# Artisan Focus Fund

QUARTERLY
Commentary

Investor Class: ARTTX | Advisor Class: APDTX | Institutional Class: APHTX

As of 30 September 2021

## Investment Process

Our investment approach is based on thematic idea generation, a systematic framework for analyzing companies and proactive risk management. Utilizing this approach, we seek to construct a focused portfolio designed to maximize alpha while limiting downside risk over the long term.

### Thematic Idea Generation

We believe a key element in alpha generation is finding areas where our views on industry fundamentals differ from consensus estimates. In this pursuit, we seek to identify inflections in multi-year trends which may be caused by changes in supply/demand dynamics, societal behavior, market conditions, technology, laws/regulations and business models, among other variables. We believe these inflections are often misunderstood by market participants, and can lead to powerful re-ratings of industries and companies. Identifying themes helps us develop a focused universe of companies to analyze more thoroughly.

### Systematic Analytical Framework

We apply a systematic framework for analyzing companies across sectors and themes, creating a repeatable and methodical decision-making process. Our proprietary company models focus on multi-year earnings power differentiation, expected outcome scenario analysis, return on invested capital and discounted cash flow valuations. Visual outputs are then produced through our internally developed technology solutions, allowing us to consistently evaluate positions across the portfolio.

### Proactive Risk Management

We incorporate risk management into all stages of our investment process. Metrics evaluated include crowding, correlation, volatility, stress tests, liquidity, factor analysis and macro drivers, all of which inform portfolio construction and position sizing. We also use various instruments, such as options, in an effort to magnify alpha and minimize downside.

## Team Overview

The investment team applies the same approach to thematic idea generation and fundamental company analysis that Portfolio Manager Chris Smith has honed throughout his career. Research analysts are sector specialists with deep knowledge of their coverage areas. Our process blends a collaborative team mentality with individual accountability.

### Portfolio Management

Christopher Smith
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: ARTTX** | **1.97** | **9.79** | **25.70** | **19.81** | — | — | **25.36** |
| **Advisor Class: APDTX** | **1.96** | **9.88** | **25.84** | **19.97** | — | — | **25.48** |
| **Institutional Class: APHTX** | **2.00** | **9.97** | **25.93** | **19.96** | — | — | **25.47** |
| S&P 500® Index | 0.58 | 15.92 | 30.01 | 15.99 | — | — | 16.52 |

Source: Artisan Partners/S&P. Returns for periods less than one year are not annualized. Class inception: Investor (24 April 2017); Advisor (31 July 2018); Institutional (3 February 2020). For the period prior to inception, each of Advisor Class and Institutional Class's performance is the Investor Class's return for that period ("Linked Performance"). Linked Performance has not been restated to reflect expenses of the Advisor or Institutional Class and each share's respective returns during that period would be different if such expenses were reflected.

| Expense Ratios | ARTTX | APDTX | APHTX |
|---|---|---|---|
| Semi-Annual Report 31 Mar 2021[1,2] | 1.26 | 1.11 | 1.02 |
| Prospectus 30 Sep 2020[3] | 1.32 | 1.15 | 1.06 |

[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. Performance reflects agreements to limit the Fund's expenses, which would reduce performance if not in effect. The Fund's investments in initial public offerings (IPOs) made a material contribution to performance. IPO investments may contribute significantly to a small portfolio's return, an effect that will generally decrease as assets grow. IPO investments may be unavailable in the future.

*"I've learned many things from him [George Soros], but perhaps the most significant is that it's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong." - Stanley Druckenmiller*

In the third quarter, the Artisan Focus Fund returned 1.97% (as measured by the Investor Class) while the S&P 500® Index returned 0.58%. We are excited about the current portfolio as we head into the fourth quarter and into next year. We believe it is composed of companies set up to both grow faster and revise earnings estimates to a far greater degree than the index in 2022 and 2023. We will detail this more in our fourth quarter letter to follow.

In this letter, we'll address a process topic that we find thought-provoking and get asked about frequently—how we think about the interplay of hit rate and payoff within the portfolio and its impacts on our process and culture.

