# Artisan Mid Cap Value Fund

QUARTERLY
Commentary

Investor Class: ARTQX | Advisor Class: APDQX

As of 30 June 2016

## Investment Process

We seek to invest in companies that are undervalued, in solid financial condition and have attractive business economics. We believe that companies with these characteristics are less likely to experience eroding values over the long term.

**Attractive Valuation**

We value a business using what we believe are reasonable expectations for the long-term earnings power and capitalization rates of that business. This results in a range of values for the company that we believe would be reasonable. We generally will purchase a security if the stock price falls below or toward the lower end of that range.

**Sound Financial Condition**

We prefer companies with an acceptable level of debt and positive cash flow. At a minimum, we seek to avoid companies that have so much debt that management may be unable to make decisions that would be in the best interest of the companies' shareholders.

**Attractive Business Economics**

We favor cash-producing businesses that we believe are capable of earning acceptable returns on capital over the company's business cycle.

## Team Overview

Our team has worked together for a long time and each member has a high level of trust and confidence in each other's capabilities. Everyone on the team functions as a generalist with respect to investment research and the entire team works together on considering potential investments. The portfolio managers are supported by two research analysts who share a common mindset and focus on the key elements of our investment process.

**Portfolio Management**

James C. Kieffer, CFA
Portfolio Manager

Scott C. Satterwhite, CFA
Portfolio Manager

George O. Sertl, CFA
Portfolio Manager

Daniel L. Kane, CFA
Portfolio Manager

## Investment Results (%)

| As of 30 June 2016 | QTD[1] | YTD[1] | Average Annual Total Returns 1 Yr | 3 Yr | 5 Yr | 10 Yr | Inception[2] |
|---|---|---|---|---|---|---|---|
| **Investor Class: ARTQX** | **3.26** | **9.65** | **-1.43** | **5.09** | **7.91** | **7.69** | **10.25** |
| **Advisor Class: APDQX** | **3.32** | **9.73** | **-1.29** | **5.16** | **7.95** | **7.71** | **10.26** |
| Russell Midcap® Value Index | 4.77 | 8.87 | 3.25 | 11.00 | 11.70 | 7.79 | 9.93 |
| Russell Midcap® Index | 3.18 | 5.50 | 0.56 | 10.80 | 10.90 | 8.07 | 9.25 |

Source: Artisan Partners/Russell. [1]Returns for periods less than one year are not annualized. [2]Investor Class inception: 28 March 2001. Advisor Class performance is that of the Investor Class from 28 March 2001 through the inception of the Advisor Class on 1 April 2015, and actual Advisor Class performance thereafter. Performance has not been adjusted to reflect the expenses of the Advisor Class for the period prior to the Class's inception, and Advisor Class performance results would differ if such expenses were reflected.

| Expense Ratios | ARTQX | APDQX |
|---|---|---|
| Semi-Annual Report 31 Mar 2016[1] | 1.19 | 1.01 |
| Prospectus 30 Sep 2015 | 1.19 | 1.05[2] |

[1]Unaudited, annualized for the six month period. [2]Includes estimated expenses for the current fiscal year.

Past performance does not guarantee and is not a reliable indicator of future results. Investment returns and principal values will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than that shown. Call 800.344.1770 for current to most recent month-end performance. Performance may reflect agreements to limit a Fund's expenses, which would reduce performance if not in effect.

## Investing Environment

The quarter ended on a volatile note, as Britain voted to leave the European Union. Our investment approach leads us to not make impulsive reactions to exogenous events—we are fundamental, bottom-up investors with a long-term investment horizon. Realistically, the UK's exit will likely take years to execute, and we anticipate several twists along the way—therefore we do not feel making specific projections at this time is worthwhile. If market volatility gives us opportunities to buy quality, well-financed companies based on fears and overreaction, we will try to take advantage of it, as our process is designed to seek out areas of fear and uncertainty.

US stocks advanced across the market-cap spectrum in Q2. The Russell Midcap® Value Index was among the best performing areas, outperforming the Russell Midcap® Growth Index. Gold prices extended their rally, and oil prices sustained their rebound off February lows, buoying the energy and materials sectors. The low-interest rate phenomenon continued, with investors gravitating toward stability—utilities, consumer staples and REITs were among the best performing areas. Indeed, these areas of the market have outperformed over the past few years as investors reached for yield and stability, despite valuations that look stretched to us.

