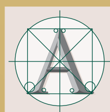
Artisan Partners International Value Team

Investment Philosophy and Process

Artisan Non-U.S. Value Strategy

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

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Artisan Partners International Value Team

Our Investment Team

Research is the foundation of all that we do, and we consider ourselves research analysts primarily and portfolio managers secondarily. There are two principles that drive our research activity. First, we strive for intellectual independence. We do not rely on third-party research or data sources, but instead apply ourselves to multiple primary sources. We form our own view about industries, businesses and the people who manage them. Second, we are generalists, organized by geographical region rather than by industry. By studying different business models across multiple industries, we are oriented toward finding attractive absolute return investments that meet our demanding investment criteria.

Our Investment Philosophy

There are three key components to our investment philosophy: valuation discipline, a long-term perspective and a focus on risk management.

Value Investing

The assessment of value is of course a judgement—and therefore subjective. The key questions for the value investor are always: What is something worth, and what is the right price to pay in order to generate an attractive return? The answers to both of these questions are open to debate, and that is why there are so many styles of value investors.

For us, an attractive value is one where the stock market is pricing the business at a minimum 25% discount to the intrinsic or cash-flow-derived value of the business. This discount provides us not only the primary source of our return, but also a margin of safety in the case of errors.

Different businesses with different characteristics will be worth different multiples of their earnings, cash flow or book equity. We assess each company individually, form an opinion of its value and buy at a price we believe affords us both an attractive return potential and a margin of safety should we make a mistake.

Long-Term Investment Horizon

Time is the ultimate arbiter of business value. In the near term, any multitude of factors can cause stock prices to deviate meaningfully from underlying business value. Investors fret about interest rates, GDP forecasts, consumer sentiment and any other number of variables which, in hindsight, often prove fleeting at best or irrelevant at worst.

There are, of course, more fundamental issues that come into play in investors' perception of value. A business might be going through a competitive challenge or might be restructuring as a result of changes in market conditions. Or, if it is a financial institution, it might be suffering from elevated credit losses which depress profitability. Often these issues and

the subsequent pressure on profitability are extrapolated into perpetuity, unreasonably depressing the stock market valuation. In short, investors might value the business as if conditions will never normalize. These types of near-term pressures are what can create the greatest opportunities for long-term investors willing to look into the future to when conditions are better and business value will be fully apparent once again.

Conversely, and just as important, investors often extrapolate extremely favorable or ideal business conditions into perpetuity. Instead of creating an opportunity for the long-term investor to buy at an attractive price, this can create the opportunity to sell and capture full and fair, or even unfair, value. Dismissing the siren song of short-term optimism is just as important as ignoring the alarm bells of near-term pessimism.

Risk Management

Just as there are many ways of defining value, there are multiple definitions of risk in the investment universe. Our view of risk is fundamentally oriented, which is to say focused on business value and the preservation of capital in real terms. Of course, as value investors, buying a business at a discounted valuation is our primary risk-management tool. No matter how great the business, if we overpay for it, we will not generate an attractive return. That being said, there are two additional concepts of risk that are central to our capital-preservation framework.

Time Value of Money Risk—"Value trap" is the industry term used to describe a stock that looks cheap statistically, yet the equity share price provides little to no return for years. Our ultimate objective is to grow the purchasing power of our investors. Value traps then are a ***real*** risk, as capital providing no return over a long time period in an inflationary world is capital with diminished purchasing power. We call that "time value of money risk."

The underlying cause of a value trap is not hard to discern. A business that does not grow, has low returns or shrinks over time will not provide protection against inflation. Of course, there is a price that is attractive for almost every business. However, most value traps trade at what can look like statistically cheap multiples—a mouth-watering prospect for value investors—but usually not cheap enough to protect the investor against declining business value and against inflation that is ever present.

Our philosophy leads us to skip past assets that are simply statistically cheap and look for high-quality undervalued companies. By high quality, we mean companies that are competitively well-positioned, have the ability to grow, and perhaps have an exceptional management team. Some mix of these characteristics should manifest not only in high returns, but also in ongoing growth in underlying business value. While we wait for a low multiple to turn into a higher multiple, the growth in underlying business value provides the needed protection against inflation. If we combine a high-quality business with an attractive valuation, we maximize our chances of generating attractive, real rates of return.

