Where We Are Finding Growth

Internal Change Catalysts

ARTISAN PARTNERS
Insights

A R T I S A N P A R T N E R S

Where We Are Finding Growth—Internal Change Catalysts

Artisan Partners Growth Team is committed to finding accelerating profit cycles globally and investing in reasonably valued companies that are positioned for long-term growth. The team's experience and broad knowledge of the global economy are key attributes helping them identify growth opportunities, wherever they occur, for the three portfolios it manages—Artisan Global Opportunities Fund, Artisan Mid Cap Fund and Artisan Small Cap Fund.

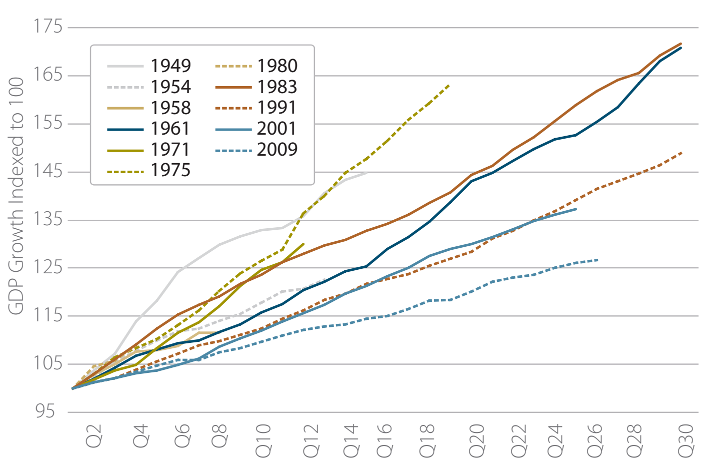
Here, the team discusses key attributes it looks for in identifying franchises that it believes can enjoy a long-term profit cycle, due primarily to compelling internal change catalysts.

A Stubbornly Slow Expansion

The current global bull market started on March 9, 2009, and most developed-world countries exited recession not long thereafter. Though neither length nor magnitude in and of itself indicates a bull market's end, it seems reasonable to posit that the current bull market is likely nearer its end than its beginning.

As bull markets mature, economic (and market) growth typically slows until it finally rolls over into a bear market—and most often an accompanying recession. Over eight years into this bull market, one would expect to see decelerating economic growth. However, this particular global expansion started slowly and never picked up meaningful momentum. Exhibit 1 shows US GDP growth through various historical expansions—the current expansion is the slowest in the post-WWII era. (Global GDP growth follows a similar pattern.)

Exhibit 1: A Historically Slow Expansion

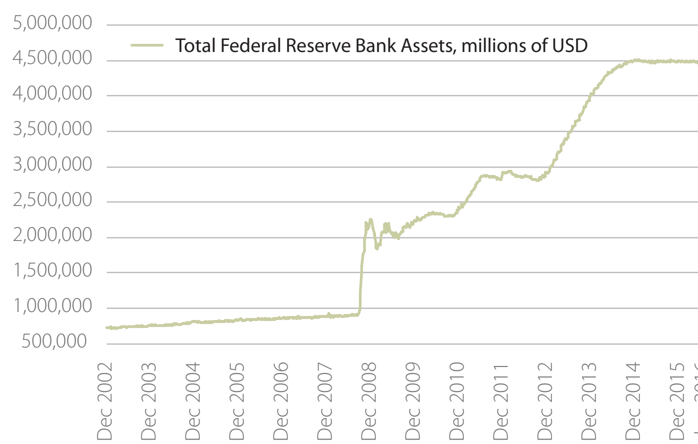


Source: US Bureau of Economic Analysis, as of 9/14/2016.

A Monetary Policy Headwind

Monetary policy has historically been a lever used to guide economies back to growth following contractions—at times more skillfully than at others. However, following the 2007 recession, which was predicated on a credit crisis, policymakers (rightly or wrongly) placed tremendous emphasis on monetary policy in their attempts to spur global growth (and, some would argue, prop up markets into the bargain). As such, global central banks have pursued arguably unprecedented monetary policies for the past seven years. The US Federal Reserve's years of quantitative easing and other dovish measures have produced a balance sheet that has reached a historic size (Exhibit 2). To put the Fed's balance sheet in perspective, its reserve bank assets amount to over 25% of US GDP.

