# Artisan International Small-Mid Fund

QUARTERLY Commentary

Investor Class: ARTJX | Advisor Class: APDJX | Institutional Class: APHJX

As of 30 June 2023

## Investment Process

We seek long-term investments in high-quality businesses exposed to structural growth themes that can be acquired at sensible valuations in a contrarian fashion and are led by excellent management teams.

**Investing with Tailwinds**

We identify structural themes at the intersection of growth and change with the objective of investing in companies having meaningful exposure to these trends. Themes can be identified from both bottom-up and top-down perspectives.

**High-Quality Businesses**

We seek future leaders with attractive growth characteristics that we can own for the long term. Our fundamental analysis focuses on those companies exhibiting differentiated and defensible business models, high barriers to entry, dynamic management teams, favorable positions within their industry value chains and high or improving returns on capital. In short, we look to invest in small companies that have potential to become large.

**A Contrarian Approach to Valuation**

We seek to invest in high-quality businesses in a contrarian fashion. Mismatches between stock price and long-term business value are created by market dislocations, temporary slowdowns in individual businesses or misperceptions in the investment community. We also examine business transformation brought about by management change or restructuring.

**Manage Unique Risks of International Small- and Mid-Cap Equities**

International small- and mid-cap equities are exposed to unique investment risks that require managing. We define risk as permanent loss of capital, not share price volatility. We manage this risk by having a long-term ownership focus, understanding the direct and indirect security risks for each business, constructing the portfolio on a well-diversified basis and sizing positions according to individual risk characteristics.

## Team Overview

Our team is intellectually curious about the world and how it is changing. Each team member is passionate about small company investing and discovering businesses with meaningful and open-ended growth opportunities.

**Portfolio Management**

Rezo Kanovich
Portfolio Manager

## Investment Results (%)

| As of 30 June 2023 | QTD | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr | Inception |
|---|---|---|---|---|---|---|---|
| | | | Average Annual Total Returns | | | | |
| **Investor Class: ARTJX** | **0.77** | **8.46** | **14.40** | **4.57** | **5.30** | **5.72** | **10.23** |
| **Advisor Class: APDJX** | **0.83** | **8.56** | **14.58** | **4.73** | **5.44** | **5.80** | **10.26** |
| **Institutional Class: APHJX** | **0.82** | **8.59** | **14.64** | **4.81** | **5.54** | **5.89** | **10.31** |
| MSCI All Country World ex USA SMID Index | 1.76 | 7.48 | 11.15 | 6.94 | 2.22 | 5.14 | 7.83 |
| MSCI All Country World ex USA Small Cap Index | 2.05 | 6.84 | 10.93 | 8.15 | 2.62 | 5.75 | 8.61 |

Source: Artisan Partners/MSCI. Returns for periods less than one year are not annualized. Class inception: Investor (21 December 2001); Advisor (4 December 2018); Institutional (12 April 2016). For the period prior to inception, each of Advisor Class and Institutional Class's performance is the Investor Class's return for that period ("Linked Performance"). Linked Performance has not been restated to reflect expenses of the Advisor or Institutional Class and each share's respective returns during that period would be different if such expenses were reflected.

| Expense Ratios | ARTJX | APDJX | APHJX |
|---|---|---|---|
| Semi-Annual Report 31 Mar 2023[1] | 1.29 | 1.14 | 1.06 |
| Prospectus 30 Sep 2022[2] | 1.29 | 1.14 | 1.06 |

[1]Unaudited, annualized for the six-month period. [2]See prospectus for further details.

**Past performance does not guarantee and is not a reliable indicator of future results. Investment returns and principal values 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 that shown. Call 800.344.1770 for current to most recent month-end performance.**

## Investing Environment

Global equities continued to advance in Q2 despite stubbornly high levels of inflation. Investors debated whether interest rates in the US will soon peak and a soft landing is achievable. While the Federal Reserve took a pause in June, it signaled more hikes are likely down the road, and some other major central banks pressed ahead with rate increases. The troubles in the US and European financial sectors that started in Q1 have subsided as authorities took measures to restore confidence in the system. On the geopolitical stage, tensions remain elevated as the Russia-Ukraine war shows no signs of ending, and the US and China remain at odds over a long list of economic, technological and political issues.

We think it's interesting to note that this quarter's stock market rally, which largely centered around artificial intelligence (AI), was extremely narrow. Six mega-cap technology stocks drove returns and created the widest difference between the market-weighted and equal-weighted S&P 500® Indices since the Global Financial Crisis.

