# Artisan High Income Fund

QUARTERLY
Commentary

Investor Class: ARTFX | Advisor Class: APDFX | Institutional Class: APHFX

As of 30 September 2021

## 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 September 2021 | QTD | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr | Inception |
|---|---|---|---|---|---|---|---|
| | | | Average Annual Total Returns | | | | |
| **Investor Class: ARTFX** | **0.82** | **5.59** | **13.79** | **7.83** | **7.63** | — | **7.05** |
| **Advisor Class: APDFX** | **0.86** | **5.62** | **13.86** | **7.97** | **7.78** | — | **7.21** |
| **Institutional Class: APHFX** | **0.89** | **5.80** | **13.97** | **8.07** | **7.83** | — | **7.18** |
| ICE BofA US High Yield Master II Index | 0.94 | 4.67 | 11.46 | 6.62 | 6.35 | — | 5.46 |

Source: Artisan Partners/ICE BofA. Returns for periods less than one year are not annualized. Class inception: Investor (19 March 2014); Advisor (19 March 2014); Institutional (3 October 2016). For the period prior to inception, Institutional Class performance is the Investor Class's return for that period ("Linked Performance"). Linked Performance has not been restated to reflect expenses of the Institutional Class and the share class's returns during that period would be different if such expenses were reflected.

| Expense Ratios | ARTFX | APDFX | APHFX |
|---|---|---|---|
| Semi-Annual Report 31 Mar 2021[1,2] | 0.96 | 0.79 | 0.70 |
| Prospectus 30 Sep 2020[3] | 0.97 | 0.83 | 0.73 |

[1]Unaudited, annualized for the six-month period. [2]Excludes Acquired Fund Fees and Expenses as described in the prospectus. [3]See prospectus for further details.

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.

## Performance Discussion

Our portfolio modestly trailed the ICE BofA US High Yield Index during the quarter but maintains its advantage over the benchmark YTD. As always, our returns tend to be more idiosyncratic than our peers, and our material underweight to BB-rated bonds in favor of more credit-sensitive risk weighed on relative returns with the outperformance of BBs this quarter. This was offset by strong security selection across the portfolio's bond and loan book, particularly among our credit-specific and turnaround opportunities. From an asset allocation perspective, our leveraged loan exposure outpaced the broader benchmark as rising interest rates created a strong demand for floating-rate assets. As we look ahead, we remain comfortable with our positioning, and we believe our flexibility to pivot across the capital structure to areas that offer the best risk-adjusted potential will be a clear differentiator in today's low dispersion environment.

## Investing Environment

Uncertainty returned to markets in Q3 as rising delta variant cases, building inflationary pressure and Chinese debt concerns resulted in waves of risk asset volatility. Still, the reaction in the high yield market was relatively muted, as modest price declines were offset by coupon income. Credit investors preferred to look through the noise, focusing on the continued strength of high yield issuer earnings and improving credit fundamentals. All told, the ICE BofA US High Yield Index provided another quarter of gains, advancing 0.9% to push YTD returns to 4.6%.

Interest rates responded to the uncertainty, trending lower for much of the quarter. But a more hawkish outlook from Fed officials in September led to a selloff in Treasurys that pushed five-year yields to the highest levels since February 2020. A reversal in interest rates redirected investors' attention back toward floating-rate products. The quarter saw record collateralized loan obligation (CLO) origination and $7 billion into retail loan funds as investors sought leveraged loans for their rate hedging potential and yield advantage. As leveraged loans rallied alongside higher interest rates, underperformance relative to high yield bonds for the year closed—the asset class (as measured by the JPMorgan Leveraged Loan Index) gained 1.2% in Q3 to push YTD gains in line with high yield bonds.

High yield credit spreads showed resilience against the pickup in equity market volatility, finishing the quarter largely unchanged at 331bps. Within the ICE BofA US High Yield Index, return dispersion across the credit spectrum was minimal—duration damage caused higher rated segments to lag into quarter-end while down-in-quality and higher beta segments were largely insulated from late-quarter swings. In all, BBs led with returns of 1.1%, followed by CCCs (1.0%) and Bs (0.7%). Even with the pickup in volatility, limited price dispersion and tight spreads continue to characterize the market. While there have been a handful of idiosyncratic collapses, the number of discounted capital structures in the market is exceedingly small. Today, the bonds of just 12 borrowers in the ICE BofA US High Yield Index trade below $70, and the proportion of the market within 100bps of the average is at multi-year highs.

