# Artisan High Income Fund

QUARTERLY
Commentary

Investor Class: ARTFX | Advisor Class: APDFX

As of 30 June 2017

## Investment Process

We seek to invest in issuers with high-quality business models that have compelling risk-adjusted return characteristics. Our research process has four primary pillars:

**Business Quality**

We use a variety of sources to understand an issuer's business model resiliency. We analyze the general health of the industry in which an issuer operates, the issuer's competitive position, the dynamics of industry participants and the decision-making history of the issuer's management.

**Financial Strength and Flexibility**

We believe that analyzing the history and trend of free cash flow generation is critical to understanding an issuer's financial health. Our financial analysis also considers an issuer's capital structure, refinancing options, financial covenants, amortization schedules and overall financial transparency.

**Downside Analysis**

We believe that credit instruments by their nature have an asymmetric risk profile. The risk of loss is often greater than the potential for gain, particularly when looking at below investment grade issuers. We seek to manage this risk with what we believe to be conservative financial projections that account for industry position, competitive dynamics and positioning within the capital structure.

**Value Identification**

We use multiple metrics to determine the value of an investment opportunity. We look for credit improvement potential, relative value within an issuer's capital structure, catalysts for business improvement and potential value stemming from market or industry dislocations.

## Team Overview

Our team brings together a group of experienced credit analysts who are dedicated to a single investment philosophy and process. All team members conduct deep fundamental credit research as generalists with sector tendencies to identify issuers with high quality business models that have compelling risk-adjusted return characteristics.

**Portfolio Management**

Bryan C. Krug, CFA
Portfolio Manager

## Investment Results (%)

| As of 30 June 2017 | QTD[1] | YTD[1] | Average Annual Total Returns 1 Yr | 3 Yr | 5 Yr | 10 Yr | Inception[2] |
|---|---|---|---|---|---|---|---|
| **Investor Class: ARTFX** | **2.35** | **5.50** | **12.81** | **6.68** | — | — | **6.88** |
| **Advisor Class: APDFX** | **2.39** | **5.60** | **13.03** | **6.86** | — | — | **7.05** |
| BofA Merrill Lynch US High Yield Master II Index | 2.14 | 4.91 | 12.75 | 4.48 | — | — | 4.97 |

Source: Artisan Partners/BofA Merrill Lynch. [1]Returns for periods less than one year are not annualized. [2]Fund inception: 19 March 2014.

| Expense Ratios | ARTFX | APDFX |
|---|---|---|
| Semi-Annual Report 31 Mar 2017[1] | 1.01 | 0.81 |
| Prospectus 30 Sep 2016[2] | 1.03 | 0.84 |

[1]Unaudited, annualized for the six month period. [2]See prospectus for more information.

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. The performance information shown does not reflect the deduction of a 2% redemption fee on shares held by an investor for 90 days or less and, if reflected, the fee would reduce the performance quoted. Unlike the Index, the High Income Fund may hold loans and other security types. At times, this causes material differences in relative performance.

## Investing Environment

Our portfolio finished modestly ahead of the BofA Merrill Lynch High Yield Index's 2.1% return in Q2, adding to our YTD outperformance. Credit selection was key in Q2—the portfolio outperformed despite our loan exposure, which, while positive, muted relative results as the leveraged loan market trailed high yield (the JP Morgan Leveraged Loan Index returned 0.8%). In particular, our bond holdings in the energy, services and media sectors contributed positively to relative results.

As we have noted in previous letters, the BAML Index is an imperfect benchmark for our approach. Beside the fact that we have the flexibility to invest across the capital structure—including loans—the index is not replicable as an investment portfolio from a practical standpoint. Due to these benchmark limitations, we also compare our performance to other high yield active managers. In Q2, we outperformed our peer group, the Morningstar High Yield Bond category[1], which had a 1.7% average return. On a one-year basis, our portfolio return is roughly in line with that of the BAML index's 12.8% gain and ahead of the leveraged loan index's 7.2% return. But our portfolio is more than 200bps ahead of our peer group's average 10.7% return. As the High Income Fund reached its third anniversary in Q1, it's also worth noting that, as of June 30, the three-year annualized return of our portfolio was 6.7% versus 4.5% for the index and 2.9% for the peer group.

