Value Investor INSIGHT

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The Leading Authority on Value Investing

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Stacking the Deck

Many investors assume they need to take bigger risks to generate outsized returns. Artisan Partners' U.S. value team has proven the opposite to be true.

Ask James Kieffer, Scott Satterwhite and George Sertl to describe their strategy in running Artisan Partners' U.S. small-, mid- and large-cap value portfolios and the conversation turns at length to avoiding risk. "Defense really is the best offense," says Kieffer.

Their investors would agree. Since inception in 1997, Artisan Small Cap Value Fund has earned a net annualized 10.4%, vs. 4.0% for the Russell 2000® Index. Artisan Mid Cap Value Fund, with $5 billion in assets, has earned 10.5% annually since it started in 2001, vs. 6.2% for the Russell Midcap® Index. Artisan Opportunistic Value Fund has returned -0.6% since its inception in 2006 compared to a loss of -1.8% for the Russell 1000® Index. [*Note:* All Performance numbers are as of 12/31/09].

As the market focuses elsewhere, they see value now in less economically sensitive names in such areas as defense, fast-food, technology and insurance. See page 2

INVESTOR INSIGHT

Artisan Partners
Scott Satterwhite, James Kieffer, George Sertl

Investment Focus: Seek companies that concurrently meet three criteria: cheap valuation, sound finances and attractive business economics.

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Investor Insight: Artisan Partners

Artisan Partners' James Kieffer, Scott Satterwhite and George Sertl describe the edge they look to exploit across all cap sizes, why they're finally finding opportunity in consumer-staples stocks, what they think EBITDA really stands for, and why they think Lockheed Martin, McDonald's, Arch Capital, Hewlett-Packard and Emcor are mispriced.

You've described your strategy as being driven by three risk-avoiding criteria. What are they?

James Kieffer: We're basically trying to stack the deck in our favor by making sure we have valuation, the balance sheet and the quality of the business on our side. The criteria provide us with a filtering process, but they're really there in any given situation to increase our understanding of risk, to make sure we're getting properly rewarded for taking risk on, and, maybe most importantly, to avoid situations with an excessive amount.

We start with valuation, where the goal is straightforward: we want to buy things when they're cheap relative to their underlying value. We don't have a one-size-fits-all method for proving something is cheap, but use a variety of methods to fix a range of potential values – the more of which point to it being cheap, the better. If I had to generalize, we want to see high single-digit to low double-digit P/Es based on normalized earnings power. We also want to expect a low to mid double-digit annual compounded return over three to five years, without making crazy assumptions. We believe that's far more likely when you're paying an undemanding price.

The second area of focus is the soundness of the company's financial condition, which everyone seems to care about now, but which we've emphasized for as long as we've been doing this. Here again there's not a single statistical definition of what makes a company fiscally sound – it obviously starts with the amount of financial leverage and the terms associated with that leverage, but it also has a lot to do with earnings quality and stability. The basic premise is that we don't want issues of financial flexibility or liquidity to impede on the company's ability to act on opportunities or to threaten its survival in a bad environment. If you're betting on something that's out of favor, which we almost always are, you need to be sure there's breathing room in the balance sheet so your thesis has the time and opportunity to play out.

Our third criterion focuses on the quality of the business. We're interested in companies that have demonstrated over time that the economics in their industries support the generation of free cash flow. Here we're not talking about EBITDA – which we call "Earnings Before I Think to Do Anything" – but actual cash that can be reinvested in the business or returned to shareholders. I think we as investors lower our intelligence when we rely heavily on EBITDA as a measure of a business's health.

We're also, in terms of quality, looking for businesses with returns on capital that at the very least cover their costs of capital over a cycle. That way we put time on our side with an investment because the underlying value keeps growing as you wait for earnings to rebound or the valuation to come back to normal.

What situations typically create opportunities for you?

JK: You can usually only pay an undemanding price when there's fear or uncertainty associated with a name. That can result from a variety of things: when companies are restructuring, acquiring or divesting; when a turnaround is necessary, either company-specific or in the industry; or when there's been a big operating disappointment of some kind. The common denominator is typically very low expectations.

If I was stranded on a desert island and was given only one way to come up with investment ideas, I'd want to see the daily list of biggest percentage decliners. From my perspective, there's no better indicator

Scott Satterwhite, James Kieffer, George Sertl

Three's Not a Crowd

Successful examples of truly shared responsibility in corporate executive suites are rare – the buck usually only stops in one place. While still tricky to pull off, the joint management of investment portfolios is more common, and few do it better than Scott Satterwhite, James Kieffer and George Sertl. They jointly manage $12.4 billion in assets spread over three Artisan Partners' U.S. value-based strategies (including the previously mentioned mutual funds), small-cap value, mid-cap value and "opportunistic-value," which invests mostly in large-caps.

