# Artisan U.S. Mid-Cap Value Strategy

QUARTERLY
Commentary

As of 31 March 2020

## Investment Process

We seek to invest in companies that are undervalued, in solid financial condition and have attractive business economics. We believe that companies with these characteristics are less likely to experience eroding values over the long term.

**Attractive Valuation**

We value a business using what we believe are reasonable expectations for the long-term earnings power and capitalization rates of that business. This results in a range of values for the company that we believe would be reasonable. We generally will purchase a security if the stock price falls below or toward the lower end of that range.

**Sound Financial Condition**

We prefer companies with an acceptable level of debt and positive cash flow. At a minimum, we seek to avoid companies that have so much debt that management may be unable to make decisions that would be in the best interest of the companies' shareholders.

**Attractive Business Economics**

We favor cash-producing businesses that we believe are capable of earning acceptable returns on capital over the company's business cycle.

## Team Overview

Everyone on the team functions as a generalist with respect to investment research and the entire team works together on considering potential investments.

**Portfolio Management**

James C. Kieffer, CFA
Portfolio Manager

Thomas A. Reynolds IV
Portfolio Manager

Daniel L. Kane, CFA
Portfolio Manager

Craig Inman, CFA
Portfolio Manager

## Investment Results (% USD)

| As of 31 March 2020 | QTD | YTD | Average Annual Total Returns 1 Yr | 3 Yr | 5 Yr | 10 Yr | Inception[2] |
|---|---|---|---|---|---|---|---|
| **Composite — Gross** | **-34.55** | **-34.55** | **-27.22** | **-7.64** | **-2.15** | **5.80** | **10.21** |
| **Composite — Net** | **-34.72** | **-34.72** | **-27.93** | **-8.50** | **-3.07** | **4.83** | **9.17** |
| Russell Midcap® Value Index | -31.71 | -31.71 | -24.13 | -5.96 | -0.76 | 7.21 | 7.65 |
| Russell Midcap® Index | -27.07 | -27.07 | -18.31 | -0.81 | 1.85 | 8.76 | 7.82 |

## Annual Returns (% USD) 12 months ended 31 March

| | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| **Composite — Gross** | **-5.08** | **19.91** | **7.96** | **0.27** | **-27.22** |

Source: Artisan Partners/Russell. Returns for periods less than one year are not annualized. [2]Composite inception: 1 April 1999.

**Past performance does not guarantee and is not a reliable indicator of future results. Current performance may be lower or higher than the performance shown. Composite performance has been presented in both gross and net of investment management fees.**

**Investment Risks:** Investments will rise and fall with market fluctuations and investor capital is at risk. Investors investing in strategies denominated in non-local currency should be aware of the risk of currency exchange fluctuations that may cause a loss of principal. These risks, among others, are further described near the back of this document, which should be read in conjunction with this material.

# Artisan U.S. Mid-Cap Value Strategy



## Investing Environment

The first quarter of 2020 was one of superlatives. We entered an *unprecedented* period. There were *firsts* and *worsts; fastests* and *furthests*. The *novel* coronavirus became a pandemic. Financial market price swings were *historic*. Government responses were swift and *consensus-shattering*.

In a quarter that included a *breakneck* equity market correction and *record-setting* single-day price moves—both up and down—the Russell Midcap® Value Index fell 31.71%. No sector was spared. Energy, the index's worst performing sector, dropped 62.75% as crude oil prices hit 17-year lows amid a Russo-Saudi price war and collapsing demand for refined products.

Shelter-in-place orders and social distancing protocols are simultaneously crippling the demand and the supply sides of the economy. While traditional consumer behaviors are being upended, the market still reacted as we might expect in any run-of-the-mill recession: Cyclicals underperformed non-cyclicals. The consumer discretionary sector was among the worst performers in the index, as were financials. Defensive sectors—utilities, health care, consumer staples—were top performers.