## Performance Discussion

We participated in market upside in Q2, but our portfolio did not keep pace with the Russell Midcap® Value Index. We lost ground to the index following the surprising news of a Brexit, as investors gravitated towards more stable, US-centric areas of the market (e.g., REITs, utilities), where we have below-benchmark exposure. Our portfolio remains ahead on an YTD basis, as strong stock selection and the rebound in a number of our more cyclical exposed holdings has driven results.

Global macro concerns resulted in broad-based selling in the consumer discretionary sector in Q2, and our above-benchmark positioning was a headwind. In addition, some of our holdings had company-specific setbacks, putting them among our bottom individual performers. For example, motorcycle company Harley-Davidson is battling intense competition, resulting in market-share losses. Brexit news put additional downward pressure on shares, as roughly 15% of the company's bikes are sold in Europe. We acknowledge the skepticism around the brand (the skepticism is part of the reason we were able to initiate our position at an attractive valuation), and we are monitoring our position closely. However, our investment thesis remains intact—Harley-Davidson is an above-average business with a strong record of returning free cash flow to shareholders in the form of dividends and buybacks. Longer term, we believe its strong brand will allow it to win back market share.

Global aircraft leasing company Air Lease also weighed on results. Concerns surrounding over-building in the industry and slowing growth in emerging markets (China in particular) have weighed on shares. The stock looks very cheap to us—it's trading near previous trough levels—despite solid fundamentals. We believe the company is one of the best operators in the leasing space with one of the best management teams. Further, it has an investment-grade credit rating, helping mitigate financing risks while providing a competitive advantage.

Technology holdings Avnet and Arrow Electronics were weak in Q2. Both companies are IT distributors with European exposure, whose results are largely a function of global IT spending. Shares traded down in large part due to global economic uncertainty. We believe the selling is overdone. Ingram, an industry competitor, was acquired in Q1 2016 at around a 39% premium, and we believe the bid highlights the industry's attractive valuations. Both stocks currently sell for below 10X our estimates of normalized earnings, are generating strong cash flow and are repurchasing shares.

Conversely, our energy holdings as a whole were strong in Q2, with particular strength in Devon, Apache and Hess. Our process is geared toward investing in low expectation situations, which often occur in areas of the market where high levels of fear and anxiety exist. Over the past few years, fear and anxiety in energy stocks have been palpable, leading us to invest in a number of quality energy companies selling at attractive valuations. To that end, we used the dip in commodity prices in Q1 2016 to build on our positions in these names. As fundamental supply and demand pressures in oil markets show signs of rebalancing, oil prices have rebounded, benefiting a number of our holdings. As inventories decline, we believe oil prices should stabilize within our long-term price range.

Shares of Jacobs Engineering, one of the world's largest engineering and construction companies, also boosted results. The company—which has exposure to the oil and gas industry—also benefited from recovering oil prices. We like that the company's new management team is focusing efforts on long-term capital returns, discipline in pricing and cost controls. Further, its balance sheet is solid, and the company is using its ample free cash flow to reduce debt and repurchase shares.

The uptick in gold prices boosted shares of gold miners Kinross Gold and Goldcorp, putting them among our top performing stocks both QTD and YTD. We're by no means gold bugs, and for years we owned no gold miners, as we believed they priced in too rosy of an outlook on the underlying commodity price. More recently, gold price weakness made a handful of quality gold mining companies look inexpensive. Further, both Goldcorp and Kinross have low-cost reserves and are controlling their below-industry costs.

Our insurance holdings outperformed in the quarter, driven by strength in Torchmark (a provider of life and supplemental health insurance to middle-income households) and Alleghany (a property and casualty insurer). Both companies are executing well, generating free cash flow and returning it to shareholders through share repurchases.

## Portfolio Activity

Markets rallied following the mid-Q1 backslide, and our activity slowed as valuations moved higher. We waved the white flag of defeat and sold our position in enterprise data warehouse Teradata. We also exited our position in mortgage REIT Hatteras Financial—following a general rally in REITs, we reduced our overall exposure, consolidating our holdings into one name, American Capital Agency (AGNC). In our view, AGNC has an attractive return profile and a solid management team, and it trades at a more attractive valuation.