While each is responsible as the point person for a strategy, that mostly involves representing the separate portfolios to investors and giving trade instructions that the three have arrived at jointly. "There's no hierarchy, and while we're almost always in sync, there's no need for unanimous decisions," says Kieffer.

Satterwhite explains the rationale for setting things up this way: "I've sat on 'buylist' committees where everyone had to agree, and while it sounds comfortable and prudent, it doesn't work. Every good idea with a creative or provocative angle, somebody's not going to like it. You end up with ideas that don't offend anyone, which aren't likely to be very good."

of fear and uncertainty.

That said, it happens from time to time – like now, for example – that high-quality companies with great free cash flow and no real problems seem to kind of get left behind by the market. We call those "respect-the-cash-flow" ideas, and are more than happy to own them when they get cheap enough.

What are some current examples?

George Sertl: We manage all cap sizes and on a risk-adjusted basis we're finding large-cap consumer-staples stocks to be more attractive than they've been in the past 10 to 15 years. If you look at a chart since 1995 of the P/E of consumer-staples stocks in the Russell 3000 index, over the period it averaged over 20x, but earlier this year it fell as low as 12x. We could buy several excellent staples-type companies – including McDonald's [MCD], Kroger [KR], Wal-Mart [WMT] and Nestle [NSRGY], among large caps – for 10-12x normalized earnings. It was as if the market turned its attention to more cyclical companies where earnings were expected to rebound, neglecting more stable companies whose earnings never fell much, or at all, in the first place. The multiples have risen a bit, but we still believe these types of companies are generally undervalued.

You manage three portfolios, each with a different cap-size focus. Do pricing inefficiencies you try to exploit have different sources depending on company size?

JK: The common element we're trying to capitalize on is time-horizon inefficiency. We feel typical investor behavior is to want to own things coincidental to success, so there are plenty of investors out there who will bail at any sign of disappointment. By extending our time horizon out three to five years, we're trying to take advantage of bargains that result when negative news and twitchy investors drive stock prices down. Those types of opportunities are cap-size agnostic.

We think the information-inefficiency tale commonly told about the small-cap universe is over-hyped. In a diversified institutional portfolio, with 50-plus names, we believe you're deluding yourself if you think you can have some unique inside scoop on more than a handful of the names you own.

GS: The primary practical difference in how the three portfolios are run has to do with the number of positions. We've historically held around 100 names in our small-cap portfolio, 40-60 in mid-cap, and 30-40 in the opportunistic-value portfolio, which focuses on large-caps. As you go up the cap scale, individual business risk generally lessens – a large-cap company may have the equivalent of 10-20 small companies inside of it, for example – so we're more comfortable holding fewer positions.

ON POSITION SIZING:

If a stock is cheap and the business economics are fine, but it just clears the financial-soundness hurdle, we'll own less.

If there's overlap in what you can buy or sell, will each portfolio hold the same stocks?

GS: Usually, but not always. We bought Cardinal Health [CAH] in both the mid-cap value and opportunistic-value portfolios in the fourth quarter of 2008, in anticipation of value being unlocked by the spin-off of its CareFusion clinical and medical products division. We sold out of it in the large-cap fund, not because it hit full value, but because we were finding better ideas.

One of those ideas was another healthcare company, Stryker [SYK], whose stock was weak because of worries about healthcare reform's effect on its core orthopedic-implant business, the downturn in its MedSurg equipment division as hospital budgets were cut back, and some company-specific problems with the FDA. The stock historically traded at 20-30x earnings, but as it got into the mid-to-high $30s, we could buy at what we thought was a high single-digit multiple of free cash flow adjusting for the company's cash holdings. That was just a better opportunity at the time than Cardinal Health. [*Note:* Stryker shares currently trade around $51.]

How do you determine position sizes?

GS: Position sizes are set based on how well each company fits our three investment criteria. If it clears each hurdle with flying colors, it will be at the top end of the portfolio in terms of position size. If, say, it's cheap and the business economics are fine, but it just clears the hurdle on financial soundness, it will be at the bottom end. That gives a risk/reward profile to the entire portfolio – it's perfectly fine that our deepest-discount stocks may not be our biggest positions.

How long does it typically take for your investment theses to play out?

GS: We do our analysis looking out three to five years, but how long we hold something obviously depends on how the business and stock price change. Our annual turnover has typically run in the 50-70% range, although it's been a bit higher in the past couple of years because market volatility has been so high.

We'll stay with a company as long as it meets our three criteria. An example would be insurer Alleghany Corp. [Y], which we've owned in the mid-cap value portfolio since 2003. In our opinion, it's well managed and has a long history of compounding book value at a high rate – something like 8.5% annually over the past ten years, a time when the total return for the S&P 500 was basically flat. The current share price [of just under $272] is still at a discount to book value, but if you look at the quality of the businesses and how well management allocates capital, we think it should trade at a solid premium to book value.