Regular readers of this letter will be familiar with not only our enthusiasm about the revolutionary potential of AI but also our cautionary approach toward hype cycles. Starting with our letter in Q2 2021, we have routinely provided anecdotes of AI's graduation from a buzzword to real-world application. AI will undoubtedly have a meaningful impact on the global economy, and substantial investment in both hardware and software is occurring to support its expanded application. However, we believe that it is important to remain nuanced and focused on long-term outcomes and to intensely study the development of individual companies—particularly during times of great change.

At this nascent stage, it may be tempting to jump to conclusions about which companies are the winners and losers of AI's mass adoption, and investors have certainly seen much written on this topic of late. We routinely observe the market's tendency to extrapolate a few near-term data points to either justify hefty valuations or, conversely, project pessimism too far into the future. By contrast, we are steadfast in our contrarian approach to valuation in an effort to find sustainable winners. As such, we have been early investors in a select set of companies that have successfully introduced AI in commercialized products, and we believe that opportunities for these companies continue to be robust. We have chosen to focus on "quiet heroes" of AI—that is, lesser recognized AI-enablers at reasonable valuations.

On the software side, we have a range of companies to highlight. Two examples are NICE, a leading enterprise software provider focused on contact centers, and WNS, a global business process management company. Recently, shares of both have been pressured due to the misguided notion that AI will instantly uproot the value chain of their respective industries. This led to their inclusion in a basket of stocks deemed "AI losers" by short-term traders, who tend to trade AI on a wholesale basis.

For NICE, AI will serve as an additional important revenue stream, and for WNS, it will serve as a meaningful productivity tool. NICE has been at the forefront of AI adoption, integrating this technology into its world-class automation designs that are in high demand. In contact center management, NICE has the biggest data asset, which is crucial for training and refining models for accuracy and resilience. As a champion of verticalized AI, NICE will not be easily replaced by a generic generative AI tool, such as ChatGPT. In the case of WNS, AI has useful applications in areas such as automation of pricing models for the travel and leisure industry and automation of manual processing of insurance claims. We like the company's end-to-end vertical integration that aligns with customer business lines and results in strategic, stickier relationships and cross-sell opportunities.

Additionally, broadly in the software space, AI continues to enhance the value proposition of leading SaaS companies, reinforcing the role of software as a decision-support tool for company management teams. As the pressure increases to migrate to the cloud, differentiated businesses like Kinaxis and Model N should continue to benefit with more predictable recurring revenues, multifold growth in average revenue per user and higher customer lifetime value. (We published a piece titled "Software Enterprise: The Changing Landscape" that discusses this topic in greater depth.)

On the hardware and infrastructure side, meaningful additional investments are required so that the efficiency of data centers keeps pace with the increased demand for compute power associated with AI. To illustrate this point, one ChatGPT query consumes 1,000X more computer power than a Google search. Fabrinet and Alphawave are two portfolio businesses that we believe are meaningful beneficiaries of this trend.

Thailand-based Fabrinet is a leading manufacturer of optical photonics equipment. Advanced optical components are structurally replacing copper within data centers. Increasingly, large companies across industries are outsourcing this manufacturing to the most efficient providers, and Fabrinet is the largest provider of high-end connectivity modules (transceivers). The company is asset light with an intelligent contract structure embedded in the business. Pre-payments provide it with negative working capital and fund manufacturing capacity expansions.

UK-based Alphawave licenses silicon IP building blocks that customers integrate into a chip design that is specific to their processes. Given the increasing levels of spending on computing infrastructure, large companies, also known as hyperscalers, that require vast data processing and storage are moving to internalize chip manufacturing and optimize costs associated with more data center capacity. This shift should create meaningful opportunities for Alphawave, a high return on capital business that derives most of its revenue from the design of chips.

Throughout our history, now approaching a dozen years with the same investment approach, we have always based investment decisions on thorough fundamental company research and the understanding of industry value chains. We have never made top-down allocation decisions or traded baskets of securities, and AI is no exception.

## Performance Discussion

Our portfolio marginally underperformed the MSCI ACWI ex USA SMID Index in Q2. Stock selection in information technology was the main detractor from relative return, followed by an underweight in financials. Security selection in health care was a source of relative strength for the portfolio.

On an individual company basis, ViewRay, NICE and FibroGen were the largest detractors. ViewRay's MRIdian MR-LINAC system combines MRI visualization with cancer radiation therapy, allowing treatment to exclusively target cancerous tissue and limit the harm to healthy tissue. We believe this platform has the potential to be the next-generation modality for cancer radiation therapy. Shares of ViewRay fell recently following the company's abrupt shift in tone regarding the ability of its customers to obtain financing for large capital equipment purchases, changes among the C-suite and the reveal of the potential breach of a prior undisclosed debt covenant. Despite the clear long-term promise of this technological breakthrough, we are left with serious questions about the recent execution of management and the forthrightness of the board.

