Three Criteria to Avoid Value Traps

A firm's financial condition and business economics are critical analytical guardrails to help mitigate excessive business risk, says Artisan's George Sertl Jr.

Fund Manager Q & A | 04-29-11 | By Esther Pak

George Sertl Jr. is a managing director at Artisan Funds. As comanager of Artisan Value (ARTLX) and participating once again in our Manager Q&A, he answered our questions regarding the fund's recent name change as well as his current stance on cyclical companies and energy-related names.

He also discussed where on the market-cap spectrum he was finding the most attractive opportunities, and explained his continued optimism for Cisco Systems (CSCO) despite its falling share price.

Finally, he commented on how the current portfolio capitalizes on international opportunities.

1. The fund recently underwent a name change, though its strategy remains unchanged. What was the reasoning behind dropping "Opportunistic" from the fund name?
Since launching the fund in 2006, we feel that the term "opportunistic" has become more generally defined in the marketplace as a description for strategies that make asset-class or broad-allocation bets. Since that is not the goal of our fund, we felt dropping the term "opportunistic" was appropriate in order to reduce marketplace confusion. We manage Artisan Value with the same investment process that we use for the Artisan Mid Cap Value (ARTQX) and Artisan Small Cap Value (ARTVX) funds*. So we really felt that the new name better represented the product, which is designed to be a flexible, high-conviction portfolio that is focused on fundamental security selection with a high level of risk awareness.

2. Although the fund performed very well in 2009 as a result of your emphasis on cyclical companies, you've since reduced your exposure to such firms in favor of firms with less leverage and greater competitive advantages. Was valuation the chief driver of the shift, or were you looking at other factors, as well? Additionally, your energy-related names have had a big hand in the fund's recent outperformance. Have you been scaling back on some of them as they've run up, or are you as enthusiastic about them as ever?

When cyclical stocks ran up in 2009, noncyclical companies were left behind. We did what we normally do, which is to say that we remained committed to our valuation discipline (by reducing our exposure to the cyclical names), and we focused our attention on areas of the market that were forgotten or ignored, which at that time were the more non-cyclical-type companies.

One example of a high-conviction stock in the portfolio is Microsoft (MSFT). It was our largest position as of March 31. We think the market is severely underappreciating the company's diversification and leading market positions within the enterprise segment. Microsoft is the world's largest software company, with its offerings running on a variety of hardware, from computers to servers to cell phones. It has also built a healthy hardware business and a solid Internet and cloud-based computing platform. Moreover, Microsoft is very strong financially, a characteristic that we think the market has overlooked given its single-digit multiple.

In the first quarter, we trimmed all four of our energy names—Chesapeake Energy (CHK), Nabors Industries (NBR), ExxonMobil (XOM), and Apache (APA)—as they posted solid gains. Those trims resulted in a decline in our exposure to the energy sector—down from about 15% at the end of last year to about 8% as of March 31. The primary reason for the reduction in these names was valuation. Oil prices have risen substantially since last fall (from about $70 to more than $110 per barrel), on the heels of the geopolitical events in the Middle East. This has helped boost the share prices of energy stocks across the board. Although we continue to have conviction in the long-term prospects of these businesses, we trimmed our positions as their share prices reached our target selling ranges.

3. Although you generally stick with companies with market caps greater than $2 billion, the fund has broad latitude to invest in companies of varying cap sizes. Would you say you are finding the best opportunities among larger or smaller companies lately?
Our investment parameters for Artisan Value allow us to invest in companies that are $2 billion or greater in market cap at time of

purchase. This gives us the flexibility to invest in the 30-40 best ideas that meet our three margin of safety criteria.

Generally speaking, I would say that large-cap stocks look more attractive to us right now. And if you look at our portfolio characteristics (such as average market cap), it is fair to say that we have found more interesting investment ideas higher up on the market-cap spectrum as of late. That said, we've had stocks from the smaller end of the spectrum, including tax-services provider H&R Block (HRB) and chip manufacturer National Semiconductor (NSM), post solid gains thus far in 2011.

4. Despite shares of Cisco Systems falling sharply as a result of competitive pressures and reduced government spending, you continue to express optimism for this firm (still part of the top 10 holdings) and jumped on the opportunity to purchase additional shares last month as it was trading at a huge discount to your estimate of fair value. What merits continued optimism in this firm? How do you avoid value traps?

Although we agree directionally with some of the concerns that the market has with regard to Cisco, we think the reaction in the market has been overblown. Shares of Cisco are trading at a large discount to our estimate of intrinsic value despite the company's leading market share, scale advantages, and strong balance sheet. Even though there are some near-term headwinds, we still think Cisco has the potential to drive new product cycles and penetrate new markets. Given our conviction in its long-term trajectory, we took advantage of the drop in price in the first quarter to purchase additional shares at around 9 time our estimate of normalized earnings.