Turning to some specific ideas, describe why you think Lockheed Martin [LMT] is unjustly out of favor?

GS: Lockheed's stock peaked at nearly $120 in August of 2008 and has since pulled back quite a bit, primarily due to concerns that overall defense spending by a cash-strapped U.S. government is poised to go down. That's about as deep as the analysis goes, but the conclusion seems to be that if defense spending is going down, Lockheed, as the world's biggest defense contractor, is in for a rough patch.

There are really two buckets of defense spending, the baseline spending on the systems and fleets that represent our long-term military preparedness, and the supplemental spending that covers ongoing wars in places like Iraq and Afghanistan. We fully agree that supplemental spending will decline as we eventually pull back from Iraq and Afghanistan, but we don't think it's at all obvious that baseline spending goes down – even Democrats talk about that kind of defense spending at least growing with inflation longer term. One of the things we like about Lockheed is that roughly 2% of its revenues are attributable to the supplemental budget that may come under pressure.

We also think the company has a better growth profile than the average defense contractor going forward, mainly because of the F-35 fighter-jet program, the largest defense program ever. To give you a sense of its scope, there are more than 3,000 planes currently on order, with a total price tag of around $300 billion, the bulk of which goes to Lockheed as the primary contractor. Currently in the development stage, the program should run for 40 to 50 years and could end up producing 5,000 to 6,000 planes.

Aren't even the biggest programs vulnerable to cuts?

GS: We don't see a big risk of that here. The average Air Force plane is more than 20 years old, so the U.S. is going to have to invest in new aircraft over the next 15 to 20 years or it's not going to have anywhere near the air power it currently has – think of it as a maintenance level of capital spending. The same is generally true of the Air Forces of our allies, who are included in the F-35 program as well. With other fighter-jet programs being cut back, we don't believe there's really any going back at this point.

Could the program get pushed out a year or two or have some of its terms renegotiated? Sure. But given its scope and importance to the military, we think it's unlikely to materially diminish the long-term attractiveness of the F-35 to Lockheed.

How material can the F-35 be to Lockheed's results?

GS: Management says that when they hit full production, the program could generate an additional $15 billion of annual revenue. The aeronautics division usually earns more than 12% operating margins, so at a full run rate the F-35 could result in $2 billion or so in incremental operating profit. Put almost any multiple on that and you get a pretty big number relative to the current $29 billion market cap.

The nice thing today is that we're paying a low multiple on current earnings - which include almost nothing from the F-35

INVESTMENT SNAPSHOT

Lockheed Martin
(NYSE: LMT)

Business: World's largest defense contractor operating in four segments: Electronic Systems, Information Systems and Services, Aeronautics and Space Systems.

Share Information
(@12/31/09):

Price	**75.35**
52-Week Range	57.41 – 87.06
Dividend Yield	3.3%
Market Cap	$28.86 billion

Financials (TTM):

Revenue	$43.80 billion
Operating Profit Margin	9.5%
Net Profit Margin	6.9%

Valuation Metrics
(@12/31/09):

	LMT	S&P 500
Trailing P/E	10.0	74.8
Forward P/E Est.	10.3	18.2

Largest Institutional Owners
(@9/30/09):):

Company	% Owned
State Street Corp	20.0%
Massachusetts Fin Serv	4.6%
Barclays Global Inv	4.1%
Vanguard Group	3.0%
Capital Research Global Inv	2.8%

Short Interest (as of 12/15/09):

Shares Short/Float	1.3%

THE BOTTOM LINE

George Sertl considers fears over potential defense-spending cuts to be overdone for Lockheed, given its almost exclusive reliance on long-term spending programs like the massive F-35 fighter-jet project. At 12-15x his estimate of normalized earnings, the shares would trade for $90 to $120, "without assuming any ramp up from the F-35."

Sources: Company reports, other publicly available information

– so we're paying very little for its potential upside.

At a recent share price of around $77, how are you looking at valuation?

GS: At the current share price, Lockheed trades at about 70% of annual revenues and 10x annual earnings power we estimate at $7.50 to $8 per share. Historically defense companies have gone for around 1x sales and 13-15x earnings. We think in terms of ranges, so putting a 12-15x multiple on our estimate of normal earnings gives us a target price for the shares of around $90 to $120. Again, that's without assuming any ramp up from the F-35.

Any concerns about the overall quality of business or balance sheet?

GS: The business is fairly well-balanced, with each division – Electronic Systems, IT Services, Aeronautics and Space Systems – generating comparable levels of revenue and operating profit. Having been assembled through some large mergers, the company for a time had below-average margins, but now it earns at or above the average rates for the industry.

