

Fine Craftsmanship

“Our strategy is sensible and simple,” says Dan O’Keefe, “but not easy.” The returns he and David Samra are putting up have made it look just that.

INVESTOR INSIGHT



Artisan Partners

Dan O’Keefe (l), David Samra (r)

Investment Focus: Seek fundamentally undervalued companies with “insurance policies” of a quality business, financial strength and value-focused management.

They manage some \$33 billion in both global and international equity strategies for Artisan Partners, but David Samra and Dan O’Keefe still think of themselves primarily as analysts. “Success obviously requires the right strategy and process,” says Samra, “but then it comes down to your level of engagement. We’re still engaged.”

Apparently so. The Artisan International Value Fund they launched in 2002 has earned a net annualized 15.6%, vs. 9.8% for the MSCI EAFE Index.

Contending with valuations worldwide that O’Keefe says tend to be “fair to expensive,” he and Samra are finding mispriced value today in such areas as banking, consumer electronics, semiconductor equipment and software.

You’ve spoken recently about how value investing has evolved since you came to Artisan in 2002. Describe that.

David Samra: In 2002 value investing was more about buying statistically cheap stocks and few value investors made distinctions between good and bad businesses. That mindset seems to have changed dramatically, to the point where statistical cheapness isn’t nearly as important today as owning a high-quality business.

Our view hasn’t changed at all. You make your money by buying businesses at a significant discount to intrinsic value, so the first thing we look for is an undervalued stock. We then add on three what we call insurance policies, which is that the business is of high quality, the balance sheet is strong and the management team is focused on creating shareholder value. We want it all in terms of both price and quality.

Isn’t the problem that finding “it all” at the same time is quite difficult?

Dan O’Keefe: Of course, but there are many shades of grey in how different investors define quality. Google’s [GOOG] business slowed down during the recession and many investors dumped the stock, but it had by no means become a lower-quality business, if by quality you mean the ability to generate over time high and sustainable returns on capital. At that time the share prices of good and bad companies went down together, giving us an opportunity to buy great companies at great prices.

A few years later we were able to buy Google again – at 11-12x earnings, net of

cash – after the stock went down because margins were under pressure for explainable reasons and it had announced what seemed to be the nonsensical acquisition of Motorola’s phone business. The notion that Google was a quality business, incontrovertible now, at the time wasn’t the consensus view. Our job is to cut through the negatives and determine whether they affect the long-term value of the business. If we conclude they don’t, that can provide another opportunity to buy quality on the cheap.

DS: It’s interesting to consider that our investment in Baidu [BIDU], China’s largest search engine, was made under almost exactly the same set of circumstances. It also was highly profitable with net cash on the balance sheet, but the big issue for the stock 18 months ago was that the customer transition from PC search to mobile search created some headwinds for market share and operating margins. Looking through that transition, we thought the company’s mobile investments were set to pay off and that revenue growth would reaccelerate, making the then 13x P/E, net of cash, highly attractive. This turned out to be one of our biggest winners last year and we still own it.

DO: One thing I’d add about combining a great business with a great price is the leverage you can get on the return. A perfect example of that for us was buying MasterCard shares a few years ago after the Durbin amendment passed and everybody thought the company’s business model was in big trouble. When the market concluded that wasn’t so much the case and went back to looking at MasterCard as a duopolistic business with a long growth

runway, the P/E multiple went from something like 15x to 25x. On top of that, earnings kept growing 15-20% per year and management plowed free cash flow into both reducing the share count and increasing the dividend. Having these multiple drivers of value creation can be pretty powerful when they work in combination.

Is this a tough market environment to find that sort of thing?

DS: Yes, which says a lot about how market psychology can separate from underlying economics. I'll give you an example. Four or five years ago we bought shares in Icon plc, an Irish company that provides outsourced R&D services for pharmaceutical companies. Soon after we bought it, the company won a huge contract from Pfizer, which entailed upfront costs but over time would add significantly to earnings. The stock proceeded to go down, because no one was willing to believe the signed contract would eventually show up in the numbers.

Fast forward to last year, when we were considering our options with Mallinckrodt [MNK] after it was spun out from Covidien, which we owned. The company faced a number of what we considered temporary issues and we bought the stock, but soon after the initial spinoff-related selling, the market started ascribing considerable value to still pretty speculative drugs it had in its pipeline. The shares revalued quite quickly to our estimate of intrinsic value, arguably without having earned their stripes.