NICE, the portfolio's top holding, was a detractor this quarter after being a lead contributor in Q1. Shares have been volatile this year as the market sorts through the implications of AI adoption across industries. As mentioned in the Investing Environment section, NICE has been ahead of the curve in using AI to drive customer value through existing and new products with its rich data asset. Its journey as a leading enterprise software company with AI-enabled decision tools continues to gain momentum. NICE has expanded market share at the expense of competitors and recently introduced its new suite of products dubbed "Enlighten AI." The company has also been innovative in evolving its pricing paradigm from a per seat to a per transaction model, which should meaningfully expand its addressable market. Management runs the business with greater than 20% margins, more than $1 billion of cash on the balance sheet and a continued focus on R&D. We are highly confident in its multiyear opportunity and believe the stock is attractively valued. Investment in AI is just beginning, and we believe there will be an increasing gap between companies with resources to continue developing AI products, such as NICE, and those that deployed their cash flow on unproductive activities.

Shares of biopharmaceutical company FibroGen fell after pamrevlumab, its lead drug to treat idiopathic pulmonary fibrosis (IPF), failed in late-stage study. While disappointing, we were aware of the higher risk nature of the trial due to the heterogeneous patient population inherent with a disease of unknown origin. We conducted extensive diligence and right-sized the position appropriately to reflect the attractiveness of the opportunity while limiting the potential downside cost. One of our risk management tools is to avoid overconcentration in any company with a binary aspect to the outcome. As it pertains to biotechnology companies in particular, we have a high bar on our conviction and limit the overall industry exposure as a percentage of the portfolio. Through time, a small collection of highly idiosyncratic investments in the tail of the portfolio has been effective in delivering positive convexity for the portfolio as well as an uncorrelated source of returns. We believe our position sizing is such that the upside opportunity is greater than the potential downside cost.

On the positive side, Immunogen, Glaukos and Kornit Digital were the largest contributors. Immunogen is a leading oncology company specializing in antibody-drug conjugates (ADCs) for the treatment of cancer. ADCs are designed to harness the targeting power of antibodies to deliver small molecule drugs to tumors. Immunogen's lead drug Elahere, an ovarian cancer treatment, has shown impressive data with improved survival versus chemotherapy. Elahere's strong safety and efficacy profile is resulting in its rapid adoption as it positions itself to be the standard of care in a large subtype of ovarian cancer. This commercial success also stands to further bolster Immunogen's existing pipeline, including applying Elahere to earlier lines of treatment.

Glaukos focuses on novel therapies for the treatment of glaucoma, corneal disorders and retinal diseases. It is on a journey from a single-product company to a comprehensive ophthalmology enterprise. Glaukos has successfully commercialized a suite of microinvasive glaucoma surgery (MIGS) products that are usually administered in conjunction with cataract surgery. The long-term opportunities for Glaukos stem from a rich pipeline of medical devices, including iStent Infinite and iDose TR, that has the potential to revolutionize the market. Shares performed strongly with increased recognition of iDose TR's potential, as well as mollified fears around the reimbursement of MIGS. Glaukos also continues to expand internationally, with overseas revenue approaching a third, and growing.

Kornit Digital is an intellectual property-protected leader in the digital transformation of the apparel industry that enables automation, near-shoring, eco-friendliness and working capital efficiency of garment manufacturing. Kornit's shares performed strongly during Q2 after the market digested the e-commerce channel's post-COVID destocking and with the development of new printers and novel ink chemistry. After meeting with Kornit's management, customers and competitors at the International Textile Machinery Association conference in Milan, where the company showcased its digital on-demand garment production technologies, we are increasingly convinced of the inevitability of the industry's transformation. Kornit's opportunity lies in both the merchandising market—such as concert t-shirts and sports jerseys—and the much larger mass retail market. The latter tends toward slower adoption, given the magnitude of the capital decisions to transition supply chains, but we believe our patience and long-term orientation will continue to serve us well. With its best-in-class technology, strong customer relationships and strong net cash position, Kornit can fund further R&D and maintain its leadership position in the apparel industry's structural shift to automation.

## Perspective

We recently spoke at Artisan Partner's Investment Forum in Manhattan and took the opportunity to discuss the current macroeconomic environment, misperceptions about the risks inherent in our asset class and the idea of a long-term journey for successful small companies. We focused the majority of the session on the final topic and highlighted key lessons we have learned from our companies.

The path from small to large is rarely easy and hardly ever occurs in a linear fashion. Hence, our approach requires patience and a commitment to contrarian thinking to capitalize on short-termism in the market. We do not invest in fly-by-night operators but rather in resilient, largely non-cyclical, high-quality businesses.