The balance sheet is strong, with less than $1.5 billion in net debt supported by roughly $4.5 billion in annual earnings before interest and taxes. We also like that they give capital back to shareholders. The current dividend yield is nearly 3.5% and they have been consistent buyers of their stock. Given that the industry is consolidated and there isn't a lot of large M&A left to do, we expect much of the capital generated going forward to come back to us, which we believe lessens our risk.

Earnings have taken pension-related hits lately. Is that a concern?

GS: The fall in asset prices over the past 18 months did impact the pension portfolio and has resulted in charges to GAAP earnings. In terms of the impact on economic value, though, we don't consider it a problem. As a government contractor, Lockheed is allowed to price future pension obligations into contracts. That, plus a recovery in the portfolio's assets, should make this a non-issue over time.

Describe the investment thesis for one of the blue-chip stocks you mentioned snapping up earlier this year, McDonald's.

GS: Jim mentioned that while there's usually fear and uncertainty around our stocks, the market today is also serving up opportunities in high-quality companies that people just seem uninterested in. McDonald's is a good example of that.

There are obviously significant aspects of the business to like. The company owns or franchises nearly 32,000 restaurants in over 100 countries, serving a remarkable 58 million people every day. In the U.S., with about 2.5% of all U.S. restaurant units, it generates about 8% of total restaurant sales. The scale offers big advantages in marketing – the yearly ad budget is around $2 billion – and in the efficiency of the supply chain.

This is primarily a franchise royalty business. McDonald's owns most of the land and buildings, but the large majority of the restaurants operate under franchise agreements – typically running for 20

INVESTMENT SNAPSHOT

McDonald's
(NYSE: MCD)

Business: World's largest restaurant chain, with close to 32,000 owned or franchised fast-food locations operating in 120 countries worldwide.

Share Information
(@12/31/09):

Price	**62.44**
52-Week Range	50.44 – 64.75
Dividend Yield	3.5%
Market Cap	$67.83 billion

Financials (TTM):

Revenue	$22.34 billion
Operating Profit Margin	28.4%
Net Profit Margin	19.3%

Valuation Metrics
(@12/31/09):

	MCD	S&P 500
Trailing P/E	16.3	74.8
Forward P/E Est.	14.3	18.2

Largest Institutional Owners
(@9/30/09):

Company	% Owned
Capital World Inv	6.2%
Barclays Global Inv	4.5%
State Street Corp	4.0%
Vanguard Group	3.7%
Fidelity Mgmt & Research	3.4%

Short Interest (as of 12/15/09):

Shares Short/Float	0.8%

THE BOTTOM LINE

Trading at 14x estimated 2010 earnings – vs. a historical multiple closer to 20x – McDonald's shares don't adequately reflect the company's growth potential, profitability and stability, says George Sertl. Even without multiple expansion, he likes the return potential.

Sources: Company reports, other publicly available information

years – in which franchisees pay something like 14-15% of gross sales in the U.S. (and more in Europe) to McDonald's in the form of royalties, which include franchise fees and rent. Roughly 90% of the company's cash flow comes from those royalties and rents, making for a stable, high-margin business. Company-wide return on equity is roughly 30%, and the return on capital runs in the high-teens.

The balance sheet is impeccable, with annual earnings before interest and taxes covering annual interest expense by more than ten times. They also have the highest credit rating in the industry, which gives them a cost-of-capital advantage.

Are there any important operating challenges on the horizon?

GS: There's some concern in the U.S. about burger price wars and people maybe trading up from McDonald's as the recession ends, but we don't see any real fundamental issues ahead. The company went through a real mindset change earlier in the decade as it went from focusing on getting bigger to getting better. That resulted in a significant cutback in store growth in the U.S. and Europe, but it didn't diminish the company's appetite for growth in developing markets like China, Russia, Brazil and India. Today 65% of system-wide sales and 50-55% of operating profits come from outside the U.S., which we believe provides a nice hedge against U.S.-dollar weakness. We also think McDonald's does fine if inflation takes off, given their low capital spending needs and decent pricing power.

Currently trading around $63.50, how cheap do you consider the shares?

GS: The stock has drifted up some from where we bought it in the mid-$50s, but it still trades at only 14x the roughly $4.50 in earnings we expect in 2010, which is a profit level we consider the low side of normal. At 14x, that's well off the historical multiple in the high-teens and low-20s, which is more reasonable for a still-growing company that is this profitable and stable.

We expect annual earnings growth from 7-8% at the low end, to 10-12% at the high end. On top of that you get a nearly 3.5% dividend. So even with no change in the multiple we like the return potential. If the multiple moves up as well, the return gets that much better.

