



# Artisan International Value Fund

QUARTERLY  
Commentary

Investor Class: ARTKX | Advisor Class: APDKX

As of 30 June 2017

## Investment Process

We seek to invest in high-quality, undervalued companies with strong balance sheets and shareholder-oriented management teams.

### Undervaluation

Determining the intrinsic value of a business is the heart of our research process. Intrinsic value represents the amount that a buyer would pay to own a company's future cash flows. We seek to invest at a significant discount to our estimate of the intrinsic value of a business.

### Business Quality

We seek to invest in companies with histories of generating strong free cash flow, improving returns on capital and strong competitive positions in their industries.

### Financial Strength

We believe that investing in companies with strong balance sheets helps to reduce the potential for capital risk and provides company management the ability to build value when attractive opportunities are available.

### Shareholder-Oriented Management

Our research process attempts to identify management teams with a history of building value for shareholders.

## Team Overview

Our team has worked together for many years and has implemented a consistent and disciplined investment process. Our team is organized by geographic regions, but within those regions we are generalists who look across all industries. We believe this model enables our analysts to become broad thinkers and gain critical insight across all economic sectors.

## Portfolio Management



N. David Samra  
Portfolio Manager (Lead)



Daniel J. O'Keefe  
Portfolio Manager

## Investment Results (%)

As of 30 June 2017	Average Annual Total Returns						
	QTD <sup>1</sup>	YTD <sup>1</sup>	1 Yr	3 Yr	5 Yr	10 Yr	Inception <sup>2</sup>
Investor Class: ARTKX	6.74	13.79	20.88	3.28	12.24	6.17	13.21
Advisor Class: APDKX	6.77	13.85	21.07	3.41	12.32	6.21	13.24
MSCI EAFE Index	6.12	13.81	20.27	1.15	8.69	1.03	8.03
MSCI EAFE Value Index	4.78	11.12	25.01	-0.59	8.12	-0.08	7.95

Source: Artisan Partners/MSCI. <sup>1</sup>Returns for periods less than one year are not annualized. <sup>2</sup>Investor Class inception: 23 September 2002. Advisor Class performance is that of the Investor Class from 23 September 2002 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	ARTKX	APDKX
Semi-Annual Report 31 Mar 2017 <sup>1,2</sup>	1.19	1.02
Prospectus 30 Sep 2016 <sup>3</sup>	1.23	1.07

<sup>1</sup>Excluding Acquired Fund Fees & Expenses as described in the prospectus. <sup>2</sup>Unaudited, annualized for the six month period. <sup>3</sup>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.



### Market Overview

Another quarter, another increase in asset values. Ho-hum. We remember what falling prices look like, but the memory is dimming. The US market crept up another 3%. Europe did roughly the same, but when translated into US dollars, returns were solidly mid-single digits as the dollar weakened considerably against most European currencies. The euro strengthened 7% and pound sterling strengthened 4%—big moves in three months. Both currencies bounced off of multi-year lows, likely reflecting dimming expectations for resurging US economic growth. In addition, the European Central Bank has indicated it may slow its bond buying, which would be positive for the euro. Conversely, the US Federal Reserve is beginning to normalize monetary policy, raising interest rates after 10 years of extraordinary monetary easing. Extraordinary indeed, because rising interest rates normally mean a stronger currency, not a weaker one. And we note that the spread between UK and US 10-year government bond yields is at one of the widest levels in years.

Emerging markets enjoyed mid-single-digit gains as well. Even fixed income indices marched higher despite higher US interest rates. And then there is bitcoin—the anti-currency currency. It more than doubled in dollar value in just three months. That strikes a dissonant chord for us. Volatility as measured by the VIX Index is near its all-time pre-crisis lows. Stocks and bonds are rising together. The Fed is signaling a slow move toward a more normal monetary policy. And yet, one of the best performing asset classes globally (bitcoin) is a private, digital currency untied to any central bank, limited in its supply and arguably a hedge against the instability of a fragile monetary and economic system. It's a bit (no pun intended) like the establishment and the revolutionaries dancing together on the same floor.

### Portfolio Discussion

All but eight portfolio stocks increased in value during the quarter (all returns in US dollar unless otherwise stated). The three largest contributors to return were ING, Samsung Electronics and Compass Group. However, Compass only made the top three due to pound sterling's strong performance relative to the US dollar—though up 12% in USD, it was up 8% in local currency. The top three contributors in local currency were ING, Samsung Electronics and Tokyo Electron.