In some sense, despite all the overwhelming change, the more things change, the more they stay the same. Economic cycles come and they go. Exogenous shocks push markets and business models to the brink; some break, others survive, and we revert to the mean over time. The business of investing—the business of taking stakes in the equities of publicly traded companies, with the explicit goal of investing capital to get a better return for the risk being borne—has not and will not change as a result of COVID-19. This is why we have a process and stay disciplined to it. Amid conditions where fear is heightened, where economic uncertainty is as high as we have ever seen it, where current earnings are just a guess by even the smartest analysts, a disciplined process is what separates professional investors from speculators. And while we concentrate on periods well beyond the next 12-months, of course a major near-term, even short-lived shock that resets base earnings power has major implications for the long-run fundamental economics of a business. More on that in our Perspective section.

## Performance Discussion

Our portfolio underperformed the benchmark—almost entirely the result of sector allocations. We're stock pickers, and sector allocations are the byproduct of our fundamental research and rigorous stock-selection process. Sometimes this works against us—as it notably did in Q1. For example, we have regularly and diligently explored opportunities in public utilities. Yet, none have met our margin of safety criteria and we hold a zero weighting in this sector, the index's best performing sector. This detracted from relative returns. Sometimes, our bottom-up approach works for us when it comes to sector allocations, as it did by being underweight energy. Despite their best intentions of trying to live within their cash flow means, energy industry fundamentals before the recent selloff were weak. We continued our multi-quarter journey of reallocating capital to businesses with more control over their destinies. Our REITs positions were also positive for the portfolio. In addition to strong performance from a particular holding (Equity Commonwealth), our below benchmark exposure contributed to returns. Unlike prior periods of market stress, REITs didn't hold up. Their cyclicality and financial leverage, combined with *unprecedented* rent deferrals or refusals by tenants, overwhelmed the benefits they receive from declining interest rates.

Among our top contributors was Equity Commonwealth, a REIT with commercial office properties throughout the US. We like the company's management team, which has a history of creating shareholder value and maintains a large stockpile of cash, enabling it to opportunistically deploy capital. In Q1, Equity's cash position left it less vulnerable to asset risk and mark-to-market problems, helping it hold ground relative to peers. Having held its ground and having decreased in appeal as a result, we pared the position and moved capital into new ideas.

We also benefited from exiting positions in Jacobs Engineering and Delphi Technologies, moves we completed before the bottom fell out of the market. Selling on strength freed up capital for us in better situations.

Our top detractors were RV manufacturer Thor Industries, consumer financial services provider Synchrony Financial and airplane leasing firm Air Lease Corp. Each of these companies was acutely affected by the virus-related shutdowns. At the same time, each has market-leading positions and is led by a battle-tested management team. These firms are carefully and wisely financed, and they have undemanding valuations based on normalized earnings power.

## Perspective

The Q1 market selloff was broad-based and intense, fueled by deep uncertainty about the pandemic's true threat. In our view, the market did little to discriminate among individual firms, preferring to re-rate sectors given the short timeframe, rapid price action and lack of information.

Of course, our process is built to capitalize on market dislocations, when fear and uncertainty dominate, as is the case in our current environment. But we are also vigilantly risk-aware. This is where a thoughtful and repeatable process makes all the difference.

Clearly, the markets are navigating a series of risks for which history is a poor guide. We can't reasonably draw on prior experiences because there are none. Without a reliable empirical guide, we are operating with a high level of intellectual honesty about what we do know, about what we might not know, about what we can know, and about what we can't know all that well. Working within our process, we focus on understanding the range of potential outcomes and look for opportunities where the asking price today tilts in our favor. And currently, the range of outcomes may never have been wider in our time as professional investors. Not only is the range wider, the left-tail

of the distribution—the one with the worst outcomes—is fatter than usual; the right-tail of the distribution—the one with the best outcomes—may not be similarly wide.

Dispersion and skewness are useful statistical concepts, but like any tool, only as good as the skill and judgment of the analyst. These objective tools can help to push emotion and cognitive biases aside, but we don't approach the opportunity set with a math-explains-all approach. Rather, we use statistics to amplify our judgment. Our probabilistic thinking is one prime example.