Similar to Lockheed, we also expect much of the capital McDonald's generates to come back to us in the form of dividends and buybacks. They've raised the dividend rate for 33 straight years, and have returned almost $13 billion of capital to shareholders over the last several years. As long as the market isn't recognizing the value here, we'd expect the buybacks to continue.

You've owned Arch Capital [ACGL] for many years. Why is it particularly attractive now?

JK: Arch is one of the many Bermuda-based insurers that was born after 9/11 on the bet that the tragedy would result in a positive insurance pricing cycle. Unlike a lot of those companies, Arch set about building a full-line property/casualty business. Given that buyers of insurance consider sellers' longevity and reputation a big selling point, that's not an easy thing

INVESTMENT SNAPSHOT

Arch Capital
(Nasdaq: ACGL)

Business: Bermuda-based insurer and reinsurer, offering a full line of property, casualty and specialty insurance products sold primarily through independent brokers.

Share Information
(@12/31/09):

Price	**71.55**
52-Week Range	44.68 – 72.25
Dividend Yield	0.0%
Market Cap	$4.26 billion

Financials (TTM):

Revenue	$3.11 billion
Operating Profit Margin	15.8%
Net Profit Margin	14.5%

Valuation Metrics
(@12/31/09):

	ACGL	Nasdaq
Trailing P/E	10.6	48.9
Forward P/E Est.	7.8	20.7

Largest Institutional Owners
(@9/30/09):

Company	% Owned
Baron Capital	8.0%
Artisan Partners	7.6%
Axa	4.1%
Barclays Global Inv	3.1%
Steinberg Asset Mgmt	2.8%

Short Interest (as of 12/15/09):

Shares Short/Float	4.4%

THE BOTTOM LINE

A soft overall pricing cycle has left the insurer's shares trading at a bare premium to tangible book value, says Jim Kieffer, "as if it were a startup, not a profitable franchise run by one of the best management teams in the industry." He expects upside from at least 10% annual growth in book value and the multiple returning to 1.2-1.4x book.

Sources: Company reports, other publicly available information

to do, but they've done an excellent job in building their franchise.

Property/casualty insurers are currently out of favor, for a variety of reasons. The primary one is that they are in a soft pricing cycle that is likely to get worse in 2010 before it gets better. There is actually excess capital in the industry right now, which has historically put downward pressure on prices as people push to put capital to work even if the pricing isn't as good as it should be. The value destruction stemming from that often doesn't show up for years, but it can be substantial.

There also seems to be some valuation overhang from investors who saw insurance- company book values get creamed as the financial crisis unfolded. This provided a reminder that liquidity and capital risk can be terminal for insurers, a concern that certainly hasn't gone away as industry investment portfolios have somewhat recovered. Combine that general concern with the fact that insurance is already a complex business, with future risks that are opaque at best, and you can understand why many insurers are selling for only six to nine times next year's earnings and for book value or less.

We believe Arch's strengths come to the fore in an environment like this. It has a clear track record of disciplined underwriting and is willing to write much less business when pricing is weak. They've helped institutionalize that discipline by paying underwriters on the profitability of their book of business over as much as ten years, an ethic [CEO] Constantine Iordanou brought with him from his many years at Berkshire Hathaway.

We also like that the company has a history of releasing reserves as evidence builds that it was too conservative in booking initial loss estimates. Arch was an aggressive writer of casualty policies from 2002 to 2005, when pricing in that part of the business was strong. As that book has aged, they've been releasing reserves, to the benefit of earnings and book value. They're doing it at a responsible pace, and we believe there's still a good chunk of reserves still to come out of that.

How has the investment portfolio held up?

JK: They had some of the same problems everyone did when credit spreads blew out, but for the most part their view is to set themselves apart through underwriting, not by being real creative on the investment side. The portfolio is worth about $11 billion and growing, so they can earn nice money on that without taking excess risk. We like that they have one of the shorter-duration portfolios out there, a positive if interest rates eventually start rising again.

ON HEWLETT-PACKARD:

There isn't a lot of controversy here – this is another of those respect-the-cash-flow kinds of situations we like.

What upside do you see for the shares, now trading at around $72?

JK: The current price is at almost no premium to tangible book value of $69 per share. It's like we're investing in this as if it were a start-up, even though it's an established, profitable franchise run by what we consider one of the best management teams in the industry.

The upside then comes in two ways. If the valuation stays constant, we have a company that over time is likely to increase book value by at least 10% per year. Even in a not-expected-to-be-great year – consensus 2010 Earnings Per Share (EPS) estimates are $9-10 per share – the growth of that $69 book value should be well above 10%. On top of that, as the pricing cycle eventually improves and the industry returns to favor, we'd fully expect Arch shares to revert to at least their historical 1.2-1.4x multiple of tangible book.