We initiated a position in drug distribution company AmerisourceBergen. We've complained for some time that valuations in the health care space generally appeared stretched. However, more recently, earnings-guidance disappointments and negative sentiment surrounding drug-pricing practices have weighed on investor sentiment, presenting us with an opportunity to initiate our position in the company at roughly 13X our estimates of normalized earnings. We believe it's an above-average business that has managed to compound value well over time. The company returns a good deal of cash flow to shareholders via dividends and share repurchases, and it has a management team financially aligned from a ROIC basis.

We added to a number of our higher-conviction holdings in Q2. A number of the names at the front-end of the portfolio have increased in size not because of success, but because of conviction—meaning, we believe there's still embedded alpha in the portfolio's front end.

## Perspective

The market environment remains challenging for our investment philosophy and process. The low interest-rate phenomenon continues to have an effect on valuations—when rates are this low, the discounting mechanism becomes disjointed. In an environment with low interest rates and high valuations, unloved areas of the market tend to get cheaper still. However, we believe that one of the best ways to find quality investments at a distinct discount to intrinsic value is to show a willingness to go where there is fear and uncertainty in the market place.

As stability has outpaced cyclicality over the last few years, there has been a big push into safer, less cyclical areas. These names had momentum behind them and continued to do well, resulting in money flowing out of more cyclical elements, widening valuation spreads. Indeed, it makes sense to like stability, and you should pay more for a more stable business with high returns—but that doesn't mean there isn't a price for a cyclical business.

We stayed true to our philosophy and process despite this challenging environment and believe our portfolio positioning demonstrates this. We look considerably different from the index, and that's by design. We build the portfolio on a stock-by-stock basis—caring less about what the index owns and caring more about where we think the value is in the market. We are thoughtful and selective in our buying process, and while we may find a holding in sound financial condition with attractive business economics, valuations have increasingly and broadly appeared stretched. As such, we've reached into those unloved areas in order to find opportunities, and many of our stocks have lived through a massive bear market over the last few years while the broader market hit new highs.

We've seen pockets of opportunity in the market, and have been able to selectively add to a number of our higher-conviction names. We believe the portfolio looks to be in better shape, and we feel the return potential on an absolute and relative basis looks compelling.

**For more information:** Visit www.artisanpartners.com | Call 800.344.1770

**Carefully consider the Fund's investment objective, risks and charges and expenses. This and other important information is contained in the Fund's prospectus and summary prospectus, which can be obtained by calling 800.344.1770. Read carefully before investing.**

**Securities of 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. Value securities may underperform other asset types during a given period.**

Russell Midcap® Value Index measures the performance of US mid-cap companies with lower price/book ratios and forecasted growth values. Russell Midcap® Index measures the performance of roughly 800 US mid-cap companies. Russell Midcap® Growth Index measures the performance of US mid-cap companies with higher price/book ratios and forecasted growth values. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

This summary represents the views of the portfolio managers as of 30 Jun 2016. 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 comprise the following percentages of the Mid Cap Value Fund's total net assets as of 30 Jun 2016: Harley-Davidson Inc 1.6%; Air Lease Corp 2.7%; Avnet Inc 2.8%; Arrow Electronics Inc 2.9%; Devon Energy Corp 3.5%; Apache Corp 3.0%; Hess Corp 2.8%; Jacobs Engineering Group Inc 2.5%; Kinross Gold Corp 1.3%; Goldcorp Inc 2.5%; Torchmark Corp 2.2%; Alleghany Corp 3.2%; American Capital Agency Corp 1.7%; AmerisourceBergen Corp 1.7%. Securities named in the Commentary, but not listed here are not held in the Fund as of the date of this report. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities. All information in this report, unless otherwise indicated, includes all classes of shares (except performance and expense ratio information) and is as of the date shown in the upper right hand corner. This material does not constitute investment advice.

Attribution is used to evaluate the investment management decisions which affected the portfolio's performance when compared to a benchmark index. Attribution is not exact, but should be considered an approximation of the relative contribution of each of the factors considered.

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**Return on Invested Capital (ROIC)** is a measure of how well a company generates cash flow relative to capital invested in the business. **Free Cash Flow** is a measure of financial performance calculated as operating cash flow minus capital expenditures. **Alpha** is a quantitative measure of the volatility of the portfolio relative to a designated index. A positive alpha of 1.0 means the fund has outperformed its designated index by 1%. Correspondingly, a similar negative alpha would indicate an underperformance of 1%.

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