Solid corporate profitability buoyed non-investment grade credit markets in Q2. High yield bond yields touched YTD lows of 5.5% in early June—the lowest levels since 2014—before closing the quarter at 5.7%, a decrease of 20bps over the quarter and 48bps YTD. Likewise, high yield spreads compressed 17bps in Q2 and 48bps YTD to 391bps. Correspondingly, leveraged loan spreads tightened 6bps in Q2 and 28bps YTD to 430bps. This is not dissimilar to what occurred in the equity markets, as risk assets generally continued to perform well.

Aside from energy, all high yield sectors produced positive returns, with banking, financial services and health care the top performers. Re-emerging volatility in the oil market weighed on energy credits. Oil prices hit YTD lows—falling below $43/barrel in June as rising US oil production complicated efforts, sincere or otherwise, by OPEC to bolster prices with production cuts.

Higher rated bonds led in Q2 with returns of 2.6% for BBs, 1.8% for Bs and 1.7% for CCCs. Conversely, lower rated credits remain ahead over the YTD and one-year periods—CCCs returned 7.0% YTD, compared to 4.7% for BBs and 4.5% for Bs, while over the one-year period, CCCs gained 23.1%, compared to 9.8% for BBs and 13.2% for Bs.

High yield new issuance totaled $77 billion, which is in line with average quarterly issuance of recent years, but a reduced pace from Q1's $99 billion in volume. The majority of new-issue activity, as it has been over much of the current credit cycle, was the result of refinancing—acquisition-related issuance was just 15% of the quarterly total. At $246 billion, loan market new issuance was more robust, with more than two-thirds of that tied to repricing and refinancing activity. This represents the second highest quarterly total ever, behind only Q1's $331 billion. For perspective, quarterly loan issuance averaged $121 billion in 2016.

US default activity totaled $9.2 billion in Q2, a modest increase from $8.8 billion in Q1, but substantially lower than in late 2015 and early 2016 when there was severe dislocation in commodities markets. Year to date, 22 companies have defaulted on $18 billion in debt, relative to 38 defaults totaling $43.4 billion in the first half of 2016 and 26 defaults totaling $15.8 billion in the second half of 2016. The par-weighted US high yield default rate ticked up to 1.5% but is still substantially lower than the 3.6% rate at the start of the year. Our view is default rates will remain relatively low as the weakest operators in the energy patch have restructured their balance sheets.

## Portfolio Positioning

Portfolio positioning has not materially changed from last quarter. Our portfolio weighting in bonds marginally decreased to 74.2% from 74.5%, while our loan exposure ticked up to 22.8% from 20.3%, funded primarily by our cash position's falling to 2.5% from 4.5%. From a sector perspective, the biggest changes were increased weightings in services and media, and decreased weightings in insurance, energy and technology & electronics, although these are still among our largest sector exposures. With regard to our ratings distribution, we incrementally increased exposure to higher rated credits because, from a valuation perspective, we're seeing little differentiation in the market. Our CCC exposure fell to 27.0%, driven this quarter by the roll off of our position in insurance broker USI, which we'll discuss further. Our BBB weighting dropped a couple percentage points to 9.2% as we sold some of our MLP exposure. As always, we are ratings agnostic but aware, and our aim is to ensure we're adequately compensated for the amount of risk we take.

Our portfolio remains focused on our highest conviction names, with 33.8% of the portfolio in the top 10 holdings, compared to 35.6% at the end of Q1. New to the top 10 were KIRS Midco 3, a provider of insurance intermediary services, and Intelsat Jackson, a communications satellite services provider.

KIRS is a new business entity created from the merger of Towergate with four other insurance brokers that were owned by private equity groups HPS and Madison Dearborn. Towergate went through a restructuring in 2015, converting debt to equity as it sought to clean up its balance sheet. The company has brought in a proven, top-tier management team that is focused on the turnaround of the legacy Towergate business. With the business now stabilized, we anticipate management can grow the business through key strategic hires and further acquisitions. If that transpires, we would anticipate price appreciation on the bond, which would be on top of its 8 5/8% coupon.