While the economic backdrop in these two cases wasn't much different, the market psychology was very different. Investors today seem far more forgiving of problems and far more optimistic about opportunities. When that's not supported by the economics, that makes for a dangerous environment.

How do you tend to generate ideas?

DS: We screen a lot on the metrics you'd expect for companies with a combination of low valuation and high business qual-

ity. We also like to search databases using keywords that indicate problems or big changes at a company – things like “profit warning” or “spinoff” or “restructuring.” As with all screening, it's usually valuable only to point you in a direction.

I'd say most of our ideas come from just knowing our markets. Late last year,

ON TODAY'S ENVIRONMENT:

Market psychology can separate from underlying economics. That makes for a dangerous environment.

for example, we visited a Japanese semiconductor-equipment company called Tokyo Electron after it announced it planned to merge with Applied Materials [AMAT]. That's extremely unusual in Japan, for a healthy company to consider merging with a foreign one. Management talked about how they didn't want to go down the path of many Japanese companies, such as Toshiba, NEC or Fujitsu, who over the years had ignored the globalization of their industries and, to negative effect, tried to go at it alone. That struck us as quite enlightened and prompted us to look at the merged entity from the Applied Materials angle, which ended up in our buying the stock.

DO: Another idea example in the category of knowing our markets: One of our more successful investments over the past couple of years has been Lloyds [LYG], the largest retail banking franchise in the United Kingdom. If you own Lloyds you have to pay attention to the other big U.K. commercial and retail banks, and we followed closely how Royal Bank of Scotland [RBS:LN] was pulling back on a number of fronts to pursue a business model closer to the pure U.K. banking focus of Lloyds. We concluded that RBS is in the process of uncovering the same jewel of a retail and commercial banking franchise, but based on how the stock is valued now, that jewel

is considered hidden under a couple of layers of rubble from the financial crisis. That got our attention.

Your global strategy is currently 60% invested in North America. Is that share higher than usual?

DO: It probably is at the higher end of the historic weighting, a result of nothing more complicated than the fact that after the financial crisis we've consistently found in the U.S. more companies trading at attractive prices that have great balance sheets, great business models and great management. We don't really pay much attention to geographic weighting because most of the companies we own are truly global businesses. Companies like 3M, Johnson & Johnson, MasterCard, Google and Microsoft may be domiciled in the United States, but earn half or less of their profits here.

DS: To add a bit more perspective on that, we recently assembled some numbers on regional valuations, profitability and leverage. Excluding financials, total equity-market capitalization to annual GDP is about 99% in the U.S., 66% in Europe and 45% in Japan. Why such a big difference? One explanation is to look at aggregate net public-company profits to annual GDP, which is about 6% in the U.S., 5% in Europe and 3.5% in Japan. What you have in the U.S. is 320 million people, one language, one distribution network, a strong legal structure, generally good education, and management teams that focus on profitability. At the same time in the U.S. you also have lower levels of debt: U.S. non-financial public companies have around 3x debt to net profit, while in Europe it's 4x and in Japan it's 9x. So if you think about what we consider important after an inexpensive valuation, it's not surprising that the U.S. is a more-qualified market for us to invest in. We know this from a micro standpoint, and you can see it as well in these types of macro statistics.

Are you finding more to buy of late in emerging markets?

DO: The short answer is no. After a very long period of credit-induced outperformance, we don't think most of these markets have actually sold off all that much. The aggregate indexes you hear about that are doing poorly tend to be dominated by large state-owned companies that may look cheap, but are generally pretty bad businesses. Smaller companies that are more economically than politically driven are usually of higher quality, but don't have valuations we're finding attractive.

Somewhat of an exception to this rule today is South Korea, which from time to time becomes an oddly cheap place to invest. We still don't find the corporate governance there to be terrific, but we also don't find the management teams – especially at world-class companies such as Samsung Electronics [005930:KS] or Kia Motors [000270:KS] – to be value-destructive in any way.

So Russia hasn't piqued your interest?

DO: As price-driven value investors we can't help but look at Russia, and in fact, many equities there by standard valuation measures appear to look absurdly cheap. That said, there are significant issues to consider aside from statistical valuation, including government interference, cultural and legal corporate-governance concerns, and – to state the obvious – geopolitical risk.