ING is a Netherlands-based European bank with the Benelux as its home markets. For many years, outside its home region ING has been a branchless challenger bank utilizing a digital-based lending and deposit-taking strategy, with a presence across Europe including Germany, France, Spain, Italy and several Eastern European markets. Today, ING is in an interesting position. Having received state aid very early in the financial crisis, ING has completed a multi-year divestment and restructuring process. The bank has significant capital (some of which we believe is excess), is growing and is investing in its digital presence (fin-tech in today's vernacular). Compare ING's position with many banks in markets such as Germany, Italy and Spain that continue to struggle with bad loans, the need to raise capital, and significant restructuring. Yet despite its advantaged position, ING's

shares suffer from a depressed valuation, and uncertainty around final regulatory capital rules has kept the bank from returning excess capital to shareholders. Nonetheless, earnings are growing, capital is building, and the bank has modestly increased its payout to shareholders. The share price has reacted, and year to date the shares have appreciated 16% in local currency, 9% of which came in Q2. Tacking on the help from a stronger euro, and the stock is up 26% YTD in USD.

Samsung has been our best performer for two consecutive quarters, and we don't have much new to add to our comments from the last quarter. To summarize: The stock is cheap at a mid-single-digit, unlevered PE; the memory business continues to grow in value as a result of a disciplined industry structure and strong demand; and the smartphone business is moving forward despite last year's unfortunate battery fiasco. The stock gained 13% in USD and 15% in local currency, and Samsung remains our largest holding.

Tokyo Electron was up over 20% in Q2 and 45% for the year. Tokyo Electron (TEL) is a supplier of equipment used in the manufacture of semiconductors. Just as Samsung is effectively printing money selling semiconductors, so too is TEL by selling the equipment that makes them. In the most recent quarter, revenue in the core division was up 63%, and both gross and operating margins reached all-time highs. TEL is benefiting from growth in the overall market, but it is also gaining share in key areas that allows it to expand its addressable market. In etching systems (which are used to remove photoresist films, exposing the wafer so that interconnecting layers can be added), TEL's market share has moved from 1% to 23%, as its leading edge systems gained adoption. The business is booming; however, the valuation has become less attractive, and we have reduced our position.

Our worst performing stocks in Q2 were Tesco, Telefonica Brasil and Amec Foster Wheeler. Tesco declined 9% in local currency but only 6% in dollars as the pound sterling appreciated. The company actually reported good earnings in April. Comparable store sales were positive for the second half of Tesco's fiscal 2017, as well as for the full year, marking its first full year of positive comparable store sale growth in seven years as the volume-led recovery appears to be gaining traction. Margins also showed progress, both in the core UK operation as well as at the group level. Free cash flow was strong, and the balance sheet is improving.

We can only speculate on why Tesco's share price remains weak. It could be a function of investor disapproval of the Booker transaction (we share said disapproval—as discussed in our Q1 letter) as well as general fatigue with the turnaround's very slow and grinding nature. There is no hockey-stick recovery—it will take years for Tesco's margins to normalize. At any rate, we are pleased to see the business returning to health, and the valuation is attractive, assuming margins continue recovering.

Telefonica Brasil (VIV) declined 5% this quarter, but this was more of a Brazil issue than a VIV issue. Brazil's current president, Michel Temer, who assumed power as a result of the former president's impeachment on corruption charges, has himself now been accused of corruption. That a Brazilian president might be corrupt is not in itself all that newsworthy: Brazil's political system and its politicians are among the most rotten and corrupt of any major economy. The disappointment stems from the fact that Temer himself was focused on reforms aimed at driving out the systems and structures that foment this corruption and hobble Brazil's ability to achieve its economic potential.

VIV, however, continues performing well despite Brazil's political and economic morass. Revenues are growing slightly, and costs are coming down. VIV dominates the mobile market and is outgrowing its competitors while maintaining industry-leading margins. The cost control is notable given Brazil's inflationary pressures. The balance sheet is pristine, with net debt a fraction of annual operating profit—a notable contrast to most telecom companies globally which on average carry leverage levels that are multiples of their cash flow. The stock remains cheap, and we added to our holding on recent weakness.

As we mentioned in our Q1 2017 letter, Amec Foster Wheeler has agreed to be acquired by John Wood Group, with Amec's shareholders receiving equity in the new entity. We view the transaction positively, as John Wood's management is well regarded with an excellent track record, and the combination should improve Amec's financial position. However, initial enthusiasm has faded, and Amec's stock price fell 12% in local terms and 9% in USD in Q2. There are two issues causing share-price weakness. First, the price of oil has been weak—Amec will not see a recovery in earnings until the oil price is higher and its customers re-open the investment spigot. Second, the UK's serious fraud office (SFO) recently opened an investigation into a company called Unaoil which provides engineering and construction services to oil and chemical companies in the Middle East, Asia and Africa. Unaoil is suspected of bribery, corruption and money laundering, and investors were worried that either Amec or John Wood might be targeted by an SFO investigation. Indeed, after the close of the quarter, the SFO confirmed that such an investigation has begun. The SFO may find no irregularities in its investigation, or it may find illegal activity which could result in fines and penalties.