In general, we aim to avoid value traps by remaining focused on our three margin-of-safety criteria—valuation, financial condition, and business economics. We believe that investors are most susceptible to value traps when they focus purely on valuation. Almost by definition, value traps are often found in businesses with bad balance sheets and poor business economics. This is precisely why financial condition and business economics are two of the main criteria in our investment process. Even though we do look for companies that are trading at a distinct discount to their underlying worth, we want to avoid stocks that are cheap for a reason. We think of financial condition and business economics as analytical guardrails that help us mitigate excessive business and/or financial risk.

5. The fund can invest up to 25% in stocks of non-U.S. firms. Does the portfolio's current positioning imply that management is finding an abundance of opportunities in the U.S. or a dearth of opportunities abroad?

Actually as of March 31, approximately 10% of the portfolio was invested in non-U.S.-domiciled stocks. We held Europe-based retailer Tesco and consumer staples companies Unilever (UN)(UL) and Nestle (NSRGY). Unilever and Tesco were also in our top 10 holdings at the end of the first quarter.

Although 10% non-U.S. exposure might not seem like a significant amount, I would not characterize our view by saying that we think the opportunities in the U.S. are better than they are abroad. One thing investors should remember is that the revenue sources of large multinational corporations today are highly diverse and come from many different regions and countries. With the continued globalization of markets, we actually have quite a bit of exposure to non-U.S. markets through our U.S.-based holdings. If we looked at the portfolio in aggregate, about half of the revenues from our holdings are generated outside the United States (as of March 31). So it all depends on how someone defines non-U.S. exposure.

** Sertl is also a comanager of Artisan Small Cap Value and Artisan Mid Cap Value.*
Esther Pak is an assistant site editor of Morningstar.com.

Average Annual Total Returns

As of 31-Mar-11	YTD[1]	1 Yr	3 Yr	5 Yr	Inception[2]	Expense Ratio[3]
Artisan Value Fund (ARTLX)	7.23%	13.59%	1.97%	3.17%	3.12%	1.18%
Russell 1000® Value Index	6.46%	15.15%	0.60%	1.38%	1.25%	
Russell 1000® Index	6.24%	16.69%	2.98%	2.93%	2.86%	

Source: Artisan Partners/Russell. [1]Returns are not annualized. [2]Fund inception 27-Mar-06. [3]The Fund's operating expenses have been restated to reflect a reduction in management fees, effective as of 1-Dec-10, as if such reduction had been in effect during the fiscal year ended 30-Sep-10. The information has been restated to better reflect anticipated expenses of the Fund.

The performance quoted represents past performance, which does not guarantee future results. The investment return and principal value of an investment in the Fund will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For current to most recent month-end performance information, call 800.399.1770.

Investors should consider carefully before investing the Fund's investment objective, risks and charges and expenses. For a prospectus or summary prospectus, which contains that information and other information about the Fund, please call us at 800.399.1770. Please read the prospectus or summary prospectus carefully before you invest or send money.

International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging markets. Securities of medium-sized companies tend to be more volatile and less liquid than those of large companies, may have underperformed the securities of large companies during some periods and tend to have a shorter history of operations than large companies. Value securities may underperform other asset types during a given period.

This summary represents the views of the portfolio managers as of 29-Apr-11. Those views may change, and the Fund disclaims any obligation to advise investors of such changes. For the purpose of determining the Fund's holdings, securities of the same issuer are aggregated to determine the weight in the Fund. The holdings mentioned above comprise the following percentages of the Fund's total net assets as of 31-Mar-11: Microsoft Corp 5.0%; H&R Block Inc 2.0%; National Semiconductor Corp. 1.9%; Cisco Systems Inc 4.3%; Tesco PLC 3.6%; Unilever PLC 3.9%; Nestle SA 2.6%; Chesapeake Energy Corp 1.9%; Nabors Industries Ltd 1.3%; Exxon Mobil Corp. 1.9%; Apache Corp. 3.2%. Securities named in the Commentary, but not listed here are not held in the Fund as of the date of this report. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities.

Performance attribution is used to evaluate the quality of the separate decisions that go into the management of an investment portfolio compared to a benchmark index. Performance attribution analysis attempts to isolate the effect and measure the return contribution of market allocation (Allocation Effect), which analyzes the positive/negative impact of a portfolio's allocation to groupings such as geographic regions or market sectors, and stock selection (Selection Effect), which analyzes the positive/negative impact of a manager's security ownership and weighting decisions within a broader grouping. **Attribution is not exact, but should be considered an approximation of the relative contribution of each of the factors considered.**

Note of Clarification: Microsoft's P/E (FY2) was approximately 9X at March 31, 2011 (Source: FactSet).

Margin of Safety
Margin of Safety is the difference between the market price and the estimated intrinsic value of a business. The concept was developed by Benjamin Graham and is believed to be an important measure of risk and appreciation potential. Artisan's U.S. value team also incorporates a company's financial strength and certain business quality measures into its margin of safety estimates. A large margin of safety helps guard against permanent capital loss and improves the probability of capital appreciation; however, a margin of safety does not prevent market loss. All investments contain risk and may lose value.

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