Our most direct exposure to Russia is through our investment in Carlsberg [CARLA:DC], the Denmark-domiciled global beer company that owns Baltika, the largest Russian brewery. Baltika is probably one of the better Russian businesses there is, but it has endured years of regulatory, economic, cultural and legal hurdles that have held back growth and profitability. Our experience with that leads us to conclude that most large-cap Russian equities are too speculative, even at today's prices. With the exception of possibly adding to our Carlsberg stake, this is likely a selloff we'll sit out.

Describe generally how you approach valuation.

DO: Our intrinsic-value estimates attempt to capture what a business should be worth based on its earnings power in a normal economic environment and in a normal, liquid market. That process can obviously differ from company to company. For Diageo [DEO], the global spirits company, earnings just aren't that volatile, so if the stock is trading at a 12-13x P/E

ON RUSSIA:

Our experience leads us to conclude that most large-cap equities there are too speculative, even at today's prices.

you don't really need to normalize things to know that's cheap. For something more cyclical like Royal Bank of Scotland that is not currently earning a normal return on equity or generating a normal level of net income, we'll estimate a normalized earnings power reflecting that it has gotten its cost structure in line and that interest rates and credit costs have reverted to more through-the-cycle averages.

As a starting point, we generally become interested when there's at least 30% upside from today's price to our estimate of intrinsic value. Our discipline is then to sell when something reaches intrinsic value. You can get into situations, like today, where the portfolio for the most part is fairly valued and – because we're bumping up against our 15% portfolio limitations on cash – we're having to make some relative judgments on which fairly valued stocks to keep and which to sell. That's not ideal, but it's the reality of investing when discounts to intrinsic value are pretty close to the narrowest they've ever been.

Describe in more detail what you're seeing beneath the “rubble” in Royal Bank of Scotland.

DO: RBS effectively went bust during the financial crisis. It was the poster child for everything a bank should not do, expand-

ing rapidly and broadly, losing control of credit and overleveraging its balance sheet. The U.K. government bailed it out and still has an 80% ownership interest.

The reconstruction of the company has focused on deleveraging the balance sheet – which they've done to the tune of £800-900 billion – rebuilding capital, and shedding toxic and non-core assets. They've set up a “bad bank” to hold around £25 billion of legacy assets that they've committed to run down over time. They expect to take £5 billion out of the cost base by 2018. They recently announced a planned IPO of Citizens Financial, their U.S. bank that currently accounts for about 10% of the company's total assets and capital. They're also actively seeking a solution in Northern Ireland, where their subsidiary should probably be sold or merged with another bank to increase scale.

The balance sheet is now solid – the core equity tier-1 capital ratio is close to 10% – and RBS is on its way to being a U.K. commercial and retail bank with a loan-to-deposit ratio of less than one and with a strong #2 position behind Lloyds. That should be a very profitable franchise, with the mid-teens return on equity you'd expect from a high-quality, deposit-funded bank in an oligopolistic market.

How do you expect all that to translate into upside for the shares, now at £3.50?

DO: The stock today trades at less than 90% of tangible common equity. Lloyds' shares are at around 1.6x tangible equity. That's a massive difference, but we believe as the underlying earnings power of RBS increases to reflect the 15% ROE it can earn in the future, that will eventually justify a price/book multiple similar to what Lloyds enjoys right now. If you assume the equity base stays flat, which we consider conservative, that type of revaluation would result in 70%-plus upside for the shares. It's likely to be a journey over the next few years, but we expect it to play out similarly to our experience with Lloyds.

We have banks in the U.S. with profiles similar to RBS that you do not own. Why?

INVESTMENT SNAPSHOT

Royal Bank of Scotland
(RBS:LN)

Business: Financial-services holding company increasingly focused on retail and commercial banking in the U.K. Currently 80%-owned by the U.K. government.