We neither added nor exited any meaningful positions during the quarter. Valuations remain stubbornly reasonable, making it difficult to find attractive new investments. Our cash levels remain elevated.

### Happy Birthday, iPhone

*There is nothing permanent except change*

-Heraclitus

Heraclitus, known as the philosopher of change, lived around 500 BC. He famously said that no man can ever step in the same river twice—

the always-moving water is never the same water, and the man evolving through life never the same man. Were Heraclitus alive today, he might have been the perfect guest to blow out the candles at iPhone's recent 10-year birthday celebration and, perhaps more importantly, offer a few words of reflection on that favorite subject of his. To say that the iPhone has changed the world might be the understatement of the decade.

In just 10 years, one product (and its "me-too" variants) has revolutionized modern life, created new industries, destroyed others and conjured around \$700bn of incremental market value for a single company. Does anyone even remember the Motorola Razr? When you think about how long it took to build the Great Wall of China (2,000 years), the US interstate highway system (35 years), a national rail system (about 100 years), develop an affordable continental and intercontinental aviation industry (100 years), and electrify half the homes in the US (50 years), the scale and pace of the economic and behavioral change brought by the smartphone is staggering. Facebook didn't exist 15 years ago—today it has more than 2 billion users, enabled heavily of course by the smartphone. (That's another \$500bn of market value, by the way.) The list of high-profile, now-behemoth tech companies that have emerged from nowhere over the past 5 to 10 years comes easily to mind: Facebook, Alphabet née Google, Tencent, Baidu, Alibaba, etc. Amazon, too, if you tack on just a few more years.

But it is the less high-profile changes that are arguably more impressive and cumulatively more significant, especially for investors such as us who invest across a wide range of industries. Consider the evolution of the banking industry in those 10 years. In 2006, the pro-forma retail banking branch footprint of Lloyds and HBOS (which merged in 2006 to form the current Lloyds Banking Group) was 3,300. Today Lloyds—the largest bank in the UK—has only about 1,900 branches, and the number is set to fall further. Lloyds employs about 75,000 people today, roughly half the 2006 level. Royal Bank of Scotland, the UK's second largest bank, is on a similar trajectory. We used to apply for mortgages, make deposits, fill out change-of-address forms and open accounts inside a bank branch. Today it is done through a smartphone app or online in a browser. This is what pundits mean when they say we are living through another industrial revolution. The industrial revolution of the 1700s and 1800s was about the transition from an agrarian economy to a manufacturing, wage-earning economy. Today it is about the substitution of software for human labor. In just a few years (if not sooner!), it is unlikely an actual human will take your order at McDonald's. You will just swipe on a tablet.

The word of the day, then, is *disruption*, which is just the businessperson's way of saying change—change for the worse for the disruptee, and the kind of change that might arrive in large denominations for the disruptor. We reflect on this today not only because of the iPhone's 10-year anniversary, but because disruption has spread through our research activities like a bottle of ink toppled into a pool of clear water: It seems to touch almost every area we

wade into. This struck us mid-forehead when we were recently researching—of all things—the cigarette industry.

Yes, disruption is knocking on the door of an industry that has prospered for years—hundreds of them—with just paper, shreds of tobacco and that seminal technological advance of thousands of years ago, fire. The largest and most valuable cigarette maker in the world—Phillip Morris—has invented a new smart device that, instead of burning cigarette tobacco, heats the tobacco to just below burning temperature, creating smoke that supposedly has far fewer carcinogens than traditional cigarette smoke. Philip Morris believes this invention may lead to the extinction of the traditional cigarette business. The product has launched in just a few countries, but in Japan, it's already gained as much as 10% market share within just a year of its national rollout.

We can easily compile a list of industries we follow or have recently researched that are being disrupted on some level:

- Retailers by Amazon and e-commerce generally
- Transportation by Uber and Lyft
- Advertising agencies by Google and Facebook, among others
- TV, radio and print media by Google, Facebook and others
- Shopping malls as retail store counts drop due to e-commerce
- Cigarettes
- Automakers by electric cars and the prospect of self-driving cars
- Manufacturers of razors and razor blades
- Fashion brands
- Industrial supply distributors
- Payments businesses by Internet-enabled peer-to-peer models

That's just a handful, but the point is clear. The ground under the feet of many businesses is shifting, and that makes business analysis and valuation about as interesting as it's been in our careers. In some cases, technology is enabling winner-take-all or winner-take-most outcomes. Apple is perhaps the perfect example of that. The phone businesses of Motorola, Nokia, Sony Ericsson and BlackBerry have been erased. But most situations are not as clear cut.