Exhibit 2: The US Federal Reserve has Amassed a Sizeable Balance Sheet



Source: Federal Bank of St. Louis, as of 9/7/2016.

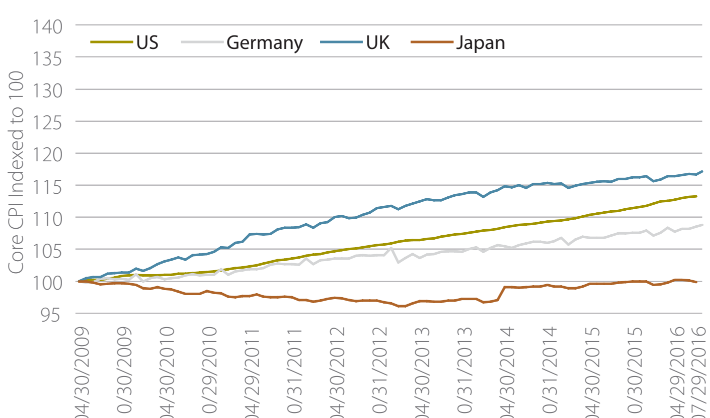
Until recently, global monetary policies had been generally aligned, with most major central banks adopting increasingly and exceptionally dovish stances following the credit crisis--some going as far as deploying some form of quantitative easing. However, more recently, the US in particular has shifted to an ever-so-slightly tighter stance. After years of vowing to keep rates low with an aim of bolstering growth, the Fed has stopped taking much definitive action, preferring a slow-and-steady approach as more economic data are gathered. Indeed, with just three 25bps increases since December 2015, the Fed seems inclined to be patient.

The UK, meanwhile, is moving back toward dovishness. The UK had shifted to a modestly tighter stance in 2012—well before the Fed began to indicate its potential willingness to tighten—ceasing asset purchases under its quantitative easing program. However, in the wake of the UK's recent affirmative vote on the Brexit referendum, the Bank of England cut its benchmark interest rate in July 2016 for the first time in seven years, and BoE Governor Mark Carney has left open the possibility of further cuts, should the economic environment warrant them.

Then we have the European Central Bank and Bank of Japan, which have remained accommodative to the point of implementing negative interest-rate or zero interest-rate policies (NIRP and ZIRP, respectively). Under a negative interest-rate policy, investors effectively pay banks in order to park their cash—and banks pay central banks for the same privilege. Officials have hoped the latter fact would incentivize banks to lend out the cash on their tremendous balance sheets in search of a better yield than the negative one at the central bank—theorizing that sought-after increase in lending would underpin faster economic growth. While the degree to which this is happening is debatable, what is clearer is many investors have sought better yields elsewhere—potentially contributing to the current bull market's duration and helping explain why investors remain willing to invest in riskier assets.

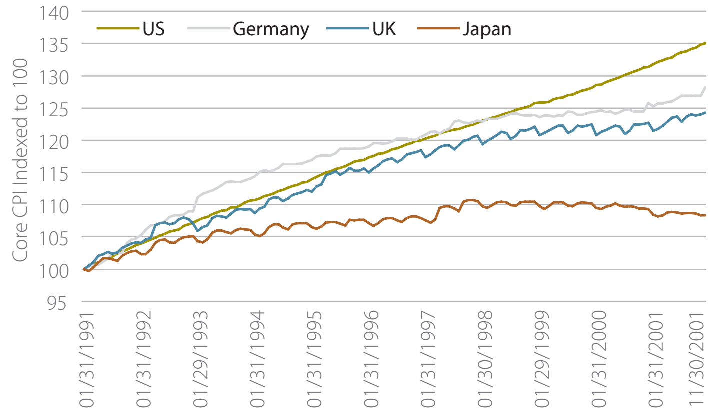
Contrary to what policymakers have been hoping to produce, a byproduct of generally accommodative global monetary policy has thus far been disinflation—and in some countries, outright deflation. Exhibits 3 and 4 show inflation in major developed-world economies during the current expansion versus during the 1990s. Whereas the faster 1990s expansion produced higher rates of inflation than we've seen today, it's no surprise Japan falls to the bottom in both time periods. Japan's challenged macro environment since the late 1980s has made inflation scarce. In fact, Japan's attempts to spur growth through ongoing extraordinary policy have certainly not worked—arguably exacerbating a secular malaise characterized by periodic fits of deflation. And, more recently, scarce growth combined with extraordinary monetary policy has once again produced deflation.

