Artisan High Income Strategy 5-Year Review

A Discussion with Artisan Partners Credit Team portfolio manager Bryan C. Krug, CFA

PORTFOLIO MANAGER
Viewpoints

March 2019

Bryan C. Krug, CFA
Portfolio Manager

18 Years Investment Experience

The Artisan High Income Strategy recently celebrated its five-year anniversary. Since its launch on April 1, 2014, the strategy's total return is among the best in its peer group, ranking in the top percentile within the eVestment US High Yield Fixed Income Universe. Founding portfolio manager Bryan Krug reflects on the portfolio's last five years and offers insights into the team's differentiated approach.

Investment Results

(%) as of 31 March 2019	YTD	1 Yr	3 Yr	5 Yr	Inception[1]
Composite—Gross	6.74	5.36	9.95	7.11	7.11
Composite—Net	6.56	4.63	9.18	6.35	6.35
ICE BofAML US High Yield Master II Index	7.40	5.94	8.69	4.69	4.69
eVestment Percentile Rank		63	9	1	1
eVestment # in Category		206	194	181	181

Annual Returns (%) 12 months ended 31 March 2019	2015	2016	2017	2018	2019
Composite—Gross	5.94	0.12	17.90	7.01	5.36

Source: Artisan Partners/ICE BofA Merrill Lynch/eVestment. Returns for periods less than one year are not annualized. % rank based on eVestment US High Yield Fixed Income Universe. eVestment rankings are based on gross-of-fee total returns. eVestment is a manager-reported database of institutional investment managers and does not independently verify the data. [1]Composite inception: 1 April 2014.

Past performance does not guarantee and is not a reliable indicator of future results. Current performance may be lower or higher than the performance shown. Unlike the Index, the High Income Composite may hold loans and other security types. At times, this causes material differences in relative performance. Composite performance has been presented in both gross and net of investment management fees.

Investment Risks: 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 on the last page, which should be read in conjunction with this material.

What sets your approach apart from your peers?

There are several aspects that differentiate us from many of our high yield bond peers. In my opinion, our commitment to fundamental research stands out. We take a value investor's approach to the below investment grade market and rely on rigorous fundamental bottom up credit selection. This requires passion and dedication plus a significant amount of time and effort, but this is where we believe we add the most value and ultimately drive investment outcomes. Our analysts take a focused approach to coverage responsibilities with a self-imposed limit of 20 issuers per analyst, which allows for deeper due diligence and a better understanding of an issuer's covenant flexibility. To supplement this research, we use extensive third-party resources such as expert networks and unconventional data sources to either verify or challenge our investment thesis.

Also notable is our belief that a focused, high-conviction portfolio can generate consistent and repeatable outperformance over a full market cycle. Because we dedicate significant time and resources to obtaining a complete picture of a company's fundamentals, we're able to better understand the range of possible outcomes in the credits we invest. As a result, we build a portfolio that allows our highest conviction names to meaningfully drive performance.

Finally, the last element is our flexibility to invest across the capital structure. We have no preconceived allocation targets embedded in our process, and investment decisions are a result of our bottom-up research process. When we evaluate an overall business, we overlay the relative value of the different levels of the capital structure, selecting the debt instrument we believe has the best risk-adjusted potential. Taken together, we believe our performance is evidence that this differentiated approach is the right one.

How do credit ratings factor into your investment philosophy and process?

We are ratings-aware but agnostic. We acknowledge that the marketplace looks to ratings, but we rely on our own in-depth fundamental research to determine the creditworthiness of a given company. For this reason, we generally own fewer commodity-oriented issuers and more higher-multiple businesses, often found in the software, insurance and cable sectors. These businesses often have predictable cash flows, low capital expenditures and unique deleveraging capabilities, but are rarely liked by rating agencies. The difference can partly be attributed to divergent views on recovery: The major ratings agencies, in our view, tend to overemphasize hard assets and underemphasize cash flow generated by assets such as intellectual property and technology.

While the credits we have owned play a key role in our portfolio's performance, it's worth noting the credits we've avoided have been just as important. Many of those hard-asset companies and industries that receive more favorable credit ratings tend to be more economically sensitive—consequently, that's where defaults have been most concentrated over the last five years. As a result, our comparatively light exposure in these areas has been a big contributor to our success.