Share Information

(@5/29/14, Exchange Rate: \$1 = £0.597):

Price	£3.46
52-Week Range	£2.67– £3.87
Dividend Yield	0.0%
Market Cap	£39.25 billion

Financials (2013):

Revenue	£19.44 billion
Operating Margin	(-11.8%)
Net Profit Margin	(-44.4%)

Valuation Metrics

(Current Price vs. MRO):

	RBS:LN
Price/Book	0.65

RBS:LN PRICE HISTORY



THE BOTTOM LINE

As “layers of rubble” are cleared away and the company focuses primarily on its lucrative U.K. commercial and retail banking franchise, Dan O’Keefe expects profitability, and share valuation, to increase significantly. If it earns the mid-teens ROE he ultimately expects, he believes the stock could revalue at 70% or more above its current level.

Sources: Company reports, other publicly available information

DO: First of all, that could change. But in general our preference is for banks that are more plain vanilla. Lloyds, and eventually RBS, are pretty simple banks, mostly offering mortgages to consumers and lending to small, medium and large businesses. There’s no huge trading operation or large investment bank that dominates the earnings profile. Those are the types of things you find in some of the U.S. universal-bank models.

The bloom appears somewhat off the rose for Samsung Electronics. What makes you more optimistic than pessimistic?

DS: When you get outside the U.S., you can count on one hand the good technology companies, and this is clearly one of

them. It’s actually the world’s largest technology company, a leader in smartphones, semiconductors and a variety of other electronic componentry such as displays.

We’ve owned Samsung in the past, mainly playing the DRAM cycle, as it used to be defined by its semiconductor business. When we last sold it, in 2009, it had a nascent handset business to which we assigned little value, which was obviously a mistake. Now 65-70% of the company’s earnings come from handsets, primarily from the high end of the market where it’s essentially a global duopoly with Apple.

Start there, by assessing the quality of Samsung’s smartphone business.

DS: The company has advantages that we

think make its handset franchise more sustainable. Its global scale and vertical integration in manufacturing its own components gives it a distinct cost advantage over smaller competitors. It has the largest distribution network, which allows it to get products to market more quickly and effectively than competitors. It also is successfully reinvesting some of its massive smartphone profits to expand and reinforce its brand around the world.

DO: When people look at the handset businesses of Samsung and Apple [AAPL], which we also own, two concerns typically come to mind. One, these margins are so high and can’t be sustainable, and two, why won’t Samsung and Apple avoid the fates of once-dominant handset makers like Motorola and Nokia?

To the profitability question, you hear arguments that margins will be driven down to those of other large consumer-electronics businesses like personal computers. But you can’t compare a handset to a PC, where manufacturing margins are in the low single digits, because PC manufacturers are really nothing more than distributors. They typically don’t own the software, the key components or the intellectual property. They basically just assemble it all and the value they bring is getting the end product to stores or to end consumers directly.

In contrast, a Samsung or Apple handset is a stack of software, a chip, a display panel and a number of different components, many of which the companies produce themselves, or in the case of the Android operating system for Samsung, get essentially for free. So for a Dell personal computer, the more relevant margin comparison would add in things like Microsoft’s operating-system margins and Intel’s chip margins. When we do that, we come up with a comparable synthetic PC operating margin that is still the 15-20% range. That kind of analysis adds some valuable context to the handset margins of both Samsung and Apple.

Another important difference to take into account is that a smartphone purchase is a heavily subsidized capital in-

INVESTMENT SNAPSHOT

Samsung

(Seoul: 005930:KS)

Business: Global manufacturer of consumer and industrial electronic equipment, including semiconductors, personal computers, TVs, home appliances and mobile phones.

Share Information

(@5/29/14, Exchange Rate: \$1 = ₩1,021):

Price ₩1.46 million
 52-Week Range ₩1.21 million – ₩1.56 million
 Dividend Yield 1.0%
 Market Cap ₩212.55 trillion

Financials (2013):

Revenue ₩228.69 trillion
 Operating Margin 16.1%
 Net Profit Margin 13.3%

Valuation Metrics

(Current Price vs. TTM):

	<u>005930:KS</u>	<u>S&P 500</u>
P/E	11.3	18.0

005930:KS PRICE HISTORY



THE BOTTOM LINE

Dan O’Keefe expects both the profitability and market share of the company’s large smartphone business to remain more sustainably high than the market currently appears to believe. If that proves true, he says a revaluation of the stock from today’s 7x his estimate of normalized earnings, net of cash, to at least 10x would be fully warranted.