We often hear the batting average (or "hit rate") baseball analogy in an investing context as something along the following lines—"if you can be right more than 50% of the time, you will be successful." This is a casually accepted truism in our industry. Yet in practice, this concept is incomplete at best and flat wrong in many respects. We have given this idea a great deal of attention in creating both our investment and risk management processes, and we take a different stance. Here, we will share some of our thoughts on this topic, as we think there are strong mathematical grounds that demonstrate the benefits of our process and culture—which is much more focused on "payoff" versus "batting average," as Mr. Druckenmiller's quote would suggest. Analytics has changed baseball significantly in the past decade—out with batting average and in with on-base plus slugging, or OPS—why can't it have the same effect on our industry?

We believe our process structured around a focused portfolio requires an exceptionally high level of upfront diligence and ongoing analyst focus. The intent of this approach is to maximize payoff—the profitability of relative winners to relative losers—and optimize sizing, with hit rate a lesser priority. We emphasize broad-based, large, industry-wide inflections that can lead to significant earnings differentiation and sustained changes in valuation multiples. This stands in marked contrast to many widely employed processes that focus on lower concentration and much less tracking error relative to their benchmarks.

Our process leads to higher concentration, and just as important, it leads to far less patience for us to remain flat footed with losing positions! This may contribute to higher turnover, but we believe cutting losers is mathematically just as important as sizing up winners. Forgoing this lever in your process will dilute the payoff ratio significantly, and thus the alpha potential.

In essence, our process places us in an ongoing state of drawing out our true level of differentiation and conviction, which we believe leads to better research and potentially higher payoffs. It's this focus that can be observed in our results—annualized excess returns of 890bps relative to the S&P® 500 Index. We would also like to make note that while a high payout ratio and more concentration require a higher level of focus, diligence and risk management, they do not require elevated volatility or excess overall risk. Again, this is reflected in our track record through a consistently lower standard deviation than the S&P® 500 Index and a downside capture of just 77%.

## Laying Out the Math

Defined below are some simple but important items when deconstructing a portfolio's performance.

*Excess Return = Hit Rate ∗ Avg. Profit on Winners + (1 – Hit Rate) ∗ Avg. Losses on Losers*

$$\text{Hit Rate \%} = \frac{\text{Positions that Beat the Benchmark}}{\text{Total Positions}} \qquad \text{Payoff} = \frac{\text{Profit on Winners Relative to Index}}{\text{Losses on Losers Relative to Index}}$$

Observing the interplay of these variables is revealing. Most portfolios, regardless of how many analysts are on staff, have batting averages around 50%—with the top tier around 55%. This implies a remarkably tight band and sheds light on the natural efficiency of the stock market in aggregate. Payoff levels, in contrast, demonstrate far wider variation from the mean, while having a far greater impact on returns for an unlevered portfolio with reasonable volatility.

For a portfolio with single-name relative volatility of around 10%, the lack of batting average sensitivity that annual returns have is striking and perhaps nonintuitive. In the example laid out in Exhibit 1, an equally weighted portfolio moving from an industry average hit rate (~50%) to best-in-class (~55%) generates just 100bps of additional alpha. On the other hand, improving the payoff from average to top tier has 5X the impact on excess returns.

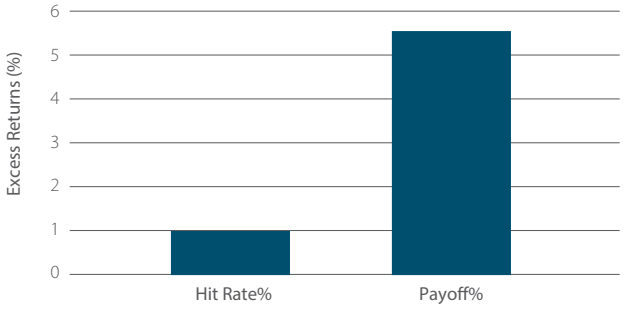
**Exhibit 1:** Illustrative Sensitivity of Hit Rate and Payoff
Excess return potential by increasing hit rate and payoff percentage

| Hit Rate % \ Payoff % | 80% | 100% | 120% | 140% | 160% | 180% | 200% |
|---|---|---|---|---|---|---|---|
| **50%** | -1.0% | 0.0% | 1.0% | 2.0% | 3.0% | 4.0% | 5.0% |
| **51%** | -0.8% | 0.2% | 1.2% | 2.2% | 3.3% | 4.3% | 5.3% |
| **52%** | -0.6% | 0.4% | 1.4% | 2.5% | 3.5% | 4.6% | 5.6% |
| **53%** | -0.5% | 0.6% | 1.7% | 2.7% | 3.8% | 4.8% | 5.9% |
| **54%** | -0.3% | 0.8% | 1.9% | 3.0% | 4.0% | 5.1% | 6.2% |
| **55%** | -0.1% | 1.0% | 2.1% | 3.2% | 4.3% | 5.4% | 6.5% |

