managers

The lead portfolio managers on the Wasatch Emerging Markets Small Cap Fund, Roger Edgley and Laura Geritz, are seasoned international investors. Roger has been investing internationally for nearly 20 years, living in Asia, Europe, and in the U.S. He is also the Director of International Research at Wasatch. Laura joined the Wasatch international team in 2006 with a strong background in international and small cap investing. Of course, in classic Wasatch style Roger and Laura are simply the point people representing a much larger team of analysts that work on finding investments for the Emerging Markets Small Cap Fund.

Dynamic Portfolio

We scour the universe of emerging markets small cap stocks to find what we believe are the best 5%. By concentrating the portfolio in roughly 5% of the available names, but with diversification across sectors and countries, we seek to reduce volatility while achieving great upside potential.
WAEMX Off to a Strong Start

The Wasatch Emerging Markets Small Cap Fund launched with ominous timing in the fall of 2007 just as Lehman collapsed and the global financial crisis began. The Fund declined in 2008 along with most funds, but it came roaring back in 2009. For the one year ended 3/31/10 the Fund was up **140.19%** and was in the **Top 3%** of all Morningstar Diversified Emerging Markets Funds (based on total returns, out of 371 funds).

From the Fund's inception on 10/1/07 through 3/31/10, it has outpaced the MSCI Emerging Markets Index by **4.34** percentage points and the MSCI Emerging Markets Small Cap Index by **2.57** percentage points on an annualized basis.

As of 3/31/10, WAEMX had one year and since inception (10/1/07) returns of 140.19% and −0.47%, respectively.

Data shows past performance. Past performance is not indicative of future performance, and current performance may be lower or higher than the data quoted. For the most recent month-end performance data, visit www.wasatch-funds.com. Investment returns and principal value will fluctuate; and shares, when redeemed, may be worth more or less than their original cost. The Advisor may absorb certain Fund expenses, leading to higher total shareholder returns. **Total Expense Ratio: 3.03%, Net: 2.05% after Advisor reimbursements.**

Wasatch Funds will deduct a 2.00% redemption fee on Fund shares held 60 days or less. Performance data does not reflect this redemption fee or taxes, which if reflected would reduce the performance quoted. For more complete information including charges, risks and expenses, read the prospectus carefully.

Recent stock market performance has caused atypical short-term returns for some asset classes, which may not continue in the future. Fund performance may be subject to substantial short-term changes due to market volatility.

For more information on the Fund and the latest performance please visit our website at www.WasatchFunds.com.
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. Investing in small cap funds will be more volatile and loss of principal could be greater than investing in large cap funds.

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.

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GDP (Gross Domestic Product) is the monetary value of all the finished goods and services produced within a country's borders annually.

The Price-to-Earnings (P/E) ratio is a valuation ratio of a company's current share price compared to its per-share earnings.

Earnings Growth is a measure of growth in a company’s earnings per share from one year to the next.

The MSCI Emerging Markets and Small-Mid Cap Indices are free float-adjusted market capitalization indices that are designed to measure equity market performance in the global emerging markets. The S&P 500 Index represents 500 of the United States’ largest stocks from a broad variety of industries. The S&P/Citigroup Global Broad Market Index is comprised of stocks of all sizes from around the world, including developed and emerging markets. You cannot invest directly in these or other indices.

1Source: International Monetary Fund, World Economic Database, April 2010. Economic Output based on GDP.
2Source: EconomyWatch, International Monetary Fund, World Economic Output Database, April 2010.
3Sources: Standard & Poor’s, MSCI. Emerging market stocks represented by the MSCI EM Index; developed country (non U.S.) stocks by the MSCI EAFE Index; U.S. equity market by the S&P 500 Index, for all 12-month periods for the 20 years ended December 31, 2009.
4Source: Standard & Poor’s. Small caps represented by the S&P SmallCap 600 Index. Large caps represented by the S&P 500 Index.
7Source: FactSet, April 22, 2010.
8Source: Bloomberg. As of April 22, 2010. Based on companies within the MSCI Emerging Markets indices.

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