Exhibit 3: Inflation has been Modest Throughout the Current Expansion...



Source: FactSet as of 8/31/2016. Core CPI indexed to 100.

Exhibit 4: ...Particularly Compared to Historical Expansions Like the 1990s



Source: FactSet as of 8/31/2016. Core CPI indexed to 100.

While there have been myriad factors contributing to the current lukewarm expansion, across much of the rest of the developed world, tepid inflation and persistently low interest rates have been an additional headwind to growth. And expectations looking forward are for ongoing, though slower-than-average, growth.

We do not profess to be macro prognosticators—nor does our process require it. However, currently we do not see an obvious catalyst that would tip the world into materially faster growth in the period ahead, and it seems likely growth rates remain contained for some time. Emerging markets, which have been growing at vibrant rates over the past decade or so, seem to be decelerating. Developed markets seem on sounder footing than in recent years—however, many are still contending with tighter lending standards and financial markets regulatory overhang—an additional challenge to growth.

Finding Growth in a Slow-Growth Environment

Such an environment may make investors question where to find growth without the benefit of a strong macro tailwind. However, we take a different approach to finding growth—by applying a fundamental, bottom-up process for identifying solid franchises selling at reasonable valuations and benefiting from either external or internal profit catalysts, or a combination of both.

External growth catalysts need not be predicated on a strong macro environment. Indeed, we believe we have identified a number of secular trends that can transcend the macro environment including:

- Health Care Innovation—New drugs, devices, diagnostics and delivery models that make health care more effective and efficient
- Mobile Internet—Widespread mobile device usage is driving increasing mobile search, advertising and e-commerce

- Next-Gen Data Analytics—Proliferating sensors and mobile connectivity is boosting the profit potential of data analytics
- Industrial Process Innovation—Precision technologies and systems that increase quality, synchronize information streams and speed throughput to lower production costs
- Emerging Markets Consumer—A rising middle class is driving demand for products, experiences and services

We have written about each of these trends in recent communications, and continue to find companies benefiting from them. However, given the slower-growth environment, we believe internal change catalysts can also provide meaningful sources of growth for well positioned companies.

Companies capitalizing on an internal catalyst or catalysts may be in better control of their own destinies—which is an attractive proposition when profits are not being aided by a macro tailwind. These companies often have strong balance sheets that provide better competitive positioning, particularly during periods of economic uncertainty or duress—allowing them to take meaningful share. A sound financial position can also allow such companies to embark on profitable new strategic initiatives regardless of the macro environment. Such companies may not experience explosive top-line growth (though some certainly might). However, we consider ourselves profit-cycle hunters—not strictly revenue hunters—and therefore are just as happy to uncover a compelling margin expansion story. Therefore, we believe the current, more tepid macro environment remains a good backdrop for our approach.

Identifying Internal Catalysts

That said, companies positioned to benefit from an internal catalyst may not present themselves as readily as those that can benefit from an external secular trend—partly because internal catalysts are the definition of company-specific. They also tend to be country and sector agnostic, which can require a deeper level of analysis in order to identify potential candidates.

We believe our investment process is particularly well suited to finding companies in this environment given our benchmark-agnostic approach to growth. This approach gives us the degrees of freedom we need to seek out compelling growth opportunities wherever they occur, without being hamstrung by target sector or country weights.