I'd add that in addition to being opportunistic underwriters, the company has also been opportunistic in buying back its own stock. On Nov. 6th they announced a new $1 billion buyback authorization on top of an already outstanding $350 million authorization. That can have a real impact on a company with a market value of less than $4.3 billion.

Tell us about one of your largest technology positions, Hewlett-Packard [HPQ].

GS: Like McDonald's, this is a blue-chip that went through a big overhaul when a new CEO took over, in this case when Mark Hurd arrived in 2005. He's done a great job of instilling a culture of efficiency and cost-cutting, while significantly diversifying H-P's lines of business. Several years ago the company got most of its profits from the printer division, but after a turnaround of the PC/server business and the expansion of IT services by buying EDS, those three businesses now contribute roughly equally to operating profits. They've been taking market share in their main businesses while cutting costs, which is a great formula for success.

Again like McDonald's, H-P has a global footprint, with approximately 65% of its revenues from outside the U.S. I don't want to overstate this, but that provides very nice upside that we're paying nothing for if we do enter a period of prolonged weakness for the U.S. dollar.

Are there any signs of obvious stress impacting the business or share price?

GS: There isn't a lot of controversy here – it's also more of a "respect-the-cash-flows" kind of situation. The industries in which H-P competes are all highly competitive, but the company combines a strong research and development culture with a good cost position, which has been key support for the market-share gains. It has been impacted by cyclicality in businesses like PCs and printers, but has mostly offset that with revenue strength in servers, enterprise storage and services (from better-than-expected results from EDS). Over our time horizon of the next three to five years, we're not seeing significant business or technology risks.

The balance sheet has very little net

INVESTMENT SNAPSHOT

Hewlett-Packard
(NYSE: HPQ)

Business: Global provider of technology products and services organized into three units: Personal Systems, Imaging and Printing, and Technology Solutions.

Share Information (@12/31/09):

Price	51.51
52-Week Range	25.39 – 52.95
Dividend Yield	0.6%
Market Cap	$123.76 billion

Financials (TTM):

Revenue	$114.55 billion
Operating Profit Margin	9.6%
Net Profit Margin	6.7%

Valuation Metrics (@12/31/09):

	HPQ	S&P 500
Trailing P/E	16.7	74.8
Forward P/E Est.	11.0	18.2

Largest Institutional Owners (@9/30/09):

Company	% Owned
State Street Corp	4.7%
Barclays Global Inv	4.3%
Fidelity Mgmt & Research	3.5%
Vanguard Group	3.5%
Dodge & Cox	3.1%

Short Interest (as of 12/15/09):

Shares Short/Float	0.9%

HPQ PRICE HISTORY

THE BOTTOM LINE

With strong market shares, low costs, solid finances and a healthy ROE, the company's shares deserve to trade at more than a 12x multiple of normal earnings, says George Sertl. A market multiple of at least 14x would be more reasonable, he says, but in the meantime, earnings growth should increase value by at least 10% annually.

Sources: Company reports, other publicly available information

debt and the company generates a great deal of free cash flow, so in terms of financial condition, there's very little risk there either.

So it comes down to valuation – how are you looking at that with the share price recently at less than $53?

GS: This stock has also risen nicely since we bought it, but still trades at less than 12x our $4.50 per share estimate of normalized earnings. The long-term median P/E multiple of American companies has been around 14x earnings. Given that, and the fact that H-P has less debt than the average company, a better ROE, and what we think are sustainable market positions, we see no reason it shouldn't earn at least a market multiple, probably higher. On top of that, given how well it's run, we believe over time the company can translate low single-digit annual revenue growth into earnings growth of around 10% per year. If it does that and the multiple corrects, we as investors will do very well.

Moving down the cap-size scale, describe your interest in Emcor [EME].

Scott Satterwhite: Emcor is a leading player in the business of installing and maintaining electrical, mechanical and plumbing systems. We've been involved with this stock off and on since the company emerged from bankruptcy in the mid-1990s, and the person installed to rehab it, Frank MacInnis, is still in charge. Much of our enthusiasm for the company comes from how it's run, with little financial leverage, tight working-capital management and a clear focus from top to bottom on generating cash flow.

This is certainly the most cyclical bet we've discussed so far. How are you thinking about that?

SS: There clearly is a cyclical element to the business. Going into the downturn at the end of 2007, nearly half of the revenue backlog was in commercial and hospitality-industry construction, areas that clearly have been and will continue to be hard hit. But the rest of the business, spread out over sectors like energy, healthcare, transportation and government facilities, has held up fairly well. Overall, we're expecting revenues to trough next year at $5 to $5.3 billion, down from the latest cycle peak of $6.8 billion in 2008.

