

# A Scientific Approach to Identifying Profit Cycles

Artisan Partners Growth Team

PORTFOLIO MANAGER  
Viewpoints

August 2017

## 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.

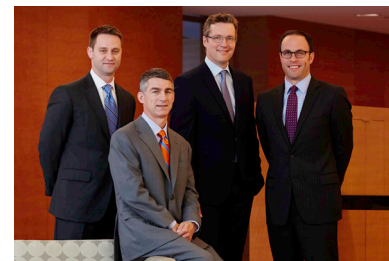
## Why is profit growth so important to your process?

**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-enhancing 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.



Portfolio Managers (L-R):

**Jason L. White, CFA**  
Portfolio Manager

**18** Years Investment Experience

**James D. Hamel, CFA**  
Portfolio Manager

**21** Years Investment Experience

**Craig A. Cepukenas, CFA**  
Portfolio Manager

**30** Years Investment Experience

**Matthew H. Kamm, CFA**  
Portfolio Manager

**18** Years Investment Experience



## 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<sup>SM</sup> 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<sup>SM</sup> holding. Our intention over time is to have the majority of our capital behind our highest conviction Crop<sup>SM</sup> 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.



---

For more information: Visit [www.artisanpartners.com](http://www.artisanpartners.com)

---

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.

This summary represents the views of the investment team as of 31 Mar 2018, which will fluctuate and those views are subject to change without notice. While the information contained herein is believed to be reliable, there is no guarantee as to the accuracy or completeness of any statement in the discussion. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation.

Strategy information contained herein relates to a representative account managed within the investment composite. It is intended to provide a general illustration of the investment strategy and considerations used by Artisan Partners in managing the strategy.

For the purpose of determining the portfolio's holdings, securities of the same issuer are aggregated to determine the weight in the portfolio. Securities named in the Commentary but not listed here are not held in the portfolio(s) as of the date of this report. The holdings mentioned above comprise the following percentages of a representative account within the Composite's total net assets as of 30 Sep 2018: Artisan Global Opportunities Strategy—IHS Markit Ltd 6.7%. Artisan U.S. Mid-Cap Growth Strategy—IHS Markit Ltd 3.6%. 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<sup>SM</sup>, Crop<sup>SM</sup> and Harvest<sup>SM</sup>. Garden<sup>SM</sup> 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. Crop<sup>SM</sup> investments are holdings where we have gained conviction in the company's profit cycle, so positions are larger. Harvest<sup>SM</sup> 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<sup>SM</sup> investments are generally being reduced or sold from the portfolios.

This material is provided for informational purposes without regard to your particular investment needs. This material shall not be construed as investment or tax advice on which you may rely for your investment decisions. Investors should consult their financial and tax adviser before making investments in order to determine the appropriateness of any investment product discussed herein. We expressly confirm that neither Artisan Partners nor its affiliates have made or are making an investment recommendation, or have provided or are providing investment advice of any kind whatsoever (whether impartial or otherwise), in connection with any decision to hire Artisan Partners as an investment adviser, invest in or remain invested in any funds to which we serve as investment adviser or otherwise engage with Artisan Partners in a business relationship.

Artisan Partners Limited Partnership (APLP) is an investment adviser registered with the U.S. Securities and Exchange Commission (SEC). Artisan Partners UK LLP (APUK) is authorized and regulated by the Financial Conduct Authority and is a registered investment adviser with the SEC. APLP and APUK are collectively, with their parent company and affiliates, referred to as Artisan Partners herein.

Artisan Partners is not registered, authorized or eligible for an exemption from registration in all jurisdictions. Therefore, services described herein may not be available in certain jurisdictions. This material does not constitute an offer or solicitation where such actions are not authorized or lawful. Further limitations on the availability of products or services described herein may be imposed.

In no event shall Artisan Partners have any liability for direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) losses or any other damages resulting from the use of this material.

This material is only intended for investors which meet qualifications as institutional investors as defined in the applicable jurisdiction where this material is received, which includes only *Professional Clients* or *Eligible Counterparties* as defined by the UK Financial Conduct Authority where this material is issued by APUK. This material is not for use by retail investors and may not be reproduced or distributed without Artisan Partners' permission.

In the United Kingdom, issued by APUK, 25 St. James's St., Floor 3, London SW1A 1HA, registered in England and Wales (LLP#: OC351201). Registered office: Reading Bridge House, Floor 4, George St., Reading, Berkshire RG1 8LS.

**Australia:** This material is directed at wholesale clients only and is not intended for, or to be relied upon by, private individuals or retail investors. Artisan Partners Australia Pty Ltd is a representative of APLP (ARBN 153 777 292) and APUK (ARBN 603 522 649). APLP and APUK are respectively regulated under US and UK laws which differ from Australian laws and are exempt from the requirement to hold an Australian financial services license under the Australian Corporations Act 2001 in respect to financial services provided in Australia.

**Bailiwick of Guernsey:** The financial services referred to in this material and this document are not being made available in the Bailiwick of Guernsey (Guernsey) to more than 50 persons in Guernsey and the financial services may not be accepted by more than 50 persons in Guernsey.

**Canada:** This material is distributed in Canada by APLP and/or Artisan Partners Distributors LLC, which conduct activities in Canada under exemptions from the dealer, portfolio manager and investment fund manager registration requirements of applicable Canadian securities laws. This material does not constitute an offer of services in circumstances where such exemptions are not available. APLP advisory services are available only to investors that qualify as "permitted clients" under applicable Canadian securities laws.

© 2018 Artisan Partners. All rights reserved.

For Institutional Investors Only—Not for Onward Distribution

A R T I S A N



P A R T N E R S