Among the characteristics we look for as internal catalysts are:

- New management teams
- New products
- Strategic acquisitions or divestitures
- Margin expansion or cost-cutting initiatives

Internal Catalysts in Action

To illustrate the impact internal catalysts can have on profit growth, it's best to consider a few case studies. For example, Shiseido is a leading Japanese beauty brand with a growing global presence. We first purchased Shiseido in June 2015 in the Artisan Global Opportunities Fund due to several positive, internal strategic developments—including a recent change in senior management. The company had hired a new CEO with prior experience from Coca-Cola, and at the beginning of his tenure, he brought in a number of brand managers from outside the company.

From a strategic and cost-cutting standpoint, Shiseido's management team has articulated a clear plan to renew its focus on more profitable product lines and bolster Shiseido's global brand presence with targeted R&D and marketing investments. It also outlined an e-commerce strategy aimed at building its online presence—domestic Japanese distribution has historically been primarily through department stores, introducing an opportunity for strategically improving its e-commerce presence.

Internal and external catalysts often go hand in hand. For example, bolstering those internal catalysts, Shiseido is also positioned to benefit from growing Chinese tourism, which has proved resilient despite China's recent macroeconomic slowdown. Regulatory changes, including more relaxed visa processes, and rising incomes have boosted Japan's tourism, and cosmetics are a popular purchase. While these external trends can reverse, we believe the internal catalysts driving Shiseido provide an attractive growth runway.

Nintendo—a holding in the Artisan Global Opportunities Fund—is the original and dominant leader in gaming intellectual property. Traditionally, Nintendo has limited access to its games to its proprietary platforms, while smartphone-enabled gaming has taken massive share over the last several years. We first purchased Nintendo in April 2015 in the wake of its announced plans to monetize its tremendous IP library via a partnership with Japanese mobile-gaming company DeNA—a compelling strategic shift.

Nintendo also introduced a new CEO in September 2015 who has thus far been committed to continuing Nintendo's transition to mobile and smartphone platforms. And indeed, the tremendous initial success of the release of Pokemon Go for smartphones in July 2016, followed by a mobile platform treatment of Nintendo's popular Mario Brothers characters, seems a promising start for what should be a long growth runway.

Though Electronic Arts (a holding in the Artisan Global Opportunities and Mid Cap Growth Funds) and Nintendo are both gaming-software companies, we view them as benefiting from quite different and distinct internal change catalysts. Whereas Nintendo is primarily benefiting from the compelling growth opportunity tied to the release of its intellectual property in an entirely new and rapidly growing channel, EA's growth runway is predicated on its internal initiatives aimed at margin expansion and more focused product development—where its relatively new management team is already making progress. Resources have been redirected toward core, high-quality franchises such as Madden NFL and FIFA Soccer. In addition, EA's late-2015 launch of its new Star Wars game benefited from Disney's extensive marketing efforts surrounding the release of the next Star Wars film.

The company also maintains its focus on developing robust digital content. Here, too, EA's internal initiatives position it well for secular, industry developments—namely the growing demand for gaming content thanks to the successful introduction of next-generation video game consoles by Sony and Microsoft. At the same time, more of the content business is shifting away from CD sales and toward digital downloads—either of the full game itself or to supplement an already owned game with additional content (i.e., new characters, new levels, etc.). The ongoing trend toward digital gaming should have an additional positive impact on EA's margins while enabling longer-lasting direct relationships with end customers.

We believe that Veeva Systems, a holding in the Artisan Small Cap Fund and Artisan Mid Cap Fund, is also positioned to benefit from solid internal catalysts. Veeva is a life sciences software-as-a-service (SaaS) company whose highly specialized software allows its customers to address and oversee complex government-regulation compliance. At a broad level, it is helping usher in an industry-wide move to SaaS and the cloud—though it is still in the very early stages of displacing on-premise software solutions. In addition to success selling its customer relationship management software, Veeva's Vault product, which helps customers manage highly regulated marketing and clinical trial data and content, is showing signs of similarly rapid uptake.