Investing is not gambling, but they share some common traits. Consider a pair of fair, six-sided dice. If you were offered a chance to wager on the outcome of a roll of those dice, you absolutely must first know how many outcomes are possible: 11 with 36 possible combinations. We think exhaustively about the paths and permutations an out-of-favor stock can take. But what makes the current environment particularly challenging is that the game isn't with two dice. Now, it's more like a three-dice game, with 16 outcomes, across 216 combinations.

Going to 16 outcomes from 11 certainly raises the level of difficulty. When the range of outcomes widens even modestly, the possible combinations expand exponentially. This intuition is simple, but powerful. If you focus only on the range of outcomes and ignore the complexity in the combinations of paths that get you there, then you could be left bearing unintended risks. Consider how a company not only needs resilience in this economic downturn, its survival may depend on bridging a liquidity gap, which means navigating a dysfunctional financing market where central banks are now the activist investor. Such a path is complex and fraught with uncertainty. Given those conditions, a risk-aware value investor must recognize this and adjust valuations and expectations accordingly.

Our process relies on investing with a margin of safety. Those safety elements aren't foolproof in times like these or under these conditions, but they are intellectually honest, based on sound principals and time-tested. Let's discuss what this meant in practice.

## Portfolio Activity

We were as active in the portfolio in the first quarter as we were in the whole of 2019.

We added eight new names to the portfolio: multinational hospitality company Marriott International, global agricultural sciences company Corteva, ski resort owner and operator Vail Resorts, global logistics company Expeditors International of Washington, boutique investment bank Moelis & Co, first-tier aerostructures manufacturer Spirit AeroSystems, food products distributor Sysco and tier-one auto parts supplier BorgWarner.

Marriott International is a global operator and franchisor of hotels. After merging with Starwood in 2016, Marriott became the world's largest hotel company and rewards program owner. Its iconic brands are known and trusted worldwide, by vacationers and business travelers, predominantly in the upscale and upper upscale hospitality segments. By leveraging its scale and reach, Marriott drives cost savings for hotel owners and improves guest experiences. In addition to new unit growth, management is focused growing revenue per available room (RevPAR), which can vary by location. Marriott's exposure to the top revenue per available room markets is nearly double the next closest competitor. It may seem like Marriott is a massive property owner, but it is not. It operates an asset-light model, franchising the Marriott name and providing management services and operational expertise to outside owners who use one of their flagship brands. Marriott's balance sheet is healthy with reasonable leverage and adequate interest coverage. Management has also recently taken proactive steps in an effort to fortify the balance sheet to outlast the current environment. The company reliably generates cash in most economic environments but suffered considerably under the strains of the COVID-19 pandemic. From its all-time high price in December 2019, the stock had fallen 28% by the time we initiated our position. The P/E multiple also collapsed from the mid-20s to the high teens, which offered a sufficient margin of safety in our estimation, to take on the position. It may be tough to see right now, but travel will likely pick up again, both personal and professional. It's exemplary of our process when the discounts are large enough to acquire an iconic, long-lived global franchise with competitive advantages to peers, value-conscious management, a flexible financial structure and cash producing capabilities.

One of three companies spun out of the Dow-Dupont merger, Corteva is an agricultural chemical and seed company that operates through two distinct segments: seed and crop protection. Management is focused on helping farmers maximize yields and improve profitability, while serving a critical function in sustaining and building global food supply. As the COVID-19 pandemic has stressed supply chains in almost every industry, food security has become increasingly important. Farmers are facing a great deal of uncertainty about this planting season, so we expect this will translate into near-term volatility for Corteva. Over a longer time horizon, Corteva is positioned as a leader in helping farmers manage and meet demand. By remaining disciplined with capital and resource allocation, Corteva is leveraging a greatly improved cost structure to launch a host of new products over the next several years and reinforce strong relationships with its agricultural customers. Its cost-conscious approach to growth is consistent with our own risk-aware philosophy when it comes to identifying strong balance sheets and long-duration cash flows. In our view, Corteva's current earnings power is dramatically below its long-term potential. We think the market is not focusing far enough into the future to appreciate the earnings power of the business as more cost cutting is in the works, a global enterprise resource planning system brings efficiency, and important licensing deals are exited. What we see for the patient investor with a three- to five-year horizon is a well-capitalized business with a wide moat, trading under 10X what we consider normalized earnings power.

