# Artisan High Income Fund

QUARTERLY
Commentary

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

As of 31 March 2022

## 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 31 March 2022 | QTD | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr | Inception |
|---|---|---|---|---|---|---|---|
| | | | Average Annual Total Returns | | | | |
| **Investor Class: ARTFX** | **-1.49** | **-1.49** | **2.29** | **7.17** | **6.35** | — | **6.46** |
| **Advisor Class: APDFX** | **-1.56** | **-1.56** | **2.34** | **7.30** | **6.50** | — | **6.62** |
| **Institutional Class: APHFX** | **-1.44** | **-1.44** | **2.44** | **7.40** | **6.59** | — | **6.60** |
| ICE BofA US High Yield Master II Index | -4.51 | -4.51 | -0.29 | 4.40 | 4.56 | — | 4.60 |

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 |
|---|---|---|---|
| Annual Report 30 Sep 2021 | 0.95 | 0.79 | 0.70 |
| Prospectus 30 Sep 2021[1] | 0.96 | 0.80 | 0.71 |

[1]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 materially outpaced the ICE BofA US High Yield Index in Q1, representing the strongest three-month stretch of relative performance since inception. Asset allocation and credit selection both positively contributed to our portfolio's strong relative performance. From an allocation standpoint, our significant out-of-benchmark exposure to leveraged loans—and resulting short-duration bias—helped shelter the portfolio during Q1's rate-driven volatility. In the same way, our material underweight to rate-sensitive BB-rated bonds in favor of more credit-sensitive risk benefited performance amid a period of persistently rising interest rates. Overall, the quarter speaks to the successful execution of our process, which seeks to emphasize downside protection and broad flexibility to generate strong risk-adjusted returns across all phases of the credit cycle.

## Investing Environment

Volatility returned to markets in Q1 as the investing backdrop quickly shifted from one driven by reopening-fueled momentum to one pressured by inflationary pressures and the humanitarian and economic costs of the war in Ukraine. With consumer prices rising uncomfortably across many segments of the economy, global central banks moved to begin withdrawing virus-induced policy accommodation in an effort to extinguish ongoing inflationary pressures. The dual shocks of tighter monetary conditions and geopolitical uncertainty led to widespread volatility across interest rates and risk assets. While drawdowns across equity markets were notable, the response across credit markets was relatively orderly in comparison. Short-lived periods of volatility pushed credit spreads wider throughout the quarter, but valuations remained well contained below 400bps. Still, high yield bonds (as measured by the ICE BofA US High Yield Index) finished the period down 4.5%. With five-year Treasury yields at their highest levels since early 2019, high yield's difficult quarter is primarily the function of higher interest rates rather than growing credit risk.

Across the capital structure, leveraged loans showed notable resilience throughout the volatility, finishing the quarter unchanged (as measured by the JPMorgan Leveraged Loan Index). The asset class experienced a nearly limitless bid from investors seeking out floating-rate assets amid a period of heightened interest rate volatility. Loans finished the quarter as one of the best performing fixed income asset classes—largely due to limited rate sensitivity.

Credit valuations made a complete round trip during the quarter, moving to December 2020 wides in March before finishing the quarter only modestly higher than year-end levels. At sub-400bps spreads, valuations remain well below long-term averages, suggesting the environment for credit risk remains relatively benign despite economic and geopolitical uncertainty. Across the credit spectrum, B-rated risk held up best as more rate-sensitive risk (BBs) lagged with higher rates and credit-sensitive risk (CCCs) trailed with increased risk-asset volatility. In all, Bs finished with a loss of 3.5%, followed by CCCs (-3.7%) and BBs (-5.4%).

On the primary front, new issuance activity across bonds and loans came to a standstill with the pickup in equity volatility and spike in interest rates. Total new supply is down more than 70% from a year ago as refinancing activity slowed with higher all-in yields.

Despite the pickup in volatility, the default backdrop remains benign. The quarter saw just three companies default on their bond and loan obligations. The quiet quarter meant the 12-month par-weighted default rate moved to near record lows below 0.5%. Importantly, despite the pickup in volatility, the number of distressed candidates in the markets is largely unchanged from the start of the year. Today, less than 2% of bonds in the high yield index trade at distressed levels, suggesting a supportive environment for credit fundamentals.

## Portfolio Positioning

As we've written for several quarters, we've considered rising interest rates to be one of the most underpriced risks in the marketplace. With this view, we came into January with nearly 40% of the portfolio in floating-rate assets based on the better tradeoff between yield and duration. As volatility reemerged, this positioning helped the portfolio withstand pressures from higher interest rates.

But later in the quarter, our relative value views became more balanced as pockets of value emerged across the high yield landscape. Yields for BB-rated bonds have moved to their highest levels since mid-2020 while the percent of the market that is call constrained dropped to 30%—from nearly 75% just three months ago. With a meaningful degree of policy tightening already priced into the market, we think a unique setup for the up-in-quality trade is emerging. The duration damage to higher rated risk has created opportunities to upgrade the portfolio without sacrificing yield. As a result, we chose to trim our loan allocation into strength throughout the quarter, reducing exposure from nearly 40% to just 22% by the end of March. We used these proceeds to incrementally allocate to higher rated and more rate-sensitive bond risk. We also maintain a higher-than-average cash balance, which we will look to opportunistically deploy with continued volatility.

The portfolio's top holdings included three new issuers during the quarter: Charter Communications, NCL Corp and Altice France. Exiting the top 10 were Ultimate Software Group, Surgery Center Partners and VistaJet. Our portfolio continues to be populated with our highest conviction names, with 27% of the portfolio in the top 10 issuers.