Business Value Volatility—In the same way that a seemingly modest valuation is often associated with a troubled business, a cheap valuation is often attached to a highly leveraged business. This also presents a significant challenge for the value investor. Leverage, whether it's in the form of high fixed operating costs or in the form of financial leverage (debt), introduces a wide range of potential outcomes. Simply put, a small change in the overall enterprise value of a leveraged company can translate into large movements in the equity value—after the fixed claims of the debt holders are satisfied. We call this business-value volatility. Often when we analyze these types of businesses, the risk/reward outcomes appear to us to be symmetric: If things go well, we should do great because the leverage will work for us; if things go wrong, we will likely do terribly because the leverage will result in large losses. In an always uncertain world, this doesn't strike us as an attractive proposition. As a result, we focus on financially strong businesses where we can generate attractive returns if things go well, but we will not suffer huge value impairment if we are wrong.

For us, an attractive value is one where the stock market is pricing the business at a minimum 25% discount to the intrinsic or cash-flow-derived value of the business. This discount provides us not only the primary source of our return, but also a margin of safety in the case of errors.

Our intrinsic value estimate attempts to capture what a business should be worth based on its earnings power in a normal economic environment.

Our Investment Process

The aim of our process is to own portfolios of businesses that have the four key characteristics we have described— undervaluation, quality, financial strength and management alignment. If we have done our job correctly, the portfolios should aggregate into a group of undervalued companies that are generating high returns on capital, are financially strong and are managed by people who are working to build value over time. We think that all these characteristics together help maximize our chances of success and minimize our chances of permanent loss of capital.

Idea Generation

We generate research ideas in a few different ways. Like most investors, we run screens that sort through the investable universe in an effort to identify potential interesting leads. We run screens based not only on valuation metrics, such as price to earnings, price to book and dividend yields, but also on quality characteristics. We are not interested in identifying the merely statistically cheap, but rather the truly undervalued. This requires a consideration of not only statistical indications of cheapness, but also indications of quality such as margins, cash-flow generation and balance sheet metrics.

We also screen through news databases for key words that might indicate potential undervaluation. For example, we screen on key words such as restructuring, turnaround and spin-off. Companies going through turnaround or restructuring situations are often sold by frustrated investors, and this can create a value opportunity. Companies that are being spun off are often not well understood by the market or the existing shareholder base, and this can also create opportunities for long-term investors.

Perhaps our most important source of idea generation is what we call "knowing our markets." All of our investment team members spend a good portion of their time on the road in local markets, meeting with companies. These companies include not only current holdings, but competitors and comparables to current holdings, as well as potential new investment ideas. This kind of on-the-ground, locally based research is essential to our process.

Business Analysis

Once a business has made it past our initial screening, the intensive research process begins. Company filings are the source material for our financial analysis and financial modelling. Interviews with company executives and industry experts are the primary basis for our industry and competitive research. We attempt to gather information from as close to the source as possible and reach our own conclusions *not predicated on third-party analysis or opinion*. Our objective is always to ascertain whether the business meets our four key criteria of **undervaluation, quality, financial strength** and **management alignment.**

Undervaluation—Assessing the long-term intrinsic value of a business is the most important component of what we do. Our intrinsic value estimate attempts to capture what a business should be worth based on its earnings power in a normal economic environment and in a normal, liquid market. Assessing fair value is as much art as it is science. A business is worth the present value of its future cash flows. Of course, estimating those cash flows and the terminal value at which a rational buyer should capitalize those cash flows is imprecise. Our estimates reflect what we believe are conservative judgements and our years of experience in valuing businesses, as well as what private buyers have been willing to pay for similar businesses.

As a starting point, we generally become interested in a company if the current price is at least 25% below our estimate of intrinsic value. We would stress, though, that it's less about the math and more about the work that goes into assessing risk and reward.

Business Quality—In general, we look to return on capital as the best indicator of underlying business quality. Companies that earn high returns often have financial characteristics such as high profit margins, limited need for additional investment and high levels of cash-flow generation available for distribution to shareholders or to fund growth. Such financial characteristics in turn reflect business fundamentals, including the level of competition in an industry, the relative concentration of suppliers and customers, and the degree of regulation facing an industry. In situations where a company continues to re-deploy capital at a high rate of return, the value of the business should grow over time.

In general, we look to return on capital as the best indicator of underlying business quality.

Financial Strength—Financial strength is probably the easiest of the four characteristics to recognize. We like companies with little to no debt because there is very little margin for error when investing in heavily indebted companies. When a leveraged business is doing well and profits are growing, the returns to equity holders can be enormous, as every incremental dollar of profit accrues to the equity owners. Of course, the opposite is also true: When a leveraged business shrinks, all of the incremental decline is absorbed by the equity owners, as returns to the debt holders are fixed. This is why investors often clamor for management teams to take on more debt when times are good, only to shun the same companies when the road gets bumpy.