Vail Resorts, a premium skiing, lodging and resort company, owns and operates some of the most recognizable and most visited ski resorts in North America. Of course, this is a highly seasonal business, dependent on appetite for ski vacations and the right weather conditions. Although it's also a high fixed-cost business, management can pull several levers with regard to using a flexible labor force and deferring capital expenditures. Management has done well to navigate poor snowfall in recent years and grow through acquisitions, all the while returning excess cash to shareholders. Debt is well-structured and backed by assets that are virtually non-replaceable in today's marketplace. With this spring's ski vacations cancelled and the concern that next season will be affected by COVID-19, Vail Resorts has fallen out of favor. As valuations collapsed from the mid 20X pretax profit levels to the low teens on a normalized basis, we saw an opportunity consistent with our philosophy and process: Take a stake in an iconic, sustainable franchise at a sufficient margin of safety in relation to potential downside risk scenarios.

When tier-one auto parts supplier BorgWarner made an all-stock offer to buy its competitor (and our holding) Delphi Technologies, the economy had not yet been roiled by the pandemic. The market lifted Delphi's price on the prospects and knocked BorgWarner's for taking on the challenge. As Delphi shareholders, we were now carrying new risks, namely that the deal would break down. We determined the premium in the deal wasn't paying us to bear that risk, so we took advantage of the opportunity to, in a sense, finalize the merger for ourselves. We sold our Delphi position on the strength and bought BorgWarner on the weakness. We continue to like the long-term prospects for tier-one auto suppliers, especially well-managed ones with differentiated products and strong balance sheets, like BorgWarner. Borg is a great example of a company we have thoroughly researched and that met all of our margin of safety criteria, except for the valuation, until now.

We completely closed positions in independent oil and gas firm Devon Energy, financial market exchange firm Intercontinental Exchange, one of the world's largest engineering and construction companies Jacobs Engineering and the super-regional bank formed from the BB&T and SunTrust merger, Truist Financial.

With economic conditions deteriorating and fear and uncertainty dominating market prices, our flurry of activity may come as a surprise. It shouldn't. We devote all our time to researching companies from every available angle, building a bench of cash-producing businesses in strong financial condition. When valuations reach undemanding levels and we are comfortable with the margin of safety, we are agile and opportunistic. We work precisely so we can be very active in these investment environments. This, we believe, is the best way to build a portfolio of long-term compounders and create value for our investors.

**For more information:** Visit www.artisanpartners.com

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**Normalized Earnings** are earnings that are adjusted for the cyclical ups and downs over a business cycle. **Margin of Safety**, a concept developed by Benjamin Graham, is the difference between the market price and the estimated intrinsic value of a business. A large margin of safety may help guard against permanent capital loss and improve the probability of capital appreciation. Margin of safety does not prevent market loss—all investments contain risk and may lose value. **Price-to-Earnings (P/E) Ratio** measures how expensive a stock is. Earnings figures used for FY1 and FY2 are estimates for the current and next unreported fiscal years.

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

# Artisan U.S. Mid-Cap Value Strategy

Quarterly Contribution to Return (% USD)