That's certainly a hit, but the company has actually become less cyclical over time as they've done a good job of expanding their facilities-services business. At the peak of the last cycle in 2002, services revenues – which are tied to longer-term contracts and are fairly stable over time – made up only 6% of the total. At last year's peak, services ostensibly generated 22% of revenues, and the actual number was quite a bit higher. The reason for the discrepancy is that if Emcor does an original installation and puts a service contract on top of that, those future revenues don't show up under facilities services. We estimate that the actual share of services revenues in 2008 was more than 30%.

How do you arrive at "normal" earnings for what is still a highly cyclical company?

SS: One reason we're so positive about management here is the way they've reinvested free cash flow to increase earnings power. Earnings peaked at $1 per share in 2002, while the 2008 peak came in at around $2.90. Looking trough to trough, earnings went as low as 30 cents per share in 2003, while we don't expect next year's cyclical trough to be lower than $1.50.

With those kinds of differences between peaks and troughs, it isn't easy to say what's "normal." Our best estimate is that after some period of recovery, the run rate of revenues should be around $6 billion, with cash operating margins in the mid-4% range. If that happens, normal earnings would be $2.25 to $2.50 per share.

How is that translating into a target price range for the stock, now at around $28?

SS: We'd expect this type of cyclical and low-margin business to trade at a 12-13x P/E, which on our EPS estimates would translate into a target price of $27 to around $32 per share. One additional adjustment we'd make, however, would be to add around $5 in net cash on the balance sheet to that, reflecting the fact that we expect management to translate that cash to net income by making more of the types of accretive acquisitions they've made in the past. That pushes our target share price to the mid-$30s.

We'll do much better than that if we play the cycle correctly and peak earnings continue to increase. We'd never count on that to justify owning the stock today.

Have events of the past two years caused you to reflect on any particular aspects of your strategy?

JK: One affirmation for us has been our focus on financial strength. George likes to say that liquidity is kind of like oxygen – you don't think about it at all if you have it, but it's all you think about if you don't. We try to think about it all the time.

SS: From late 2003 to sometime in 2007, the median P/E of stocks tracked by *Value Line* was above 17x, vs. a long-term median of 14x as George mentioned earlier. When there's a period like that of persistently high and more or less homogenous valuations, we find ourselves selling a lot of stocks. But because our charter is to be fully invested, the risk at those times is that we sacrifice a bit too much on quality to find things to buy that meet our valuation discipline.

One thing we've talked a lot about is whether at the margin we would have been better off entering the crisis with higher-quality stocks that were a bit pricey, or lower-quality stocks that just met our criteria. We don't at all have a clear answer on that, but it will at least be a discussion point the next time there's a consistently high valuation environment.

Anyone want to take a stab at what the market does in 2010?

JK: We'll leave that to others. We do believe that the economy will eventually recover and that earnings will revert towards our estimates of normal, but we don't know how long that process will take. Given how uncertain things are, we've generally widened and moderately lowered our ranges of normalized estimates, and have been vigilant about pulling back on names that seem to have gotten ahead of themselves. We always think a strict value discipline is the way to go, but it's maybe even more important in times like these. VII

INVESTMENT SNAPSHOT

Emcor
(NYSE: EME)

Business: Installs and services a wide range of electrical, mechanical and other building systems, as part of new construction or the upgrade of existing facilities.

Share Information
(@12/31/09):

Price	**26.90**
52-Week Range	13.44 – 27.88
Dividend Yield	0.0%
Market Cap	$1.83 billion

Financials (TTM):

Revenue	$5.87 billion
Operating Profit Margin	5.3%
Net Profit Margin	3.1%

Valuation Metrics
(@12/31/09):

	EME	S&P 500
Trailing P/E	10.2	74.8
Forward P/E Est.	14.1	18.2

Largest Institutional Owners
(@9/30/09):

Company	% Owned
Barclays Global Inv	7.1%
Vanguard Group	6.3%
Columbia Mgmt Adv	3.3%
Artisan Partners	2.9%
State Street Corp	2.9%

Short Interest (as of 12/15/09):

Shares Short/Float	7.0%

THE BOTTOM LINE

Management has done an excellent job of increasing trough-to-trough and peak-to-peak earnings, says Scott Satterwhite, positioning the company's shares to do well as the construction cycle turns up. Assuming a 12-13x multiple on normalized earnings and expected benefits from acquisitions, his target share price is in the mid-$30s.