We also think that the balance sheet can be a competitive advantage. Economies and industries are cyclical, and downturns often represent the best opportunities to deploy capital at attractive returns—competitors are often retrenching, capital is scarce and valuations are low. Companies with strong balance sheets have the ability to deploy capital when others are capital-constrained. This can include making acquisitions or buying back stock when valuations are low, expanding to take market share when others are retrenching, or simply investing in sales and marketing capabilities when others are cutting back.

Shareholder-Oriented Management—Evaluating management is one of the most subjective and most difficult components of what we do. A good management team can add value in often unforeseen and unquantifiable ways, whether it's an opportunistic acquisition, a well-planned expansion or the careful stewardship of financial resources. Of course, a bad management team can lead a company into a corner from which it is difficult to escape with value intact. We attempt to distinguish the former from the latter in a number of ways. We study management teams' track records; we talk to former colleagues; and we study the incentive structures under which companies choose to operate. Perhaps most importantly, we try to sit down with our management teams on a regular basis to understand the decisions they have made, and drivers behind future decisions. Our objective is always the same: to align ourselves with teams who are driven by long-term value maximization rather than short-term profit generation.

Each of these four characteristics involves shades of grey and, ultimately, relies on our judgment. Rarely do these characteristics appear in one investment in equal measure; we must weigh trade-offs in one area against strengths in another. However, we believe that if we are able to assemble a portfolio of companies that in general meet these four key characteristics, we stand a good chance of generating attractive long-term returns for our shareholders.

Sell Discipline

Our sell discipline is similarly dependent on our value judgment. If a stock has appreciated to our target price, and there is no longer an attractive discount, we are sellers. This includes mistakes where our estimate of intrinsic value has declined to a level that is no longer attractive relative to the stock price. We may also sell when we find another company at a greater discount, or one at a similar discount but with better quality characteristics.

Portfolio Construction

Our approach to portfolio construction is simple: We aim to allocate the most capital to those companies with the highest degree of undervaluation and, therefore, the highest expected rate of return. Very simply, if we estimate that a company is 50% undervalued, it will carry a higher weighting than something that we estimate is 30% undervalued.

In addition, we operate within certain portfolio construction guidelines and constraints that are designed to maintain adequate diversification.

Artisan Non-U.S. Value Strategy

- Typically 40-60 holdings
- Maximum position size 10%[1,2]
- Maximum of 35% in any one country[1]
- Maximum of 30% in emerging markets[1]
- Typically less than 15% cash

Based on a model portfolio. [1]Limitations apply at the time of purchase. [2]With respect to 75% of total assets, the portfolio limits single security sizes to 5%; as to the other 25%, the portfolio may invest up to 10% in a single security.

In Summary

The principles we adhere to—value investing, long-term thinking and risk management—lead us logically to focus on businesses meeting the four key characteristics we have described.

First, we need to purchase our shares at a discount to long-term intrinsic value. As mentioned, this is the primary source of our return as price and fair value converge, and it also mitigates our downside should we make a mistake. Second, we want to own high-quality businesses that have sustainable, long-term competitive advantages that translate into attractive returns on capital. This helps reduce our time value of money risk and increases the chances that our business, purchased at a discount to fair value, should grow in value over time. Third, we want to invest in financially strong businesses. If we are wrong, we are less likely to suffer the devastating losses that high degrees of leverage can bring. And finally, we want to invest alongside management teams that are incentivized to grow business value and whose interests are aligned with ours.

An In-Depth Discussion with Eric Colson, CEO

A Distinctive Investment Culture

Visit: www.artisanpartners.com/InvestmentCulture

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Artisan Non-U.S. Value Strategy is closed to most new investors.

Price-to-Earnings (P/E) Ratio measures how expensive a stock is. It is a valuation ratio of a company's current share price compared to its per-share earnings. **Price-to-Book (P/B) Ratio** is a valuation measure used to compare a stock's market value to its book value. **Return on Capital (ROC)** is a measure of how effectively a company uses the money (borrowed or owned) invested in its operations. **Return on Equity (ROE)** is a profitability ratio that measures the amount of net income returned as a percentage of shareholders equity. **Margin of Safety**, a concept developed by Benjamin Graham, is the difference between the market price and the estimated intrinsic value of a business. A large margin of safety may help guard against permanent capital loss and improve the probability of capital appreciation. Margin of safety does not prevent market loss—all investments contain risk and may lose value.

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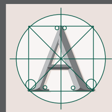
A R T I S A N  P A R T N E R S