

It has been a challenging year

IN THIS EXPANDED COMMENTARY, Portfolio Manager Kimberly Scott, CFA, provides deeper insight into factors leading to the Fund's underperformance, which includes: underexposure to momentum; outsized exposure to energy; and weakness in many of the consumer names. She also discusses the current market environment and her outlook for the Fund.



Kimberly Scott, CFA
Portfolio Manager

Mid-cap growth market in 3Q2015...what's happened?

- Mid-cap growth stocks were very weak in third quarter, losing 7.99%, as measured by the Russell Midcap Growth Index (Fund's benchmark).
- All economic sectors within the index posted losses in the quarter. Energy, materials and health care delivered weak returns, all declining double-digits. Consumer staples sector turned in the best performance for the quarter.
- The health care sector's 12.53% decline was in contrast to its 3% gain in second quarter 2015 and largely related to burgeoning concerns over politically motivated price control rhetoric.
- Energy saw the steepest decline, at 24.56%, as the price of West Texas Intermediate Crude oil fell from the \$58 range to approximately \$38 within the quarter. The 14.86% loss in the materials group was similarly related to commodity price weakness, in addition to concerns about global economic growth.
- Stocks in sectors where commodity prices and international markets are important to their business outlooks tended to fare much worse in the quarter.
- Consumer staples turned in the best performance for the quarter, falling only 2.55%. Consumer discretionary and consumer staples fared the best, likely related to more domestic economic exposure and an encouraging outlook for consumer spending.

A look at the Fund

The Fund substantially underperformed in the quarter, with much of the weakness related to our consumer discretionary and consumer staples exposure as well as health care, energy and industrials positioning. The relative underperformance in a down quarter for the market is contrary to the expected and typical behavior of our mid-cap growth strategy. A number of factors contributed to the weak performance, including:

- underexposure to momentum in the portfolio;
- outsized exposure, both direct and indirect, to the struggling energy sector in the wake of the index's annual reconstitution of sector weights, by which the weight of the energy sector in the index fell by approximately 500 basis points; and

- weakness in many of our consumer discretionary and consumer staples names associated with dollar strength and fragility in emerging markets.

Our consumer names were broadly weak. There were many performance issues associated with exposure to dollar weakness and emerging market economic concerns, but many of our more domestically focused names struggled, as well. BorgWarner, Inc., an innovative auto parts company, was very weak based first on concerns about business in Asian markets, followed by the Volkswagen automobile emissions scandal, as that company is a major customer of BorgWarner. Other weak names included:

- Polaris Industries, which is working to correct an Indian motorcycle production line problem that has persisted much longer than anticipated.
- Tiffany & Company, Ralph Lauren Corporation and Burberry Group. All three companies were exposed to the dollar and weak international consumer markets.
- Bed, Bath & Beyond and Urban Outfitters. Both experienced weakness reflected by general concerns about the strength of their businesses.
- Infant formula maker Mead Johnson Nutrition Company. This company has struggled due to related dollar weakness and price competition/distribution channel challenges in China.

On a positive note, Under Armour, Ulta Salon, Cosmetics and Fragrance and Nordstrom delivered positive performances in the quarter. The broad weakness across our consumer exposure is troubling in the near term, but we see many of the issues impacting the group as transient, with some, such as dollar weakness, being resolved sooner, while other issues, such as emerging market consumption trends, taking longer to resolve. We do not see these factors as fundamentally changing the intermediate to long-term business prospects for these firms, and fully expect to see growth build at a stronger pace for these companies as their impact abates.

continued

Underperformance from our health care names was largely based on sector allocation; as we were overweight this underperforming group. Stock selection made a small positive contribution to performance. Most of our names were less weak than the broader health care group within the index; however our specialty pharmaceutical and biotech names were weaker than the group on fresh concerns over drug pricing. Acadia Pharmaceuticals, Medivation and Biomarin Pharmaceutical were particularly weak. Incyte Corporation was the exception, turning in a positive performance for the quarter related to strong data on drugs in its pipeline. The outlook for product innovation and commercialization is strong across these companies. We expect these stocks to reflect these revenue and earnings opportunities over time, but fully understand the persistent pressure that drug price concerns may weigh on these stocks, especially in a period of heightened political rhetoric.