Sources: Company reports, other publicly available information

cash for the remaining assets, which include market-leading global businesses in memory chips and in displays. That’s not to say the stock wouldn’t trade down somewhat if the handset business went away, but we believe the value resident in the rest of the business significantly limits the downside relative to the upside if handsets happen to thrive.

What’s behind your bet that soon-to-be-bigger Applied Materials will prosper?

DS: There are several aspects to the merger – which is still going through the regulatory-approval process – that we expect to be beneficial to shareholders. Semiconductors are manufactured in a line, resulting in varied market shares for equipment providers at each step, but we estimate the merged entity would have a roughly 30% market share across the line. That’s important given that their customers have significantly consolidated over the last few years, especially on the memory side, where three companies control some 90% of the business.

The merger also allows for some other things to happen. Management has identified \$500 million of cost synergies, and we think they’ll ultimately cut more than that. There’s considerable upside in generating incremental, high-margin service revenues on equipment sold by Tokyo Electron, which has historically been a laggard on that front compared to Applied Materials. The merged company also plans to re-domicile in the Netherlands, which will both bring the tax rate down and free up trapped offshore cash for things like share buybacks.

Is the regulatory approval of the deal in question?

DS: The deal requires approval in several countries, with China expected to take the longest. Our view is that while a 30% overall-line share would be relatively high, it isn’t really that high in light of the fact that shares of competitors like Lam Research, KLA-Tencor or ASML are that high or higher in several product categories.

vestment that generates a positive IRR for network-operator buyers. That is a profound difference from a teenager buying a Sony Walkman, and should make handset margins at the high end more sustainable. The average selling price of an iPhone is higher than that for an iPad, even though it’s a lower value-add product. The reason is clearly the subsidy.

In terms of the risk of technological obsolescence, I would say – with somewhat less conviction than for my earlier points – that the industry has reached the end of its initial shakeout. You have two large players with huge profit pools to invest, meaningful scale, and network effects from the software and app environment. It will be much more difficult to break that up than it was six or seven years ago when

the differentiating factor was basically the hardware.

At a recent 1.46 million Korean won, how cheap do you consider the shares?

DS: Translating into dollars, the current market cap is around \$208 billion. The balance sheet is flush with net cash of around \$40 billion, and we estimate normalized EBIT at just under \$30 billion. If you assume a 20% tax rate, the P/E on normalized earnings, ex-cash, is about 7x. Even at a 10x comparable multiple, which we wouldn’t consider ambitious, we’d be very happy.

In the worst-case scenario, where the handset business goes to zero, today we’re basically paying 14-15x earnings net of

ries. The combined share also isn't high compared to that of many large customers in their markets. That said, we're not 100% sure they'll get through this. The reason we purchased Applied Materials instead of Tokyo Electron is that we believe if the deal doesn't go through our margin of safety in it is a lot higher.

You've written that you think coming technological changes in chip manufacturing favor Applied Materials. Explain that.

DS: One of the primary tools historically used to shrink the size of chips has been

lithography. It allows the little lines on the chips that help conduct signals to be made smaller and smaller over time. But we've more or less reached the limits of that process, with the next technological advance likely coming from materials technology, where Applied Materials has been a leader. We consider that knowhow a tailwind to their business and to their ability to take future market share.

What distinguishes management here?

DS: Gary Dickerson, the CEO, and Bob Halliday, the CFO, used to run a company

called Varian, which they sold to Applied Materials in 2011, and they have a proven record as excellent operators and stewards of capital. They've been particularly adept at taking out expenses that don't add real value, letting the savings fall to the bottom line or reinvesting it into research and development that drives market share. We expect their presence to be a clear positive for shareholders over time.

How are you looking at valuation with the shares currently at \$20.25?

DS: In a normalized environment for semiconductor-manufacturing equipment and assuming the merger goes through, we believe the company a few years out can do about \$2.60 in EPS. On that, the shares today trade at only 7.8x earnings.

This is historically a cyclical business, but we've often seen multiples on peak earnings – not even normalized – of 10-11x. That type of revaluation would provide a nice return, but we also believe with a reasonable degree of certainty that the consolidation in the semiconductor marketplace will even out some of the volatility in the business. If that happens, we'd expect that to lead to higher multiples, say 13-15x, which would make the upside even better.

Oracle [ORCL] has been a value-investor favorite for some time. Why are you bullish on its prospects from here?