Excess Returns

Source: Artisan Partners. For illustrative purposes only. Excess returns based on incremental increases in hit rate and payoff percentages. Based on an equally weighted portfolio with average single name volatility of 10% from the benchmark.

**Exhibit 2:** Illustrative Impact of Moving from Average to Top Tier
Improving Payoff % to best-in-class would increase excess returns 5X more than improving to best-in-class Hit Rate %




Source: Artisan Partners. For illustrative purposes only. Excess returns for hit rate based on moving from average (50%) to top tier (55%). Excess returns for payoff percentage based on moving from 100% to 200%. Based on an equally weighted portfolio with average single name volatility of 10% from the benchmark.

Because of this, we incorporate an unemotional and ruthless approach that recognizes some simple truths. First, we are going to be wrong often. The unemotional acceptance of this fact has a profound impact on our process and intellectual honesty. We believe we can significantly amplify our returns by recognizing this early on. While seemingly simple, executing this effectively requires a unique, analytically disciplined operating culture of humbleness and self-awareness that we've worked very hard to build and maintain. Second, we are also going to be right a lot, and maximizing these instances with aggressive sizing can generate substantial alpha. The combination of these factors is a powerful driver of excess returns in a portfolio, far more powerful than what most focus on: hit rate.

With this as context, let's also consider some common investment process descriptions of our peers and some constraints that exist within the industry. We frequently hear industry lingo such as knowing companies or management teams better than everyone else—we view this as a requirement of the job and not an edge. Another is buying stocks with significant upside to intrinsic value—again a requirement of the job and not an edge. Others include low turnover, balanced sector exposure to benchmark, lower tracking error, etc. The list goes on and on.

Consider these statements in the context of the simple analysis already laid out. Empirically, batting average is highly likely to be around 50%, so the drive toward very low turnover handcuffs the manager's ability to aggressively cut losing positions, which depresses the payoff ratio. At the same time, the drive for balance and fear of volatility further lead to under capitalization on the best ideas, yet again pressuring the payoff ratio.

Indeed, these common constraints remove many things that appear to us mandatory for success. It is no surprise in this analysis that if all these rules are followed, even an army of the best analysts is likely to outperform the benchmark only slightly before fees. Paradoxically, these concepts in total for the most part have led to mediocrity in the industry. Said another way, if a team does great research (knows their companies well), has very low turnover and/or low tracking error (balanced sectors, less concentration, etc.) and even achieves an above average hit rate, its excess returns will probably be somewhere around the equity fund average fee level of 80bps. It's just math.

We view this as strong evidence that we are deploying our most scarce resource well, which we have often said is our time. Our process aims our time and attention naturally toward the largest investments, but also the investments that are not working. We are constantly assessing if we are wrong. We have systems in place to alert us to negative revisions in our fundamental analysis, which allows us to reduce risks earlier in areas where there is adverse "change." We know what matters for an investment, and we track those areas intensely.

Maximizing payoff permeates through our process and our ability to build an all-weather portfolio. First, we are extremely focused on not losing money and are continuously probing conviction levels on losing positions, especially when they are large but even when they are small. It has been very rare so far for us to suffer a significant loss on a single position. The systematic structure of our process helps us do this as it aims to remove as much emotion as possible—earnings differentiation and expected outcome are research outputs. As our research outputs change our perspective changes, and our process leaves little room for us to defend a losing position without sound analytic reasoning. Second, we aim to employ a symmetric process. We are constantly assessing the sizing of winning positions as our thesis plays out, as well as whether we are maximizing our research. Ultimately, all aspects of our process—from our culture to our day-to-day research—are geared towards this outcome, and we are happy that our results reflect what we fundamentally believe drives investment results.

