

# ESGandMe

## Examining the Natural Integration Available to Long-Term Thematic Investors

### Artisan Non-U.S. Small-Mid Growth Strategy

## PORTFOLIO MANAGER Viewpoints

March 2021

#### Process Framework

In recent years, ESG (environment, social and governance) principles have gained prominence among investors. While some proprietary rating systems—with varying sub-groups, metrics, methodologies and ranges for scoring by third-party organizations—have been an established, an industry standard has yet to materialize. Rather than rely on third-party ESG ratings, we believe evaluating companies' enduring value propositions, risk factors and corporate governance standards likely serves investors best. As a matter of course, ESG considerations have always been a part of the DNA of our team's investing approach.

From the beginning, our distinctly long-term approach has included a focus on sustainability. We look to invest for a minimum of five years in high-quality businesses that have the potential to be tomorrow's leaders. Our long-term investment horizon requires us to examine how an industry is structured today and envision how it may evolve. This mindset orients the portfolio toward the future by focusing on areas of the investment universe at the intersection of growth and change—areas with structural tailwinds that often result from disruption in an industry value chain and allow entrepreneurial, creative businesses to drive long-term economic value. While this framework helps narrow our investment focus, we construct the portfolio with a bottom-up approach to security selection. We remain grounded in rigorous fundamental company research emphasizing companies with dynamic management teams and defensible competitive advantages that underpin sustainable growth and profitability structures.

#### Intrinsic Alignment

ESG considerations are intrinsically linked to and naturally integrated into our fundamental company research and decision-making process. Our long-term approach means we, and our clients, will directly bear the benefits and costs of management decisions affecting long-term sustainability more meaningfully than shorter-term investors.

Core to our success is partnering with high-quality management teams that foster the right culture and possess a strategic vision. Particularly in smaller companies, where founders and senior leaders tend to have disproportionate impacts on companies' future directions, a thorough underwrite of management teams is crucial. We seek companies with integrity, transparency in corporate governance practices and a proper appreciation of their range of stakeholders. Highly relevant topics we examine include treatment of minority shareholders, voting control versus economic interest, compensation policies and board independence. The costs of bad governance are not always borne out immediately, but good governance is crucial for long-term success. Further, poor corporate governance practices represent risk and may usher in adverse financial, legal and regulatory events. As a result, we exclude companies that exhibit persistently weak ESG characteristics with no course for remediation.

The primary source of information on which we base our investment decisions is direct and ongoing discussions with management teams. Our long-term focus shapes our conversations and the questions to which we seek answers. We seek out and partner with dynamic management teams that over time can thoughtfully evolve with their opportunity sets, increase the resilience of their business models and adjust to a shifting global landscape. We also meet with heads of R&D departments, warehouse facilities, company suppliers, customers



**Rezo Kanovich**  
Portfolio Manager

**22** Years Investment  
Experience



and competitors to gain a more complete picture of the industry value chain. We believe these conversations provide more meaningful insights than could be gained from third-party scoring systems, which are often exclusively quantitative. Judgment surrounding ESG factors and their impact on a business are rarely clear-cut. They usually involve nuance and require careful consideration and continual evaluation—as with all business fundamentals.

Consider, for example, Kornit Digital, an Israel-based leader in commercial printing solutions (e.g., equipment, software and ink) for the garment, apparel and textile industries. Kornit received a poor third-party ESG rating for its failure to provide stated HR policies and management disclosures. While we don't take this critique lightly, Kornit's disruptive direct-to-garment printing technology is enabling the apparel industry's structural shift to automation, fast fashion and increased customization in smaller runs for better inventory management. Kornit's breakthrough has the potential to dramatically shift the textile industry's environmental footprint by reducing the use of traditional large-batch production, which wastes water, produces toxic runoff from dyes and has a large carbon footprint. Given textile production is second only to petroleum in polluting worldwide, this evolution is meaningful. It also onshores operations, enhancing fair labor practices and allowing producers to monitor labor policies more closely. We believe a quantitative-based ESG score on Kornit hinging on the availability of HR-policy documentation may miss the forest for the trees.

### ESG Integration With Portfolio Themes

ESG considerations are also inherently linked to our thematic approach that, by design, narrows our investable universe to areas of the market at the intersection of growth and change which we believe represent enduring structural tailwinds. Creative destruction due to secular shifts in demographics, emergent technologies and discoveries in health care have created an array of opportunities to invest in early stage companies at the forefront of growth. We are interested in companies involved in curing/treating diseases through specialized biologics or gene therapies; companies that produce advanced medical diagnostics tools; companies that make the world cleaner, more efficient and more connected; and companies that solve complex problems across the virtual and physical world. Said simply, we want to invest on the right side of history.