While geopolitical tensions and turbulent markets present challenges, they can also create opportunities for agile and entrepreneurial enterprises. Many of our portfolio companies have taken advantage of market tumult to play offense and have taken the necessary actions to emerge stronger on the other side of a crisis.

One such example is Aixtron, which embodies the power of strategic thinking and a relentless focus on innovation. A few years ago, this German precision machinery maker was a single-product company largely focused on making tools for LED light manufacturing. However, Aixtron recognized a megatrend in compound semiconductors and aggressively invested in R&D, leveraging its expertise in nanoparticle deposition technologies. Today, Aixtron is not only a global leader in equipment for epitaxy—a process necessary for making power semiconductors for electric vehicles—but also in equipment for micro-LED display technologies, communication equipment and next-generation photonics. So instead of a one-legged stool, Aixtron has become a diverse and more resilient enterprise, in addition to achieving faster growth and leading global market share—in spite of all the distractions it faced.

Another example is Jet2, a UK-based vertically integrated online travel agency, which represents a common thread of good businesses playing offense during periods of widespread disruption—in this case the pandemic-led shutdowns, the worst environment for commercial air travel in the history of the industry. Led by a visionary founder, Jet2 took advantage of its historically conservative balance sheet and capitalized on the financial distress of two of its largest competitors. Jet2 used its balance sheet strength to do the following: 1) upgrade its fleet at a time when airplanes were available and cheap; 2) acquire 40 additional landing slots in key airport locations—a critical and scarce asset in this industry; and 3) strengthen its hotel partnerships—which is by far the most profitable part of the business—using its growing scale. Today, Jet2 boasts over $1 billion in net cash on a $3.3 billion market cap and continues to stay ahead of its competition. Jet2 was never a "reopening play" for us but rather a sustained strong business that should continue to get stronger over time.

The last example we'll mention is Kinaxis, which showcases how good companies are not complacent with their current success. Kinaxis is a Canadian software company that focuses on the modeling and planning of complex supply chains. With rising uncertainty and disruptions in the world, the ability to make timely decisions regarding supply chains is now a board-level topic. The company, which historically offered mainly on-premise, implementation-heavy solutions, swiftly transitioned its products to lighter, cloud-based versions that its customers could rapidly implement. Kinaxis also aggressively invested in its sales force to drive meaningful market share gains. Not satisfied only with its earlier success in supply chain modeling, Kinaxis decided to move up the value chain and create planning software, which is opening an even larger market for the company. By these actions, Kinaxis has outmaneuvered larger competitors.

These lessons apply broadly throughout our portfolio, and we remain enthusiastic about the long-term opportunities that our investment universe presents. We continue to travel around the world to find potential winners of tomorrow and invest in a risk-conscious fashion.

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**Current and future portfolio holdings are subject to risk. The value of portfolio securities selected by the investment team may rise or fall in response to company, market, economic, political, regulatory or other news, at times greater than the market or benchmark index. A portfolio's environmental, social and governance ("ESG") considerations may limit the investment opportunities available and, as a result, the portfolio may forgo certain investment opportunities and underperform portfolios that do not consider ESG factors. Growth securities may underperform other asset types during a given period. 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 and less developed markets, including frontier markets. Securities of small- and medium-sized companies tend to have a shorter history of operations, be more volatile and less liquid and may have underperformed securities of large companies during some periods.**

MSCI All Country World ex USA SMID Index measures the performance of small- and mid-cap companies in developed and emerging markets excluding the US. MSCI All Country World ex USA Small Cap Index measures the performance of small-cap companies in developed markets and emerging markets excluding the US. S&P 500® Index measures the performance of 500 US companies focused on the large-cap sector of the market. S&P 500® Equal Weighted Index gives each constituent the same weight in the index, versus the market weighted index where bigger companies hold a larger share of the index. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

This summary represents the views of the portfolio managers as of 30 Jun 2023. 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 comprised the following percentages of the Fund's total net assets as of 30 Jun 2023: Nice Ltd 4.1%, Jet2 PLC 1.9%, Glaukos Corp 1.8%, Model N Inc 1.2%, Kornit Digital Ltd 1.6%, Kinaxis Inc 1.4%, WNS Holdings 1.4%, AIXTRON SE 1.9%, Fabrinet 1.6%, ImmunoGen Inc 1.0%, Alphawave IP Group PLC 0.7%, ViewRay Inc 0.1%, FibroGen Inc 0.0%. 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. All information in this report, unless otherwise indicated, includes all classes of shares (except performance and expense ratio information) and is as of the date shown in the upper right hand corner. This material does not constitute investment advice.

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