Importantly, if we maintain focus on analytical differentiation and employ a robust risk management process, there is no mandatory tradeoff that results in elevated risk. We have produced positive excess returns (Exhibit 3) with our approach of elevated concentration, high sector active weightings and active portfolio management, without exhibiting greater volatility or drawdowns.

**Exhibit 3:** Summary Risk Statistics
As of 30 September 2021

| | Annualized Return ITD | Std Dev | Sharpe Ratio | Max Drawdown | Beta |
|---|---|---|---|---|---|
| Artisan Focus Fund (ARTTX) | 25.4% | 15.2% | 1.6 | -14.5% | 0.9 |
| S&P 500® Index | 16.5% | 15.9% | 1.0 | -19.6% | 0.0 |

Source: Antero Peak Group/S&P/MSCI. Inception: 24 Apr 2017. Risk and return statistics from 1 May 2017 to 30 Sep 2021. **Past performance does not guarantee and is not a reliable indicator of future results.**

We think recognition of this simple framework has served us well and has had a big impact on our operating culture that we continue to refine and evolve.

## Summary

As we said last quarter, economic growth is decelerating, the stock picking environment is improving, and we expect to see our portfolio materially outpace and out earn the S&P 500® Index on fundamental

metrics. In the context of the Stanley Druckenmiller statement we referenced, we aim to maximize our research efforts through an obsessive operating culture of optimizing the payoff ratio, which we think is one of our most effective tools to generate high risk-adjusted alpha. Our underlying process remains unchanged, and we remain committed to finding inflection points that can lead to accelerations in revenue and earnings. We also seek differentiation vs. consensus and thesis duration that can lead to more sustainable ROIC growth and multiple expansion. We think this combination of rigor and culture gives us a high probability of achieving investment success.

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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. A non-diversified portfolio may invest a larger portion of assets in securities of a smaller number of issuers and performance of a single issuer may affect overall portfolio performance greater than in a diversified portfolio. The portfolio's use of derivative instruments may create additional leverage and involve risks different from, or greater than, the risks associated with investing in more traditional investments. High portfolio turnover may adversely affect returns due to increased transaction costs and creation of additional tax consequences. 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. 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.**

This commentary represents the views of the manager as of 30 Sep 2021 and do not necessarily represent those of Artisan Partners. The views and opinions expressed are based on current market conditions, 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 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.

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S&P 500® Index measures the performance of 500 US companies focused on the large-cap sector of the market. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.



For the purpose of determining the Fund's holdings, exposures are delta-adjusted at the issuer level and may include multiple securities of the same issuer. 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 are obtained from various data sources and intended to provide a general view of the portfolio, or Index, at a point in time. Artisan Partners excludes outliers when calculating portfolio characteristics and may use data from a related security to calculate statistics if information is unavailable for a particular security. Exposure Pct Assets represents the portfolio's exposures based on the economic value of investments (including delta-adjusting options exposures). Delta-adjusted options exposure is a measure of the market exposure created by the options and accounts for the sensitivity of options to changes in price of the underlying security. In comparison, measuring the exposure of an option at the market value of the option or notional value can understate or overstate, respectively, the economic exposure and risk. This estimate of portfolio exposure is only an approximation of the portfolio at a point in time.

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.

Theme classifications are at the sole discretion of the team. Themes and constituents are as of the date indicated and are subject to change. Certain holdings have been reclassified subsequent to initial investment, which has impacted theme performance during the period. Portfolio sector classifications are defined by the investment team based on GICS.

**Discounted cash flow** (DCF) is a valuation method used to estimate the value of an investment based on its expected future cash flows. **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%. **Beta** is a measure of the volatility of a security or a portfolio in comparison to the market as a whole. **Duration** estimates the sensitivity of underlying fixed income securities to changes in interest rates—the longer the duration, the greater the sensitivity to changes in interest rates. **Return on Invested Capital (ROIC)** is a measure of how well a company generates cash flow relative to capital invested in the business. **Sharpe Ratio** is a measure of risk-adjusted return—it is the average return earned in excess of the risk-free rate per unit of volatility or total risk. **Standard Deviation** defines how widely returns varied from an average over a given period of time. Higher deviation represents higher volatility.

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