As of 31 March 2020

| Top Contributors | Average Weight | Contribution to Return | Ending Weight |
|---|---|---|---|
| Delphi Technologies PLC | 0.71 | 0.10 | 0.00 |
| Jacobs Engineering Group Inc | 0.41 | 0.05 | 0.00 |
| Equity Commonwealth | 2.13 | 0.01 | 1.32 |
| Cash Holdings | 2.77 | 0.01 | 2.36 |
| AmerisourceBergen Corp | 2.10 | -0.00 | 2.35 |
| Expeditors International of Washington Inc | 0.42 | -0.02 | 1.74 |
| Vail Resorts Inc | 0.05 | -0.03 | 1.47 |
| Corteva Inc | 0.38 | -0.03 | 1.62 |
| The Progressive Corp | 2.24 | -0.05 | 2.86 |
| The Kroger Co | 3.18 | -0.06 | 2.48 |
| Truist Financial Corp | 0.80 | -0.08 | 0.00 |
| GCI Liberty Inc | 1.75 | -0.10 | 1.04 |
| Intercontinental Exchange Inc | 0.98 | -0.11 | 0.00 |
| Sysco Corp | 0.06 | -0.19 | 1.61 |
| Moelis & Co | 1.38 | -0.31 | 2.57 |
| IAC/InterActiveCorp | 2.29 | -0.36 | 2.89 |
| Nutrien Ltd | 1.42 | -0.36 | 0.48 |
| Lions Gate Entertainment Corp | 1.23 | -0.38 | 1.14 |
| Aon PLC | 2.34 | -0.43 | 2.24 |
| NetApp Inc | 1.71 | -0.44 | 2.04 |
| BorgWarner Inc | 0.93 | -0.46 | 2.24 |
| Marathon Petroleum Corp | 0.69 | -0.48 | 0.50 |
| AMERCO | 2.67 | -0.50 | 3.08 |
| Devon Energy Corp | 0.61 | -0.51 | 0.00 |
| Marriott International Inc | 0.51 | -0.52 | 2.10 |
| Weyerhaeuser Co | 1.03 | -0.54 | 0.96 |
| Loews Corp | 1.58 | -0.54 | 1.53 |

| Bottom Contributors | Average Weight | Contribution to Return | Ending Weight |
|---|---|---|---|
| Thor Industries Inc | 3.78 | -1.80 | 3.32 |
| Synchrony Financial | 2.55 | -1.77 | 1.81 |
| Air Lease Corp | 3.23 | -1.48 | 2.85 |
| AutoNation Inc | 3.10 | -1.40 | 2.84 |
| Arch Capital Group Ltd | 3.36 | -1.37 | 3.19 |
| Fifth Third Bancorp | 2.21 | -1.28 | 2.28 |
| Expedia Group Inc | 2.43 | -1.25 | 2.41 |
| Spirit AeroSystems Holdings Inc | 0.88 | -1.18 | 1.05 |
| Lamar Advertising Co | 1.81 | -1.13 | 2.36 |
| Kirby Corp | 2.28 | -1.10 | 1.99 |
| Celanese Corp | 3.12 | -1.06 | 2.52 |
| M&T Bank Corp | 2.73 | -1.04 | 2.60 |
| BOK Financial Corp | 1.85 | -1.02 | 1.91 |
| ViacomCBS Inc | 1.37 | -0.99 | 0.92 |
| Ryder System Inc | 1.77 | -0.97 | 0.26 |
| H&R Block Inc | 1.97 | -0.95 | 1.79 |
| Globe Life Inc | 3.32 | -0.95 | 3.43 |
| Axalta Coating Systems Ltd | 2.10 | -0.93 | 2.05 |
| Pinnacle Financial Partners Inc | 1.79 | -0.86 | 1.96 |
| Gentex Corp | 3.14 | -0.81 | 3.36 |
| Omnicom Group Inc | 2.38 | -0.80 | 2.48 |
| News Corp | 1.83 | -0.71 | 1.75 |
| Analog Devices Inc | 3.37 | -0.71 | 3.70 |
| Arrow Electronics Inc | 1.91 | -0.69 | 1.65 |
| DENTSPLY SIRONA Inc | 2.24 | -0.63 | 2.84 |
| STORE Capital Corp | 1.08 | -0.62 | 0.93 |
| E*TRADE Financial Corp | 2.01 | -0.60 | 1.16 |

Source: Artisan Partners/FactSet. **Performance is historical and is not a reliable indicator of future results.** As of 31 Mar 2020. These investments made the greatest contribution to, or detracted most from, performance during the period based on a representative account within the strategy Composite. Upon request, Artisan will provide: (i) the calculation methodology and/or (ii) a list showing the contribution of each holding to overall performance during the measurement period. Securities of the same issuer are aggregated to determine the weight in the portfolio. % Contribution to Return is calculated by FactSet by multiplying a security's weight in the portfolio by its in portfolio return for the period referenced and does not take into account expenses of the portfolio. Purchases/sales are accounted for by using end of the day prices, which may or may not reflect the actual purchase/sale price realized by the portfolio.