As is often the case with internally driven companies, Veeva is also helmed by a strong management team—with a prior history at PeopleSoft, another software company known for its commitment to customer success—to which we attribute the company's strong, customer-focused culture. As a result of this attractive combination of industry-level trends and a strong management team, Veeva has driven solid operating margins at a relatively early stage of its growth, and we believe it has the potential to expand its target market beyond investors' current expectations.

Investment Process Highlights

We seek to invest in companies with franchise characteristics that are benefiting from an accelerating profit cycle and are trading at a discount to private market value.

Security Selection

We seek to identify companies with franchise characteristics that are selling at attractive valuations and are benefiting from an accelerating profit cycle. We look for companies that are well positioned for long-term growth, driven by demand for their products and services, at an early enough stage in their profit cycle to benefit from the increased cash flows produced by the emerging profit cycle.

Capital Allocation

Based on our fundamental analysis of a company's profit cycle, we divide the portfolio into three parts. Garden℠ investments are small positions in the early part of their profit cycle that will warrant a more sizeable allocation once their profit cycle accelerates. Crop℠ investments are positions that are being increased to a full weight because they are moving through the strongest part of their profit cycle. Harvest℠ investments are positions that are being reduced as they near our estimate of full valuation or their profit cycle begins to decelerate. We believe that adhering to this process increases the likelihood of delivering upside participation with downside protection.

Broad Knowledge

We overlay security selection and capital allocation with the capability to invest opportunistically across the entire global equity spectrum. It is our goal to have broad knowledge of the global economy to ensure that we are able to find growth wherever it occurs. This capability extends from the design of our team, which leverages the broad experience of the portfolio managers and the deep expertise of the analysts on the team.

Team Overview

We believe deep industry expertise, broad investment knowledge, a highly collaborative decision-making process and individual accountability are a powerful combination. Since the inception of the team in 1997, we have been committed to building a team of growth investors that retains these attributes and is solely dedicated to our process and approach.

For more information: Visit www.artisanpartners.com | Call 800.344.1770

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 calling 800.344.1770. Read carefully before investing.

International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging markets. Securities of 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. Growth securities may underperform other asset types during a given period.

This summary represents the views of the investment team as of 31 March 2017, and is subject to change without notice. Security examples are for informational purposes only and are not representative of the entire portfolio. There is no guarantee that investment within the securities mentioned will result in profit. While the information contained herein is believed to be reliable, there no guarantee as to the accuracy or completeness of any statement in the discussion. This material is for informational purposes only and should not be considered as investment advice or a recommendation of any investment service, product or individual security. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation.

For the purpose of determining the Funds' holdings, securities of the same issuer are aggregated to determine the weight in the Fund. Securities named in the Commentary; but not listed here are not held in the Fund(s) as of the date of this report. The holdings mentioned above comprise the following percentages of Artisan Small Cap Fund's total net assets as of 31 Mar 2017: Veeva Systems Inc 3.3%. The holdings mentioned comprise the following percentages of Artisan Mid Cap Fund's total net assets as of 31 Mar 2017: Electronic Arts Inc 1.5%, Veeva Systems Inc 1.9%. The holdings mentioned comprise the following percentages of Artisan Global Opportunities Fund's total net assets as of 31 Mar 2017: Shiseido Co Ltd 2.0%, Nintendo Co Ltd 1.7%, Electronic Arts Inc 1.5%. 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 and is as of the date shown.

Our capital allocation process is designed to build position size according to our conviction. Portfolio holdings develop through three stages: **Garden**SM **Crop**SM and **Harvest**SM. GardenSM investments are situations where we believe we are right, but there is not clear evidence that the profit cycle has taken hold, so positions are small. CropSM investments are holdings where we have gained conviction in the company's profit cycle, so positions are larger. HarvestSM investments are holdings that have exceeded our estimate of intrinsic value or holdings where there is a deceleration in the company's profit cycle. HarvestSM investments are generally being reduced or sold from the portfolios. **Private Market Value** is an estimate of the value of a company if divisions were each independent and established their own market stock prices.

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