DS: This is a company that clearly checks all our boxes. It's a great business, with 40% operating margins and leading market shares in database and other enterprise-software markets. Profits are growing at a roughly 10% annual clip and all of the earnings turn into cash, which management either gives back to us through share repurchases and dividends or reinvests in acquisitions that have consistently created value. The balance sheet is rock-solid, with \$14 billion in net cash. Finally, the valuation is cheap at roughly 13x unlevered earnings.

DO: The obvious concern here is that Or-

INVESTMENT SNAPSHOT

Applied Materials
(Nasdaq: AMAT)

Business: Provides manufacturing equipment, services and software to the global semiconductor, flat-panel display, solar photovoltaic and related industries.

Share Information
(@5/29/14):

Price	20.28
52-Week Range	14.62 – 21.16
Dividend Yield	2.0%
Market Cap	\$24.66 billion

Financials (TTM):

Revenue	\$8.51 billion
Operating Profit Margin	14.4%
Net Profit Margin	10.2%

Valuation Metrics
(@5/29/14):

	AMAT	S&P 500
P/E (TTM)	28.8	18.0
Forward P/E (Est.)	15.2	16.0
EV/EBITDA (TTM)	14.7	

Largest Institutional Owners
(@3/31/14):

Company	% Owned
Artisan Partners	5.5%
Harris Assoc	5.3%
Vanguard Group	5.2%
Waddell & Reed	4.9%
T. Rowe Price	4.5%

Short Interest (as of 4/30/14):
Shares Short/Float 6.0%

AMAT PRICE HISTORY



THE BOTTOM LINE

Especially if its pending merger goes through, the company is well positioned both strategically and technologically as its semiconductor-manufacturer clients consolidate, says David Samra. In a cyclical business where multiples on peak earnings often reach 10-11x, the company's shares today trade at only 7.8x his estimate of normalized earnings.

Sources: Company reports, other publicly available information

acle's software franchise is under competitive threat from cloud-based competitors like Salesforce.com, a \$4-billion-annual-revenue company that is growing rapidly and trades at almost the same EV multiple on sales that Oracle does on EBIT. Salesforce.com's customer relationship management [CRM] application is sold as a service to small and medium-sized companies who can't afford to build their own Oracle enterprise systems on site. Putting aside the fact that Salesforce.com is largely going after a different customer than Oracle, the bigger general question revolves around whether Oracle's on-premise busi-

ness model is going away and, if so, what replaces it.

We simply don't buy the prevailing argument that Oracle is going to be somehow displaced by the cloud. For many of its customers, an on-site solution will remain the most secure and cost-effective choice. Bank of America, for example, has something like 80,000 servers, versus Salesforce.com's 4,000. It strikes us as unlikely that a cloud competitor will be able to provide a cheaper, integrated off-site solution to a company with Bank of America's scale.

If a cloud-based solution does make

sense, Oracle has developed a number of fantastic cloud offerings that work seamlessly with its on-premise installations, making it the more logical vendor choice. The company would also argue – and the evidence supports – that such relationships should be more lucrative for it because of the ability to bundle in more products and services.

The stock has fared well even as it has remained relatively cheap. What's your estimate of intrinsic value vs. the current \$42.20 price?

DO: Our view is that the stock has gone from very cheap to just cheap, recently driven by better news in the hardware business originally bought from Sun Microsystems in 2010. Weakness in hardware had been masking somewhat the success of the core business, so renewed growth there seems to have awakened investor interest.

The market cap today is just under \$190 billion. Net cash is \$14 billion. Operating profits are \$17 billion, which after taxes of 20% gives you NOPAT [net operating profit after tax] of around \$13.5 billion. That gives you an unlevered earnings multiple, after cash, of around 13x.

A company of this quality has to be worth 15-20% more than the average business. Put a 16-18x multiple on current earnings and we believe intrinsic value is well into the \$50s.

One final thing I'd say here concerns the balance sheet, which we consider a repository of offensive as well as defensive value. What's the real value of a company like Oracle having \$14 billion in net cash? Making conservative assumptions about debt ratios, the company could borrow an additional \$35 billion on top of its \$14 billion in cash. Invest all that over time in projects earning an average 10% return, and you've created a new annual income stream of \$5 billion. At 15x, that would be an additional \$75 billion in market cap. That's just a simple math exercise, but it highlights the value in a strong balance sheet that we believe is underappreciated by most investors.