Banking is again an interesting example. Putting aside cash and checks, which are used less and less, money exists in electronic form. That makes it almost the perfect target for a digital business model. As consumers and borrowers increasingly transact online and through apps, and as the marginal cost of moving money electronically is about zero, the financial services industry would seem ripe for disruption by some technology start-up not encumbered by legacy costs, infrastructure and inertia. Then again, technology also offers tremendous opportunity for incumbent players. Banks now see into their customers' day-to-day financial activities in a way that no institutions ever have. They know how much you pay for utilities, mobile phone service, insurance, groceries, etc., and they know who

you are transacting with. That insight is valuable. It could fundamentally change the nature of the relationship between banks and consumers. Banks could perhaps tailor advice based on your spending habits, telling you where you could save on insurance, utilities and other commoditized services. They could perhaps act as a broker by partnering with providers to target certain consumers. Could this result in revenue streams that don't exist today? And if they continue reducing their operating costs as the industry digitizes, they may actually gain competitive advantages, rather than succumb to disruption. But if they don't figure it out, there is the risk that some start-up in some garage somewhere will.

Most of the businesses and industries we look at today are more like the banking model than the zero-sum Apple/mobile phone model. In other words, the analysis is murky, complicated and full of as many opportunities as threats. We already discussed some issues around our bank holdings, Lloyds and RBS. A few others examples to ponder: Any consumer-facing business, such as Unilever which sells food and Richemont which sells luxury goods, is seeing its model evolve—in how it communicates with customers, but also in how it sells. Advertising campaigns used to be via print and TV. Now they are through print, TV, social media and search advertising. Products used to be sold entirely through controlled retail channels. In the case of Unilever, for example, the manufacturer/retailer/consumer relationship is evolving. Dollar Shave Club and Harry's Razors are two start-ups that are demonstrating that you don't need a retailer to sell razors and razor blades to consumers—you just go direct. Unilever recently bought Dollar Shave Club to learn how this evolving channel might develop. Could Unilever eventually bypass retailers and sell its food and personal care items directly to consumers? That's an opportunity, or if someone else figures out how to do it with competing brands, a threat. We could go through numerous other examples in the portfolio, but in the interest of space and time, we will simply emphasize that these angles bounce off our holdings in multiple ways.

In the political and social realm, these changes are often viewed entirely negatively. That's understandable if you are a bank teller or a taxi driver. The constant debate about income inequality is maybe really about the taxi driver heading to the unemployment line while the software engineer heads to the Ferrari dealer for a new toy. It is not surprising that politicians would call for checks on the (thus far, unstoppable) forces of creative destruction. But even technology luminaries such as Bill Gates and Elon Musk have suggested government intervention in order to moderate the perceived threat to social cohesion posed by technological change. Elon Musk has called artificial intelligence the "biggest risk that we face as a civilization." Of course, he controls Tesla, the largest pure-play electric car maker which is actively engaged in creating self-driving cars using artificial intelligence. (He's not the first entrepreneur to have ever tried making the government complicit in limiting competition—nor will he be the last.)

In this sense, what's old is new again. At every major economic transition in our history, there are warnings about the future and what we are likely to lose. There are certainly always losers. The horse-drawn buggy makers yielded to the automakers. Typewriter manufacturers were displaced by the personal computer. Passenger ships gave way to commercial aviation. Reading Elon Musk's recent warnings on the dangers of artificial intelligence, we couldn't help but think of the remarks of another visionary, Charles Lindbergh, given more than 70 years ago on the anniversary of the first manned flight at Kitty Hawk.

Lindbergh was the first man to fly from New York to Paris—a flight that gave birth to the commercial aviation industry. He was conflicted in his praise of the industry to which he gave life, marveling at what it had already achieved and would achieve in the future. But he also feared for what mankind might lose: "It is for this reason I say that the Kitty Hawk plane stirs conflicting emotions within me. As it symbolizes our progress, it also symbolizes qualities of life we have left behind and which, to be successful in a deeper sense, we must retrieve ... If we are to be finally successful, we must measure scientific accomplishments by their effect on man himself."

If Lindbergh were alive today, he might see he had little reason to worry. The industry he loved and also feared undoubtedly changed the world for the better, adding to human prosperity in measurable and immeasurable ways. Nobody misses the horse and buggy when you can fly Southwest to see your family at Thanksgiving for \$75 each way. And the jobs that have been lost have been more than replaced by a larger, more productive new industry. We hope that in 70 years, Bill Gates' and Elon Musk's fears about today's technological advances will be regarded in much the same way. It's an interesting time to be alive, and a fascinating time to be an investor.

Happy birthday, iPhone, indeed.

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

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**Unlevered price-to-earnings ratio (unlevered PE)** is a valuation ratio of a company's current share price compared to its per-share earnings after subtracting debt. **Free Cash Flow** is a measure of financial performance calculated as operating cash flow minus capital expenditures.

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