The Fund's energy and industrials names struggled in the quarter related to the steep drop in the price of oil from June through August. Energy was the weakest group in the sector. Industrials, as a group, outperformed the index, based on strength in airlines and some housing-related names, but any company doing business with oil and gas customers saw its stock price sink in the third quarter. Weak names in the portfolio in these sectors included Oasis Petroleum, Continental Resources and Southwestern Energy, all oil and gas exploration and production companies, and Joy Global, Flowserve Corporation, Generac Holdings and Woodward Inc., all industrials companies with some exposure in their businesses to energy. A few of the business services names in our industrials group saw positive returns in the quarter, including Stericycle, Verisk Analytics and Expeditors International.

The Fund's best performing sectors over the quarter were telecommunications and utilities, where a lack of exposure prevented losses in those groups, and technology, materials and financials, each performing better than the index.

The Fund performed better than the index in the technology, materials and financials sectors. Pandora Media was a standout strong performer in technology. Some of the concerns around the Contract Royalty Board review, where a definitive decision about rates is due in December, began to abate in the quarter, while at the same time the solid fundamentals of Pandora's evolving advertising-based business model became more obvious to investors. Electronic Arts also had a small positive return. In materials, the Fund was underweight a very weak group and both of our names, Scotts Miracle-Gro and Valspar Corporation outperformed. The Fund was slightly overweight the financials sector, which outperformed in the index, and our names performed generally well, including CME Group, which posted a positive return in the quarter, First Republic Bank, UMB Financial and Signature Bank.

Where we are heading

Our outlook for the stock market remains cautiously constructive, as it has been for much 2015. We believe the U.S. economy is in a slow growth mode. Economies elsewhere in the world remain challenged, which restricts the ultimate strength of domestic companies and the economy. Europe has shown signs of recovery, China has become a bigger drag on world economic progress and Latin America remains broadly weak.

There are more stresses on the earnings outlook for U.S. companies than we have seen in a considerable period of time. While much of this stress emanated in the energy sector earlier in the year, the negative feedback loop associated with energy-related employment and spending has had a broader impact on economic growth and corporate health across many sectors.

The strengthening U.S. dollar has been another source of earnings pressure on many companies. This impact will subside as 2015 progresses, given current exchange rates, but we will continue to see a near-term impact on the earnings of many companies. Labor costs are also drifting higher. Commodity prices, especially prices of industrial materials, are helping the cost equation for some companies, while food commodity prices, meat protein prices and eggs, in particular, are driving cost increases for many restaurant companies.

Earnings have marked time, at best, across the economy in the first half of 2015. The significant decline in stock prices since May has done much to improve the valuations and investability of many stocks, but much of the market, particularly leading-edge growth companies, remain expensive by our calculations. Finally, ongoing uncertainty regarding the first interest rate hike in years from the Federal Reserve adds another level of uncertainty and volatility to the stock market.

Our cautiously constructive outlook is based on our confidence that the positives we see in the economy — greater employment, an improving housing market, low energy prices, more accommodative lending, supportive demographic trends — will be enough to offset the negatives to earnings, allowing earnings and stock prices to move higher. We think these positives will outweigh the negatives as we progress through the remainder of the year.

We think that the ongoing positive but slow rate of growth in the U.S. economy will drive greater demand from investors for the stocks of clearly differentiated growth companies that can deliver superior earnings performance independent of any sluggishness in the overall economy.

We think the markets will trend more defensively, as well, in terms of both earnings stability and creditworthiness. This will be a response to any increases in interest rates that might come as a result of firmer economic growth, and also because of concerns around simmering debt issues around the world. Valuation will be a concern if earnings growth is less certain and debt issues weigh, but could move upward if underlying economic trends in the U.S. continue to improve through better employment growth, a stronger housing market, and any long hoped for improvement in capital spending.