We initially invested in Intelsat in Q3 2016 and have since incrementally added to our position. We think it's a classic case of a good business with a bad balance sheet. Our first lien loan position is in the most senior secured part of the capital structure. We believe there are multiple potential catalysts for business recovery, including monetization of incremental capacity, customer growth and reversal of declining transponder pricing. We also think there is the potential for restructuring, in which case our position at the top of the capital structure would likely increase in value.

Dropping out of the top 10 were the aforementioned USI as well as HD Supply Holdings, a distributor of construction and industrial products. USI was acquired by private equity firm KKR in March. As part of the transaction, our debt position was refinanced. However, we opted not to purchase the new debt resulting from the transaction, primarily because the risk/reward did not appear compelling given increased leverage on the balance sheet and a lower yield compared to our previous position.

We pared our investment in HD Supply. The company bent to the pressure of activist investors to divest assets—selling its Waterworks business, a segment that distributes pipes, hydrants and other water-related infrastructure products. The sale was beneficial to the company's credit profile as it resulted in deleveraging, and we reduced our ownership on valuation grounds.

## Perspective

The market environment remains one characterized by historically low yields, reflecting persistently low inflation and highly accommodative central banks. We view the non-investment grade market as range bound, though perhaps at the tighter end of that range. US high yield valuations are historically high yet are less expensive than alternatives in the fixed income market, which yield substantially less. Importantly, central banks are shifting from being net buyers of bonds to net sellers. The Fed has indicated it will soon begin normalizing its $4.5 billion bond portfolio. Likewise, the ECB is preparing markets for further tapering of monthly asset purchases. At this point in the cycle, we believe investors are more likely to have a bias toward credit-sensitive instruments rather than more rate-sensitive ones.

We are pleased to have outperformed our benchmark index this quarter and over the since-inception period. Given our process is built on bottom-up security selection, our strength lies in our ability to capitalize on market inefficiencies. We remain committed to our strategy of searching for issuers with high quality business models that have compelling risk-adjusted returns. We believe our high-conviction process will be rewarded over a long-term investment horizon.

**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.**

**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 be 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.**

BofA Merrill Lynch US High Yield Master II Index measures the performance of below investment grade $US-denominated corporate bonds publicly issued in the US market. J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of the USD-denominated institutional leveraged loan market. 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 2017. 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. These holdings comprise the following percentages of the Fund's total net assets (including all classes of shares) as of 30 Jun 2017: USI Inc 0.6%, KIRS Midco 3 PLC 2.3%, Intelsat Jackson Holdings SA 2.2%, HD Supply Holdings Inc 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. Portfolio statistics include accrued interest unless otherwise stated and may vary from the official books and records of the Fund. This material does not constitute investment advice.

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Attribution is used to evaluate the investment management decisions which affected the portfolio's performance when compared to a benchmark index. Contribution to return is calculated by Bloomberg by multiplying a security's daily total return multiplied by the daily weight compounded over the referenced timeframe and does not take into account expenses of the portfolio. Attribution is not exact, but should be considered an approximation of the relative contribution of each of the factors considered.

Credit Quality Ratings typically range from AAA (highest) to D (lowest) and are subject to change. The ratings apply to underlying holdings of the Portfolio and not the Portfolio itself.



[1]**Past performance does not guarantee and is not a reliable indicator of future results.** For the period ended 30 Jun 2017, the Morningstar High Yield Bond Category had an average return of 1.75% for the quarter-to-date period, average return of 10.73% for the 1-yr period and average annual returns of 2.91% for the 3-yr period and 3.44% since the inception of Artisan High Income Fund on 19 Mar 2014. The Morningstar High Yield Bond Category consists of portfolios primarily invested in U.S. high-income debt securities where at least 65% or more of the assets are considered non-investment grade.

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.

**Free Cash Flow** is a measure of financial performance calculated as operating cash flow minus capital expenditures. **Non-Investment Grade** refers to fixed income securities with lower credit quality. **Spread** is the difference in yield between two bonds of similar maturity but different credit quality.

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