While we do not use exclusionary ESG screens, companies that exploit or deplete natural resources, produce weapons, promote gambling, operate in commoditized industries and harm individuals' and the planet's overall well-being naturally fall outside our universe. Notable ESG-friendly themes currently represented in our portfolio include smart buildings and building automation, next-generation auto, the life sciences revolution, and healthier food ingredients.

### Smart Buildings and Building Automation

Buildings consume nearly 40% of the world's energy. There is a huge opportunity to renovate and thereby decarbonize the existing stock of energy-inefficient buildings. We are attracted to innovators in the areas of smart buildings, including those involved in remote monitoring, temperature control, power efficiency and data monitoring to optimally control building systems. Today notable holdings include Japan-based Azbil and Switzerland-based Belimo. Azbil has a dominant market position in Japan and can durably grow its revenues from its multiyear service contracts for HVAC systems. Belimo makes actuators, valves and sensors for HVAC and fire safety systems and is a leader in non-residential building-efficiency optimization; nearly 95% of its sales are derived from commercial, governmental and industrial buildings. Both companies have technological leadership, strong brand and pricing power.

### Next-Generation Auto

The automobile industry is undergoing seismic changes where it is becoming electrified and connected and will eventually be autonomous. Climate change-related regulations aimed at reducing carbon dioxide emissions and decreasing air pollution are driving the transition from internal combustion engines to hybrid and electric vehicles. It's estimated that 24% of total CO<sub>2</sub> emissions from fuel combustion are transportation-related. Rather than focus on the capital-intensive battery, we're focused on the increased semiconductor and software content critical to meeting safety, durability and power standards, and enabling sufficient car range. Related holdings include US-based Cree and Germany-based Aixtron. Cree is one of only a few companies with the intellectual property and process know-how to manufacture the silicon carbide wafers from which the next generation of power semiconductors used in electric vehicles (EVs) is produced. Cree continues narrowing its focus to EV applications as evidenced by the recent sale of its LED products business unit. Aixtron has a dominant market position in making the metal-organic chemical vapor deposition equipment essential in the manufacturing of compound semiconductors. We believe Aixtron will benefit tremendously as we see tremendous growth in the use cases for compound semiconductors.



## Life Sciences Revolution

Aging populations in the developed and emerging worlds, advances in material science borne of the miniaturization and robotization of procedures, and the integration of artificial intelligence to analyze data have dramatically transformed life sciences to the benefit of many. One of our many holdings in this space is Switzerland-based Tecan Group, which provides the “picks and shovels” powering the biotech revolution. Its core specialty is designing robotic liquid handling for lab and diagnostic equipment. Tecan’s technologies require exquisite precision and have important applications in molecular diagnostics and gene sequencing. These secularly growing areas are driving increased investment in lab automation, and the COVID-19 pandemic has only accelerated this spending. We like Tecan’s coveted, concentrated position in this niche industry.

## Healthier Food Ingredients

Consumers and purveyors have been paying more attention to food ingredients in recent years, and the preference for healthier alternative plant-based fats and oils over animal-based fats and oils is growing. AAK, a Swedish manufacturer of vegetable oils and fats used in meatless and alternative food products, baby formula, chocolate and technical products, is one way we have exposure to this shift. AAK’s ingredients are engineered for longer shelf life and improved food cohesion, and the company has adeptly co-developed unique, tailored formulations with its customers. We believe AAK’s business quality, position in a niche industry and recent innovation will support long-term earnings.

## Summary

We believe the world is full of promise, and, as investors, we believe we can help drive positive change. High-quality businesses with thoughtful and long term-oriented leadership invest for the future, focus on the resilience of their business models and are sensitive to all stakeholders’ evolving preferences—enhancing their opportunity sets and positioning them to generate sustainable earnings.

Our nuanced approach to ESG considerations provides a flexible framework for identifying and investing in companies on the right side of history that make a positive ESG impact and have the potential to deliver long-term value to investors.



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Current and future portfolio holdings are subject to risk. 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. Investments will rise and fall with market fluctuations and investor capital is at risk. Investors investing in strategies denominated in non-local currency should be aware of the risk of currency exchange fluctuations that may cause a loss of principal. These risks, among others, are further described in Artisan Partners' Form ADV, which is available upon request.

Portfolio Manager: Artisan Non-U.S. Small-Mid Growth Strategy—Rezo Kanovich

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For the purpose of determining the portfolio's holdings, securities of the same issuer are aggregated to determine the weight in the Strategy. The holdings mentioned above comprised the following percentages of a representative account within the Composite's total net assets as of 31 Mar 2021: Komit Digital Ltd. 2.2%, Azbil Corporation 1.7%, Belimo Holding AG 0.8%, Cree, Inc. 1.6%, Aixtron SE 2.1%, Tecan Group AG 0.8%, AAK AB 1.0%. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities.

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