INVESTMENT SNAPSHOT

Oracle
(NYSE: ORCL)

Business: Global sales and service of a wide range of enterprise IT solutions, including hardware systems as well as database, middleware and applications software.

Share Information
(@5/29/14):

Price	42.20
52-Week Range	29.86 – 42.35
Dividend Yield	1.1%
Market Cap	\$188.16 billion

Financials (TTM):

Revenue	\$37.90 billion
Operating Profit Margin	38.9%
Net Profit Margin	29.3%

Valuation Metrics
(@5/29/14):

	ORCL	S&P 500
P/E (TTM)	17.6	18.0
Forward P/E (Est.)	13.2	16.0
EV/EBITDA (TTM)	10.5	

Largest Institutional Owners
(@3/31/14):

Company	% Owned
Vanguard Group	3.9%
Capital Research Global Inv	3.5%
State Street	3.1%
BlackRock	2.0%
Massachusetts Fin Serv	1.9%

Short Interest (as of 4/30/14):
Shares Short/Float 0.9%

ORCL PRICE HISTORY



THE BOTTOM LINE

Because the market tends to overestimate the extent to which cloud-based solutions threaten the company's prospects, its exceedingly high-quality business earns only a below-average valuation, says Dan O'Keefe. Assuming a more reasonable multiple of 16-18x current earnings, he pegs the shares' intrinsic value at "well into the \$50s."

Sources: Company reports, other publicly available information

One of your focus ideas from five years ago [VII, May 31, 2009] was Bank of New York Mellon [BK], which you still own. Is that good news or bad news?

DO: It certainly hasn't been a homerun, but the basic answer is that our estimate of intrinsic value was higher than the stock price then and it remains higher than the stock price today. I would say that the management team has underperformed our assumptions on costs, so margins have remained under pressure in a way we hadn't anticipated. Let's call it a story of pleasure deferred.

You also highlighted last time Japan's Sankyo [6417:JP], which you have since dubbed a "multi-year value trap." What happened?

DO: This is a great example of the peril of investing in Japan based upon balance sheets and statistical valuation. Sankyo was very cheap – I think our entry valuation was 1-2x EBIT – and it had a huge pile of net cash. Our mistake was believing

that management was going to return significant amounts of that cash or otherwise deploy it for shareholders' benefit, rather than just hold onto it as a security blanket. It was value destruction by neglect.

ON ORACLE VULNERABILITY:

We simply don't buy the prevailing argument that Oracle is going to be somehow displaced by the cloud.

Great performance runs like yours have proven difficult to maintain. How do you hope to be an exception to that rule?

DO: We don't know if we're going to be an exception to that rule. We have a strategy we believe is straightforward and economically rational, which we've executed the same way for many years, and which we're hopefully getting better at. That should be worth something. We also try

to fight against the forces that tend to impair performance over time. At a portfolio level, we'll close our strategies when we're worried about having too much money. On a personal level, we just refuse to believe we're geniuses, so work as hard today as we ever have. I don't believe you can continue to be successful without doing that.

DS: If you correctly execute a strategy focused on cheap stocks of companies with good businesses, good balance sheets and good management teams – and you don't manage too much money – we believe logically over time you should outperform a passive index. That doesn't mean there can't be a one-, two-, or three-year periods where our performance isn't that terrific. The market could appreciate things we don't care about, say companies growing very rapidly, or those with a lot of leverage. As Dan said, we have to stay focused on the process and building a culture that continuously learns and improves. Hopefully that translates into a situation where this has a very long tail. [vii](#)

Disclosure

Average annual total returns for the fund and benchmark as of 31 March 2014:

Artisan Global Value Fund – ARTGX (Inception 10 Dec 2007): 22.12% (1YR), 16.08% (3YR), 23.16% (5YR), 8.71% (Since Inception). MSCI All Country World Index: 16.55% (1YR), 8.55% (3YR), 17.80% (5YR), 2.03% (Since Inception).

Artisan International Value Fund – ARTKX (Inception 23 Sep 2002): 21.57% (1YR), 13.28% (3YR), 22.22% (5YR), 11.44% (10YR), 15.65% (Since Inception). MSCI EAFE Index: 17.56% (1YR), 7.21% (3YR), 16.02% (5YR), 6.53% (10YR), 9.70% (Since Inception). MSCI EAFE Value Index: 20.25% (1YR), 7.16% (3YR), 16.11% (5YR), 6.41% (10YR), 10.04% (Since Inception).