Sources: Company reports, other publicly available information

INVESTMENT PERFORMANCE

	TOTAL RETURNS			AVERAGE ANNUAL TOTAL RETURNS					EXPENSE RATIO[6]
As of 3/31/10	**1 Mo[1]**	**QTD[1]**	**YTD[1]**	**1-Yr**	**3-Yr**	**5-Yr**	**10-Yr**	**Inception**	
Artisan Opportunistic Value Fund (ARTLX)	3.89%	5.09%	5.09%	57.38%	-4.49%	--	--	0.67%[3]	1.32%
Russell 1000® Value Index	6.51%	6.78%	6.78%	53.56%	-7.33%	--	--	-1.94%	
Russell 1000® Index	6.14%	5.70%	5.70%	51.60%	-3.98%	--	--	-0.32%	
Artisan Mid Cap Value Fund (ARTQX)[2]	4.15%	3.17%	3.17%	55.81%	0.29%	5.80%	--	10.59%[4]	1.21%
Russell Midcap® Value Index	7.28%	9.61%	9.61%	72.41%	-5.22%	3.71%	--	8.05%	
Russell Midcap® Index	7.07%	8.67%	8.67%	67.71%	-3.30%	4.20%	--	7.01%	
Artisan Small Cap Value Fund (ARTVX)[2]	5.57%	5.79%	5.79%	66.78%	0.87%	6.58%	12.09%	10.70%[5]	1.22%
Russell 2000® Value Index	8.32%	10.02%	10.02%	65.07%	-5.71%	2.75%	8.90%	6.87%	
Russell 2000® Index	8.14%	8.85%	8.85%	62.76%	-3.99%	3.36%	3.68%	4.66%	
As of 12/31/09	**1 Mo[1]**	**QTD[1]**	**YTD[1]**	**1-Yr**	**3-Yr**	**5-Yr**	**10-Yr**	**Inception**	
Artisan Opportunistic Value Fund (ARTLX)	2.92%	6.97%	35.51%	35.51%	-4.67%	--	--	-0.61%[3]	--
Russell 1000® Value Index	1.77%	4.22%	19.69%	19.69%	-8.96%	--	--	-3.76%	
Russell 1000® Index	2.43%	6.07%	28.43%	28.43%	-5.36%	--	--	-1.80%	
Artisan Mid Cap Value Fund (ARTQX)[2]	4.68%	7.10%	39.25%	39.25%	0.84%	6.22%	--	10.51%[4]	--
Russell Midcap® Value Index	5.23%	5.21%	34.21%	34.21%	-6.62%	1.98%	--	7.16%	
Russell Midcap® Index	5.70%	5.92%	40.48%	40.48%	-4.59%	2.43%	--	6.20%	
Artisan Small Cap Value Fund (ARTVX)[2]	6.82%	5.80%	40.24%	40.24%	0.14%	5.85%	11.63%	10.42%[5]	--
Russell 2000® Value Index	7.57%	3.63%	20.58%	20.58%	-8.22%	-0.01%	8.27%	6.18%	
Russell 2000® Index	8.05%	3.87%	27.17%	27.17%	-6.07%	0.51%	3.51%	4.03%	

Source: Artisan Partners/Russell. [1]Returns are not annualized. [2]Closed to most new investors. [3]Fund Inception 3/27/06. [4]Fund Inception 3/28/01. [5]Fund Inception 9/29/97. [6]For the 12 months ended 9/30/09.

The performance quoted represents past performance, which does not guarantee future results. The investment return and principal value of an investment in an Artisan 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 performance information please call 800.344.1770 or visit www.artisanfunds.com.

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The holdings mentioned above comprise the following percentages of the Funds' total net assets (including all classes of shares) as of 12/31/09: Artisan Opportunistic Value Fund: Lockheed Martin 4.0%, McDonald's Corp 2.4%, Arch Capital Group Ltd 3.9%, Hewlett-Packard Co 4.1%, The Kroger Co 3.0%, Wal-Mart Stores Inc 4.0%, Nestle SA 2.7%, Stryker Corp 1.7%, Alleghany Corp 3.0% & Berkshire Hathaway Inc 4.1%. Artisan Mid Cap Value Fund: Arch Capital Group Ltd 2.1%, The Kroger Co 2.1%, Cardinal Health Inc 1.0%, Stryker Corp 2.1% & Alleghany Corp 2.6%. Artisan Small Cap Value Fund: EMCOR Group Inc 1.5%.

The holdings mentioned above comprise the following percentages of the Funds' total net assets (including all classes of shares) as of 3/31/10: Artisan Opportunistic Value Fund: Lockheed Martin 3.9%, McDonald's Corp 2.0%, Arch Capital Group Ltd 3.5%, Hewlett-Packard Co 4.0%, The Kroger Co 2.4%, Wal-Mart Stores Inc 4.0%, Nestle SA 1.0%, Alleghany Corp 3.2% & Berkshire Hathaway Inc 2.5%. Artisan Mid Cap Value Fund: Arch Capital Group Ltd 2.1%, The Kroger Co 2.1%, Stryker Corp 1.8% & Alleghany Corp 2.6%. Artisan Small Cap Value Fund: EMCOR Group Inc 1.6%.

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