Issuance trends remain firmly in favor of corporate borrowers, with the current pace of bond and loan issuance continuing its near record pace. With liquidity widely available and distress absent, the high yield market was largely default-free in Q3. The par-weighted default rate fell below 1%, as just two companies defaulted on $855 million in bonds and loans to mark the quietest quarter of defaults since late 2013. More notably, should this benign default environment continue through the rest of the year, the high yield market is on pace for its lowest calendar year of defaults since 2007. Looking ahead, we would point to the lack of distress in the market as a strong sign today's low default environment is likely to persist over the next 12-18 months. Bond and loan defaults are forecasted to trend below 1% for the rest of the year and well into 2022.

## Portfolio Positioning

We continue to manage the portfolio with a watchful eye toward interest rate risk. In our view, rising interest rates are one of the most underpriced risks for fixed income investors, and our portfolio reflects this cautiousness. Our portfolio's duration profile of 2.6 years—1.6 years shorter than the ICE BofA High Yield Index—is largely the result of our allocation to leveraged loans (35% of the portfolio). Relative to high yield bonds, we believe loans provide an attractive trade-off between yield and duration. Valuations between bonds and loans have diverged over the last several months, meaning investors are able to pick up a yield and spread premium by moving up the capital structure into loans. Also, a large portion of the high yield market now trades at levels that limit the potential for further price appreciation. At the end of September, 75% of high yield bonds were call constrained indicating less ability to absorb a pickup in volatility—whether it's interest rates or credit related. With valuations in mind, we've trimmed our exposure in several, idiosyncratic BBB-rated issuers in favor of single-B risk. Across sectors, we trimmed our exposure to credit-specific opportunities in capital goods and basic industry for select exposures in energy and health care. In energy, our portfolio maintains a preference for exploration and production companies that are well capitalized, have attractive acreage and prioritize free cash flow over production growth with the strong pricing environment.

The portfolio's top holdings included three new issuers during the quarter with the addition of Medline Industries, Delta Airlines and NCL Corp. Exiting the top ten were General Electric, Realogy Group and AssuredPartners.

The most notable new addition is Medline, the nation's largest medical supply manufacturer and distributor. The former family-owned business was sold to a consortium of sponsors during the quarter in what is one of the largest leveraged buyouts since the Great Financial Crisis. The company is a leader in providing mission-critical, single-use, branded medical supplies, creating a predictable recurring revenue stream that is largely recession-proof. The company has built out an extensive network of manufacturing and distribution facilities that has allowed it to undercut the competition through expansive private-label offerings and exclusive supply arrangements. While the

company comes to the market with a more leveraged profile, strong cash flow generation and EBITDA growth should allow the company to quickly pay down debt. Given the structure's attractive risk/reward profile, Medline is the portfolio's second-largest holding with exposure to secured and unsecured instruments across the capital structure.

Delta Airlines made its way into the top ten because of trimming elsewhere in the portfolio. Our initial investment in the airline operator began in late Q1 2020 at distressed levels, after liquidity concerns plagued its capital structure and led to its downgrade to high yield. Delta reacted quickly to the pandemic by raising liquidity early and taking out costs that will benefit the business long term as it recovers. The company maintains a healthy liquidity runway and a distinct brand premium that should allow its balance sheet to return more normalized levels in the near term. Despite a strong recovery for its entire debt stack, Delta offers an attractive yield premium relative to other BB high yield issuers. We've accumulated exposure in various unsecured instruments and in the company's term loan, and we expect the company's structure to tighten as efforts to restore its balance sheet—and investment grade rating—gain momentum over the next year.

Finally, Norwegian Cruise Lines (NCL) is another issuer we initiated at the height of the COVID crisis that has made its way into our top holdings. Similar to our investment in Carnival Cruise Lines, NCL's large portfolio of high-quality assets has allowed it to lever up its balance sheet in an effort to buy time as it waits for operations to fully return. Several rounds of equity and debt issuances helped NCL to term out its balance sheet and reduce near-term obligations, which allowed the company to extend its liquidity runway. The company expects nearly 75% of its fleet will be operational by year end and 100% by April 2022. Even with the pause in sailings, current booking trends show significant pent-up demand with 2022 booking volumes well ahead of pre-COVID levels. We anticipate the NCL will turn cash flow positive next year, allowing it to deleverage and repair its balance sheet.