Expense Ratios are for the fiscal year ended 30 Sep 2013.

Artisan Global Value Fund's expense ratio is 1.38%. The direct operating expenses are 1.37%. The Expense Ratio includes indirect expenses the Fund may incur from investing in an investment company (Acquired Fund Fees and Expenses); such indirect expenses are not paid from the Fund's assets but are reflected in the Fund's return realized by its investment in the acquired funds.

Artisan International Value Fund's expense ratio is 1.18%. The direct operating expenses are 1.16% which are reflected in the Fund's Financial Highlights in the prospectus and financial statements. The expense ratio notes includes indirect expenses the Fund may incur from investing in an investment company (Acquired Fund Fees and Expenses); such indirect expenses are not paid from the Fund's assets but are reflected in the Fund's return realized by its investments in the acquired funds.

Source: Artisan Partners/FactSet/MSCI.

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. The performance information shown does not reflect the deduction of a 2% redemption fee on shares held by an investor for 90 days or less and, if reflected, the fee would reduce the performance quoted. Artisan Global Value Fund's performance information reflects Artisan Partners' agreement to limit the Fund's expenses and has had a material impact on the Fund's performance, which would have been lower in its absence.

Carefully consider the Fund's investment objective, risks and charges and expenses. This and other important information is contained in the Fund's prospectus and summary prospectus, which can be obtained by visiting www.artisanfunds.com. Read carefully before investing.

Artisan International Value Fund and Artisan Global Value Fund: 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. Value securities may underperform other asset types during a given period. **Artisan International Value Fund:** 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. **Artisan Global Value Fund:** Securities of 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.

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For the purpose of determining the Fund’s holdings, securities of the same issuer are aggregated to determine the weight in the Funds. The holdings mentioned comprised the following percentages of the Fund’s total net assets as of 31 Mar 2014: Artisan International Value Fund—Royal Bank of Scotland Group PLC 3.0%; Samsung Electronics Co Ltd 2.8%, Applied Materials Inc 2.4%; Baidu Inc 2.3%; Lloyds Banking Group PLC 2.2%; Mallinckrodt PLC 0.9%; Covidien PLC 3.1%; Carlsberg A/S 1.9%; Kia Motors Corp 1.5%; Tokyo Electron Ltd 0.1%; Sankyo Co Ltd 0.5%; Diageo PLC 1.3%. Artisan Global Value Fund—Oracle Corp 5.0%; Bank of New York Mellon Corp 3.6%; Microsoft Corp 3.4%; Johnson & Johnson 3.1%; Royal Bank of Scotland Group PLC 3.0%; 3M Co 2.3%; Lloyds Banking Group PLC 2.2%; Applied Materials Inc 2.0%; Google Inc 1.8%; Apple Inc 1.6%; Samsung Electronics Co Ltd 1.5%; MasterCard Inc 2.0%; Sankyo Co Ltd 0.2%; Kia Motors Corp 1.7%; Tokyo Electron Ltd 0.1%; Carlsberg A/S 1.7%; Diageo PLC 1.3%. Securities named in the Commentary, but not listed here are not held in the Funds as of the date of this report. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities.

Definitions:

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

Free Cash Flow is a measure of financial performance calculated as operating cash flow minus capital expenditures.

Return on Equity (ROE) is a profitability ratio that measures the amount of net income returned as a percentage of shareholders equity.

Enterprise Value to Earnings Before Interest, Taxes, Depreciation and Amortization (EV/EBITDA) is a measure of the intrinsic value of a business. EV is calculated as the market capitalization of the company plus its long-term debt. EBITDA is an approximate measure of a company’s operating cash flow based on data from the company’s income statement. It is calculated by looking at earnings before the deduction of interest expenses, taxes, depreciation, and amortization.

Price-to-Book Ratio (P/B Ratio) is a valuation measure used to compare a stock’s market value to its book value.

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.

Short Interest or Shares Short/Float is the number of shares short divided by the float. Shares Short is the number of shares currently borrowed by investors for sale, but not yet returned to the owner

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