The portfolio has shown a unique ability to hold up well in risk-off environments. How have you been able to mitigate risk and protect the downside?

It all comes back to our deep emphasis on self-generated credit research. Having managed through several different market cycles over my career, I've learned often the best way to win is by not losing. As such, the focus on downside analysis is incorporated throughout every step of our process.

We look to manage downside risk through what we believe to be conservative financial projections that account for an issuer's industry position, the competitive dynamics and positioning within the capital structure. Ultimately, we want to make investments that are "default agnostic"—meaning we don't want to enter into a position where the portfolio would experience permanent capital losses in the event of a default.

Similarly, being value-oriented, capital-structure agnostic investors has been a notable element of our downside protection story. Being able to move into more senior positions in the capital structure based on valuations—combined with our emphasis for quality—has allowed our portfolio to weather several difficult market environments over the last five years. This flexibility has resulted in a consistently lower level of volatility relative to the index and peers. Over the last five years, our portfolio has captured roughly 67% of drawdowns while participating in 95% of the market's upside, highlighting our goal of avoiding negative credit events.[2]

Looking at the market environment when the strategy was launched five years ago, how would you compare and contrast the opportunity set today?

Many of the dynamics that drove credit market returns five years ago are still with us today. When we first launched in March 2014, spreads were tight, yields were low and many thought the credit cycle was in its final innings. The influence central banks had on the credit market was notable as below investment grade bond yields fell below 5% to all-time lows. Looking at our portfolio soon after launch, we had more than 40% of the portfolio in leveraged loans which offered materially better relative value. Five years on, and credit markets have seen several isolated booms and busts—but today's backdrop remains largely the same. Broadly speaking, credit fundamentals remain sturdy and the technical environment favorable, so we expect the current credit cycle to continue and valuations to remain relatively range-bound over the near term.

The biggest difference is the opportunity set has shifted to favor high yield bonds. Today's loan market is marked by more aggressive underwriting and an increase in issuer-friendly terms, limiting the asset class's relative value. This stands in contrast to the bond market which continues to benefit from improving issuance quality and a lack of new supply.

What are some of the main takeaways as you think about the outlook for the rest of the year and beyond?

Overall, we remain constructive on high yield credit as the fundamental and technical backdrop looks largely similar to years past. We're certainly mindful that we're closer to the end of the cycle than the beginning, but we see little evidence to suggest high yield markets are approaching an inflection point. Defaults are low and fundamentals continue to be favorable. While the economic environment should remain supportive for credit investors in the near term, swings in sentiment are likely as investors price in risks from global macro factors like decelerating global growth and uncertain monetary conditions. With this in mind, we believe our disciplined underwriting process and ability to capitalize on market inefficiencies by way of individual security selection is increasingly critical and should serve us well as we enter into the latter stages of the current cycle.

Going forward, the risk/reward profile still looks favorable in our view when compared to other fixed income alternatives—namely, investment grade and emerging market debt. And in the context of risk-adjusted returns, it's important noting that both leveraged loans and high yield bonds are historically less volatile and experience less dramatic drawdowns than equities. Past performance is not indicative of future results, but we believe this reinforces our view that not only does high yield credit warrant a permanent allocation in portfolios, it is an attractive asset class on a relative basis versus other investment alternatives in the current market environment.

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[2]Source: FactSet. As of 31 Mar 2019. Past performance is not indicative of futures results. Based on monthly returns relative to the ICE BofAML US High Yield Index.

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Fixed income securities carry interest rate risk and credit risk for both the issuer and counterparty and investors may lose principal value. In general, when interest rates rise, fixed income values fall. High income securities (junk bonds) are speculative, experience greater price volatility and have a higher degree of credit and liquidity risk than bonds with a higher credit rating. The portfolio typically invests a significant portion of its assets in lower-rated high income securities (e.g., CCC). Loans carry risks including insolvency of the borrower, lending bank or other intermediary. Loans may be secured, unsecured, or not fully collateralized, trade infrequently, experience delayed settlement, and subject to resale restrictions. Private placement and restricted securities may not be easily sold due to resale restrictions and are more difficult to value. The use of derivatives in a portfolio may create investment leverage and increase the likelihood of volatility and risk of loss in excess of the amount invested. 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.

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