On the other side of the ledger, we trimmed our position in industrial conglomerate General Electric due to valuations. The position has been among the portfolio's largest holdings since late 2018 when we accumulated longer dated, unsecured debt of the investment grade (IG) issuer at BB valuations. At the time, the company had a bloated balance sheet and a market cap at multi-decade lows following years of operational missteps and value-erasing M&A. In October 2018, deteriorating performance from key business lines and a litany of unknown liabilities related to its legacy financial arm led rating agencies to downgrade the company to BBB+ and warn of further cuts without serious efforts to transform its balance sheet. Since then, new management has pushed to overhaul the business in an effort to become a leaner, more focused conglomerate. Over the last year three years, the company has right-sized its portfolio and monetized key assets in aviation, health care, power and renewable energy. GE has directed proceeds of these sales toward debt reduction. Credit metrics have slowly returned to levels more like other industrial, high-grade issuers, and valuations have responded in kind. Yields for its 10-year debt have fallen from mid-6% in Q4 2018 to well below 3% today. With the bonds trading at more constrained levels, we chose to trim our positions in favor of better relative value in new and existing positions. While we continue to maintain some exposure to GE, we've largely concluded one of our most successful investment campaigns. Cumulative returns over the last three years have exceeded 50%, making it the portfolio's top absolute contributor since inception.

Realogy is another long-held position where we built a significant position following a period of prolonged weakness. In early 2019, the real estate brokerage franchisor saw its credit profile deteriorate after management had levered the company's balance sheets to benefit shareholders by repurchasing equity. At the same time, slowing home sales, rising home prices and competition from online brokerage solutions combined to create material headwinds for the business. We built our position after management pivoted to a more creditor-friendly financial policy that restricted the company's ability to buy back stock. As a result, the company's credit trajectory and leverage profile have dramatically improved as cash has been directed toward deleveraged and accretive M&A opportunities. With prices of our unsecured exposure back above par, we chose to trim in favor of better opportunities elsewhere.

Finally, we trimmed our position in AssuredPartners. We incrementally added to our exposure in Q2 with the purchase of the company's repriced term loan, which served as a surrogate for high-quality credit risk without the interest rate sensitivity associated with BB-rated bonds. With prices back near par, we trimmed half our position to allocate to other floating-rate exposure.

### Perspective

In our view, the value proposition for leveraged credit remains. The economic backdrop of a growing global economy, improving credit fundamentals and plummeting defaults has created a goldilocks environment for investors. For yield seekers, leveraged credit is one of the few asset classes left that still offers compelling yield opportunities in a world where they're increasingly scarce. Still, today's narrowing set of valuations has left bonds largely indistinguishable from one another. Little differentiation in pricing across sectors, industries and credit quality has created a market with proportionately less room for error. We believe fundamentals ultimately drive returns, and our ability to independently assess credit risk can create meaningful opportunities for alpha when opinions of market direction diverge. And today's environment of increased asymmetry can lead to bouts of volatility that can be exploited by opportunistic, high-conviction credit investors.

As we look ahead, we view rising interest rates and the withdrawal of monetary stimulus as potential catalysts that could lead to more differentiation across securities and capital structures. As investor risk tolerance wanes and bouts of volatility become more frequent, we

will use the growing dispersion as an opportunity to strategically invest in credits with attractive risk-reward profiles. We will continue to focus on what we do well—leaning on our fundamental research to invest in idiosyncratic and catalyst-driven opportunities. We remain committed to our strategy of searching for opportunities with compelling risk-adjusted returns and believe our high-conviction process will be rewarded over a long investment horizon.

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**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.**

**Current and future portfolio holdings are subject to risk. 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.**

ICE BofA 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 Sep 2021. 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 Sep 2021: Medline Industries Inc 3.0%, Delta Air Lines Inc 2.3%, NCL Corp Ltd 2.2%, General Electric Co 2.2%, Realogy Group 2.1%, AssuredPartners Inc 2.0%, Carnival Corp 3.0%. 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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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.

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**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. **Par-weighted Default Rate** represents the total dollar volume of defaulted securities compared to the total face amount of securities outstanding that could have defaulted. **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%. **Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)** is an indicator of a company's financial performance which is calculated by looking at earnings before the deduction of interest expenses, taxes, depreciation and amortization. **Collateralized Loan Obligation (CLO)** is a security backed by a pool of debt.

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