A Scientific Approach to Identifying Profit Cycles

Artisan Partners Growth Team

PORTFOLIO MANAGER
Viewpoints

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Portfolio Managers (L-R):

Jason L. White, CFA
Portfolio Manager
19 Years Investment Experience

James D. Hamel, CFA
Portfolio Manager
22 Years Investment Experience

Craigh A. Cepukenas, CFA
Portfolio Manager
30 Years Investment Experience

Matthew H. Kamm, CFA
Portfolio Manager
19 Years Investment Experience

What does it mean to be a profit cycle hunter?

Jim: In our experience, stocks follow profits over time. As growth investors, we're looking for companies with growing businesses. But that needn't manifest itself only in sales growth—we find companies that are expanding their margins and profitability equally compelling. So as profit-cycle hunters, we're looking for companies that are poised to grow their businesses, but to do it in a margin-enhancing way. In other words, we seek companies that may have already made the majority of big investments to support higher sales and faster growth and can now capitalize on those investments.

Why is profit growth so important to your process?

Matt: In the short term, stock prices can be driven by many different factors—including market sentiment—but we've found over the long term that stock prices tend to correlate with profit growth. Therefore, we try to compound the portfolio's value by exposing it to companies with rising profits. In order to do that, we seek to identify some key characteristics in an investment. First, we look for identifiable profit growth drivers—for example, secular trends, technological shifts in an industry, new products, new strategies—that allow us to make a case that profits are likely to grow nicely over the coming years. Second, we prefer companies that are based on a solid, competitively advantaged franchise that is likely to stand the test of competition over time—those that we believe are positioned to deliver interesting rates of growth into the future. We believe it's critical to balance business quality with growth potential—one without the other can lead to trouble.

Can you expand on the types of trends or catalysts you're looking for?

Jason: We find that profit cycles are typically driven by two key areas: external and internal drivers. External drivers often include secular trends that impact a broad industry or section of the economy—as Matt mentioned, technological shifts, demographic changes in society, sometimes regulatory changes. For example, one external driver we believe is particularly powerful right now is the trend toward next-generation data analytics—proliferating sensors and mobile connectivity that are driving increasing demand for not just data, but also the capability to gather, understand, interpret and then use those data to improve future business decisions. This trend in turn boosts the profit potential of companies that are well positioned to capitalize on it. One such company is IHS Markit, a holding in our global and mid-cap portfolios, which is capitalizing on growing demand for data in an array of industries, including finance, energy and automotive.

IHS Markit is also a good example of a company capitalizing on an internal driver. Internal drivers are changes within a specific company that allow that kind of profit growth that Jim described—growth that is margin-enahancing and can unlock faster, more profitable growth in the future. That could mean things like a new product cycle, a new management team that brings better execution, new strategies and new ways of looking at the business, or a strategic merger that allows for meaningful cost synergies and improved efficiencies. IHS Markit is benefiting from its 2016 merger, which is allowing it to consolidate its business and cut costs, and which we believe has the potential to drive meaningful future profit growth as the company takes more share of a tremendous global marketplace.

How can identifying future profit growth be repeatable or scientific?

Craigh: I think there are a number of factors that go into our ability to take this scientific approach. First, it's in the consistency—our process and approach have been consistent over the lifetime of our team. We're disciplined and diligent in our adherence to our process because we have found it to be an overall successful means of identifying growth opportunities.

Second, it's the team itself, which has meaningful experience both individually and collectively. Our analysts have deep, broad knowledge of the economy and help us find growth wherever it's occurring around the world in a repeatable fashion. Further, our senior analysts have covered their respective sectors and industries for a long time, which helps them look constantly for new growth opportunities within their sectors on a global basis.

And finally, it's the decision-makers on the portfolio management team, which has worked together for many years to help take our analysts' ideas and evaluate them for inclusion in the portfolio. The combination of these elements produces a team that is specifically designed around a scientific and repeatable process.

How does valuation play into your thinking on future profit growth? And is there a scientific approach to thinking about valuation as well?

Matt: We certainly strive to do our best to ensure we're paying a reasonable price for future growth. When we look at valuation, we're taking into consideration the business quality, the business model's risk profile and the growth potential we expect for the business. These factors help guide us in terms of understanding a reasonable price to pay for that aspect of the business so we can determine what we anticipate the value of the investment might do in the future.

Specifically, we think about valuation in terms of private market value (PMV)—or the amount we estimate a private market buyer would pay to buy the entire company. As public market investors, we expect to be able to purchase the company at a discount to the PMV. We typically prefer companies that are trading between 60% and 85% of PMV.

That said, we're less interested in the absolute discount we pay at the outset of our investing campaign than in the potential for the PMV to rise over time. Ideally, as a company capitalizes on its profit cycle potential, its PMV goes up along with its price, and we're able to benefit from a virtuous investing campaign.

How do you mitigate or manage risk in this process?

Jim: Risk management is obviously key because one of the greatest threats to long-term return potential is capital impairment. We seek to mitigate this risk via our capital allocation process, which is designed to build position sizes in a measured way such that we can obtain as much confirmation as possible along the way that our profit cycle thesis is playing out as we envisioned. So newer ideas that we believe have meaningful potential but for which we have less evidence start out in the portfolio as Garden℠ positions, which typically represent a smaller proportion of the total portfolio. As we gain conviction in our thesis and gather confirmatory evidence from the company's results, we build the position into a Crop℠ holding. Our intention over time is to have the majority of our capital behind our highest conviction Crop℠ holdings.

And finally, as the profit cycle winds down and our thesis matures, we begin harvesting that position, shifting capital into higher-conviction, younger profit cycles. Executed well, we believe this process helps manage the risk that we're wrong about any individual profit cycle. Our capital allocation has served us well over time, allowing us to take a scientific and repeatable approach to finding highly compelling profit cycles and capitalizing on their growth.

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This summary represents the views of the investment team as of 31 Mar 2018. Those views may change, and the Fund disclaims any obligation to advise investors of such changes. For the purpose of determining the Fund's holdings, securities of the same issuer are aggregated to determine the weight in the Fund. The holdings mentioned above comprised the following percentages of the Funds' total net assets (including all share classes) as of 31 Dec 2018: Artisan Global Opportunities Fund—IHS Markit Ltd 7.0%. Artisan Mid Cap Fund—IHS Markit Ltd 3.9%. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities.

Private Market Value (PMV) is an estimate of the value of a company if divisions were each independent and established their own market stock prices.

Our capital allocation process is designed to build position size according to our conviction. Portfolio holdings develop through three stages: Garden℠ Crop℠ and Harvest℠. Garden℠ investments are situations where we believe we are right, but there not clear evidence that the profit cycle has taken hold, so positions are small. Crop℠ investments are holdings where we have gained conviction in the company's profit cycle, so positions are larger. Harvest℠ holdings are investments that have exceeded our estimate of intrinsic value or holdings where there is a deceleration in the company's profit cycle. Harvest℠ investments are generally being reduced or sold from the portfolios.

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