We added to our long-time exposure in the unsecured debt of Charter Communications as increased interest rate volatility weighed on the company's debt complex. While Charter has been a main holding since the portfolio's inception, we've added and trimmed around the name based on relative value. Charter fell out of the portfolio's top 10

in Fall 2021 due to an increasingly asymmetric risk profile, given tight spreads and low yields across the credit landscape. But with materially higher interest rates in Q1, many solid and liquid performing high yield bonds now trade at unusually low dollar prices. In the case of Charter, many of the company's credits that traded at premium to par six months ago now trade at high 80s to low 90s prices despite no material change in fundamentals. While the company is likely to see difficult new subscriber comparisons in the near term, given the pull forward from the pandemic, it continues to grow operating earnings and generate significant free cash flow that provides plenty of flexibility and liquidity. Our exposure in Charter represents high quality, BB-rated risk that now offers unique convexity and total return potential.

We also added to our existing exposure in the secured and unsecured debt of Norwegian Cruise Line (NCL). The company's credit profile has been pressured by omicron and other COVID-related disruptions, but strong demand and pricing patterns across all its brands help offset any near-term negatives. Bookings for the second half of 2022 and beyond are in line with pre-pandemic comparables while pricing trends remain well above 2019 levels. Importantly, supportive capital markets have provided the company plenty of options in addressing its cash burn while operations ramp up to capacity. Credit-friendly equity dilution has been meaningful with outstanding shares now double pre-pandemic levels. Similarly, continued demand for lower rated debt has allowed management to reshape NCL's balance sheet by refinancing high coupon debt, lowering interest costs and moderating cash needs in the near term.

Finally, we initiated a position in the secured and unsecured debt of telecom provider Altice France during the quarter. The company is France's second-largest telecom operator by revenues and subscribers with major positions across all segments of the French market. Over the last several years, Altice France has undergone significant opportunistic and high-multiple asset sales to improve liquidity and reduce leverage. The moves were broadly supported by credit investors and facilitated the refinancing of the capital structure in 2019. But since then, its deleveraging plans have failed to materialize as Altice's management has prioritized overhauling and simplifying other parts of the Altice capital structure. While the company is unlikely to meet its 4.5X leverage goals over the next year, Altice is likely to refinance several tranches of debt over the coming quarters, resulting in a longer duration and lower cost capital structure, improving free cash flow generation for the company.

On the other side of the ledger, we used the strong demand for floating-rate assets to trim our exposure in the first and second lien loans of Ultimate Software Group. With prices for both instruments trading through par, we sold roughly half of our exposure to allocate to better risk/reward opportunities elsewhere in the portfolio. For Surgery Center Partners, the unsecured debt trades yield to call given expectations management would refinance higher cost debt later in Q2. With limited upside, we chose to exit a portion of our allocation based on valuations. Finally, our high-coupon position in VistaJet was refinanced. While we participated in the new issuance, our overall exposure to the issuer was reduced.

## Perspective

The price action over the quarter gives us confidence to say the era of ultra-low dispersion that has characterized the credit environment over the last year is over. Idiosyncratic credit risk has largely been masked by a pull-to-par, risk-on environment. But with a less supportive macro backdrop and policy maker's rapid hawkish pivot, we expected volatility to be an ongoing theme as the Fed's policy put is removed from the market. As we move forward, investors are likely to contend with an environment of improving credit fundamentals offset by the risks of tighter monetary conditions and geopolitical uncertainty. We think this will lead to a more robust opportunity set and a better environment for credit selection as the differences in pricing across credits become more pronounced. With our process built on bottom-up security selection, we believe our approach of identifying mispriced securities across the credit spectrum and across capital structures will be notable differentiators. We welcome the reemergence of volatility and will use dislocations to add risk in areas with supportive fundamentals.

**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.**

**Current and future portfolio holdings are subject to risk. The value of portfolio securities selected by the investment team may rise or fall in response to company, market, economic, political, regulatory or other news, at times greater than the market or benchmark index. 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 31 Mar 2022. 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 31 Mar 2022: Charter Communications Inc 2.8%, NCL Corp Ltd 2.7%, Altice France 2.5%; Ultimate Software Group Inc 1.8%; Surgery Center Holdings 1.3%, VistaJet Ltd 1.2%. 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.

Source ICE Data Indices, LLC is used with permission. ICE® is a registered trademark of ICE Data Indices, LLC or its affiliates and BofA® is a registered trademark of Bank of America Corporation licensed by Bank of America Corporation and its affiliates ("BofA"), and may not be used without BofA's prior written approval. The index data referenced herein is the property of ICE Data Indices, LLC, its affiliates ("ICE Data") and/or its third party suppliers and, along with the ICE BofA trademarks, has been licensed for use by Artisan Partners Limited Partnership. ICE Data and its Third Party Suppliers accept no liability in connection with the use of such index data or marks. See www.artisanpartners.com/ice-data.html for a full copy of the Disclaimer.

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.

This material is provided for informational purposes without regard to your particular investment needs and 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.

**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. **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. **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.

Artisan Partners Funds offered through Artisan Partners Distributors LLC (APDLLC), member FINRA. APDLLC is a wholly owned broker/dealer subsidiary of Artisan Partners Holdings LP. Artisan Partners Limited Partnership, an investment advisory firm and adviser to Artisan Partners Funds, is wholly owned by Artisan Partners Holdings LP.



A R T I S A N  P A R T N E R S

4/22/2022 A22577L_vR