Our preference for high-quality growth companies with stable and sustainable earnings profiles and strong balance sheets should serve investors well if the economy struggles to regain a faster growth rate as it progresses through the end of 2015 and into 2016.

We will continue to invest in well-managed growth companies in the key growth areas of the U.S. economy, including health care, technology, consumer discretionary, some aspects of consumer staples, financials and industrials. Health care remains our biggest overweight sector, as we continue to find many opportunities to invest in interesting long-term growth companies in that sector, although pressure on the stocks related to worries over drug pricing make us reluctant to add exposure, and we may reduce exposure over time.

We are happy with the Fund's energy overweight, as we think oil prices are likely to trend higher based on downtrends in production and supply and growing demand. We are most likely to add to our weightings in the technology and consumer discretionary sectors, and possibly industrials, over the next three to six months.

TOP 10 HOLDINGS *(as of 09/30/2015)*

Holding	% of net assets
Northern Trust Corp.	3.0
Pandora Media	2.8
Intuitive Surgical	2.8
Electronic Arts	2.7
Fortune Brands Home & Security	2.5
CME Group	2.5
Signature Bank	2.4
Zoetis, Inc.	2.4
Microchip Technology, Inc.	2.4
First Republic Bank	2.2

FUND PERFORMANCE – Average Annual Total Returns (%)

As of 09/30/2015	Ticker	Inception Date	1-Year	3-Year	5-Year	10-Year	Life	Expense Ratio
Class A (NAV)	UNECX	06/09/1983	-2.93	9.66	10.58	8.51	10.58	1.37
Class A (Load)	UNECX	06/09/1983	-8.52	7.52	9.27	7.87	10.38	1.37
Russell Midcap Growth Index	—	—	1.45	13.98	13.58	8.09	—	—
Morningstar Mid Cap Growth	—	—	0.70	11.75	11.39	6.58	—	—

Data quoted is past performance and current performance may be lower or higher. Past performance is no guarantee of future results. Investment return and principal value of an investment will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. Please visit www.waddell.com for the Fund's most recent month-end performance. Class A Share performance, including sales charges, reflects the maximum applicable front-end sales load of 5.75%. Performance at net asset value (NAV) does not include the effect of sales charges. Performance at net asset value (NAV) does not include the effect of sales charges.

The Russell Midcap Growth Index measures the performance of the mid-cap growth segment of the U.S. equity universe. It is not possible to invest directly in an index.

The opinions expressed in this commentary are those of the Fund's manager and are current through October 2015. The manager's views are subject to change at any time based on market and other conditions, and no forecasts can be guaranteed. Past performance is no guarantee of future results.

Risk factors: The value of the Fund's shares will change, and you could lose money on your investment. Investing in mid-cap growth stocks may carry more risk than investing in stocks of larger more well-established companies. An investment in the Fund is not a bank deposit and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Not all funds or fund classes may be offered at all broker/dealers. These and other risks are more fully described in the Fund's prospectus.

Investors should consider the investment objectives, risks, charges and expenses of a fund carefully before investing. For a prospectus, or if available a summary prospectus, containing this and other information for the mutual funds offered by Waddell & Reed, call your financial advisor or visit www.waddell.com. Please read the prospectus or summary prospectus carefully before investing.

Why Waddell & Reed?

Since opening our doors in 1937, our approach has remained decidedly simple, genuine and straightforward: know our clients well, treat them with respect and measure our success by their success. This deeply personal approach is the reason Waddell & Reed advisors typically enjoy long-lasting client relationships. We take your journey seriously, and will be there every step of the way, listening, planning and advising.

Listening. To us, success demands not only a deep understanding of your objectives, but your needs, values, time horizon, risk tolerance and expectations.

Planning. By building personalized plans supported with highly competitive investment products and dedicated service, we enable you to not only identify goals, but take consistent action toward achieving them.

Advising. Our mission, every day, is to help clients at all stages and through the changes that life may bring.



PRINTED ON
RECYCLED PAPER

NOT FDIC/NCUA INSURED | MAY LOSE VALUE | NO BANK GUARANTEE
NOT A DEPOSIT | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY

