



# Artisan High Income Strategy

QUARTERLY  
Commentary

As of 30 June 2020

## 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 (% USD)

As of 30 June 2020	QTD	YTD	Average Annual Total Returns				
			1 Yr	3 Yr	5 Yr	10 Yr	Inception <sup>1</sup>
<b>Composite — Gross</b>	<b>12.33</b>	<b>-2.92</b>	<b>2.13</b>	<b>4.77</b>	<b>6.58</b>	—	<b>6.42</b>
<b>Composite — Net</b>	<b>12.14</b>	<b>-3.26</b>	<b>1.42</b>	<b>4.04</b>	<b>5.84</b>	—	<b>5.67</b>
ICE BofA US High Yield Master II Index	9.61	-4.78	-1.10	2.94	4.58	—	3.97

## Annual Returns (% USD) 12 months ended 30 June

2016 2017 2018 2019 2020

<b>Composite — Gross</b>	<b>4.95</b>	<b>13.98</b>	<b>5.84</b>	<b>6.41</b>	<b>2.13</b>
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Source: Artisan Partners/ICE BofA. Returns for periods less than one year are not annualized. <sup>1</sup>Composite inception: 1 April 2014.

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. Unlike the Index, the High Income Composite may hold loans and other security types. At times, this causes material differences in relative performance. 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 on the last page, which should be read in conjunction with this material.



# Quarterly Commentary

## Artisan High Income Strategy

As of 30 June 2020

### Performance Discussion

Our portfolio solidly outpaced the ICE BofA US High Yield Index in Q2 to push YTD returns ahead of the index. Our relative outperformance can be attributed to strong security selection across our book of bonds and loans, with notable outperformance from the portfolio's lower-rated holdings. Our CCC-rated exposure has historically behaved in an uncorrelated fashion with the broader CCC portion of the index—that has been particularly true in Q2 and YTD. Despite broad investor risk aversion to lower-rated risk, our CCC-rated holdings are outpacing the broader index by more than 400bps YTD, highlighting our idiosyncratic approach to credit selection and our unique ability to assess credit risk independent of ratings agencies.

### Investing Environment

Following one of the worst drawdowns in more than a decade, credit markets rallied meaningfully as supportive monetary conditions and optimism around the economy's reopening helped fuel a turn in market sentiment. The improved outlook was met by a period of record inflows for the asset class as the Fed's explicit support for corporate borrowers gave the green light to investors to reenter the market. A two-month stretch of sharp reflation gave way to a month of sideways performance, as accelerating virus cases raised questions about whether optimistic expectations for a V-shaped recovery were premature. Despite concerns, high yield bonds still had their best quarter since 2009, returning 9.6% in Q2 to push YTD returns to -4.7% (as measured by the ICE BofA US High Yield Index). Leveraged loans (as measured by the JPMorgan Leveraged Loan Index) followed a path similar to high yield bonds', returning 9.8% in Q2, but remain down 4.5% YTD.

An important element of the quarter's rally was a record pace of new issuance in May and June. The Fed backstop reopened primary markets to high yield borrowers, allowing companies to raise enough liquidity to avoid default and bridge a sustained period of cash-flow shortfalls. While issuance was largely concentrated in high-rated, secured deals early in the quarter, investors became more willing to lend down the capital structure and to COVID-disrupted sectors later in the quarter. All told, there was a quarterly record of \$75 billion in net new issuance, easily exceeding Q2 2014's prior high of \$53 billion.

Valuations have improved markedly since the depths of the crisis in late Q1. Credit risk premiums collapsed from late-March wides of 1,082bps to 647bps at the end of June. As the market stabilized in April, investors had a clear preference for higher-rated risk as fundamental issues remained front of mind, but sentiment shifted dramatically in May when investors were willing to reach down to capture yield among lower-rated bonds. In all, BB-rated bonds returned 10.8%, followed by Bs and CCCs with 9.7% gains. Despite an improved outlook for lower-rated risk, CCCs trail BBs by more than 1,350bps YTD. Across sectors, all but airlines and entertainment posted positive returns in Q2, with energy, hotels and autos strongly outperforming. Despite a 34% gain in the quarter, energy remains down nearly 20% YTD.

Default activity remained elevated in Q2 with record numbers of defaults and distressed transactions. Close to 50 companies defaulted or engaged in distressed exchanges on \$82 billion in bonds and loans, surpassing Q1 2009's previous record of a combined total of \$80 billion. Defaults have also been met with record-low recovery rates, with an average recovery of 17% for bonds and 47% for first lien loans over the last 12 months. With the increased activity, the par-weighted default rate jumped to a 10-year high of 6.2%—up more than 3.5% from the start of the year. Close to 30% of the year's defaults have been concentrated in energy. When energy is excluded, the high yield default rate is 4.2%.

### Portfolio Positioning

As in Q1, we looked to exploit broad risk aversion early in the quarter by adding to existing exposure or initiating new positions in select COVID-disrupted companies—many of which contributed to our outperformance in Q2. We remained focused on directing our portfolio toward companies and industries with sufficient access to capital and enough flexibility to make it to the other side of this crisis intact. Across sectors, the biggest change occurred in leisure. Appreciation from our Q1 investments in several lodging and gaming-related companies along with new Q2 investments in recreation and travel pushed our leisure exposure from 4.0% in Q1 to 11.0% in Q2. Roughly 40% of this exposure is in investment grade issuers that trade at high yield valuations.

We ended the quarter with 73% of the portfolio in bonds and 26% in leveraged loans. While our bond weighting increased 5% to 73% in Q2, the increase is temporary and largely due to the timing of refinancing activity. Our long-held position in the secured debt of Ardonagh Midco 3 PLC was successfully refinanced in the period, and it was announced that our exposure would be called after the end of the quarter. While we will continue to hold a small position in Ardonagh's unsecured debt, the refinancing marks the conclusion of a multi-year investment.

Our portfolio remains focused on our highest conviction names, with 35.3% of the portfolio in the top 10 holdings. New to the top 10 were surgical care provider Surgery Center Holdings, cruise ship operator Carnival Corp and snack food manufacturer Shearer's Foods.

We used weakness to add to our existing exposure in Surgery Center Holdings—also known as Surgery Partners. The company operates short-stay surgical facilities throughout the US that specialize in non-emergency outpatient procedures. Given the concerns around access to affordable health care services, payors like Medicare and private insurers are increasingly redirecting patients from traditional hospitals toward less expensive surgical facilities for elective procedures. But because Surgery Partners focuses on non-emergency procedures, virus-induced shutdowns caused surgery volumes to drop by as much as 75% in Q2. Liquidity concerns caused the price of its debt to move into distressed territory in early Q2, but the company made several moves to bridge the current period and support its liquidity profile. It

was able to raise funds by drawing down its revolving credit line, raising cash through incremental borrowings and receiving cash infusions from CARES Act grants and advanced Medicare payments. Volume weakness constrains Surgery Partner's credit profile in the near term as surgeries are deferred, but long term the company is well-positioned to capture secular trends associated with the low-cost outpatient setting. We used weakness to incrementally add to our exposure in the first lien loan and senior unsecured risk. The position landed among our portfolio's top contributors in the quarter as prices rallied from distressed levels back toward par as the outlook for COVID pressures eased.

Facing suspended operations and limited liquidity, Carnival Corp came to the market in early April to shore up its balance sheet and raise enough liquidity to bridge a period of prolonged revenue declines and reimburse customers for canceled sailings. Carnival successfully raised more than \$6 billion through a combination of debt, convertible bond and equity sales. We participated in the biggest piece of financing, which came from the issuance of a \$4 billion senior secured bond offering. Because lending markets were largely closed to all but the best borrowers, the first-priority senior secured debt came with significant concessions, despite Carnival's investment grade rating. The debt was issued with 11.5% coupon at a one-point discount, backed by collateral that includes 86 of its 105 cruise ships and documentation that limits the debt's loan to value at a conservative 25%. While significant questions remain about what the future of cruising will look like coming out of the current crisis, we believe the secured debt will be covered in even the most bearish scenarios for Carnival Corp. We also participated in the convertible note issuance but exited the position based on valuations after it rallied close to 30% shortly after coming to the market.

We also added to our position in the first and second lien loans of snack food manufacturer Shearer's Foods. The company is the leading national private label supplier and contract manufacturer of salty snack foods in North America. While the healthy food trends in the US remain intact, the salty snack category continues growing faster than the market and has been particularly resilient in light of COVID trends. Over the last few years, the company has gone through a period of rapid growth following several bolt-on acquisitions intended to increase its capacity and expand its geographic footprint. But with acquisition costs and integration challenges largely behind it, Shearer's Food is well positioned to grow free cash flow and improve profitability as it leverages its wide-reaching scale.

Among issuers falling out of the top 10 were cable provider Charter Communications, general contractor Tutor Perini Corp and insurance brokerage company AssuredPartners. Charter Communications has been among the beneficiaries of the COVID-19 crisis and various shelter-in-place orders that have followed as the need for bandwidth becomes increasingly important. The company's debt rallied alongside higher-rated structures during the quarter but, with all-in yields below 4%, we believe the unsecured risk offers limited relative value at current levels. We chose to trim our long-held position in the

senior unsecured debt and reallocate to opportunities with more attractive risk/reward. With Tutor Perini Corp and AssuredPartners, the names fell out of the top 10 as a result of appreciation and portfolio management moves elsewhere.

### Perspective

As we enter July, the landscape across credit markets appears much different from late March's. The record selloff at the beginning of the pandemic was shortly followed by one of the fastest spread-tightening rallies in history, helped by unprecedented intervention by fiscal and monetary authorities. While credit markets have recovered much of their coronavirus-induced losses, we recognize the path forward remains uncertain. The tug of war between an enormous amount of central bank liquidity and economic disruption associated with a surge in new cases means volatility likely remains a dominant feature of the market environment moving forward. We will continue to use volatility as a selective liquidity-provider during periods of stress and will use dislocations to add risk in areas with supportive fundamentals.

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Securities of the same issuer are aggregated to determine a holding's weight in the portfolio. Securities referenced may not represent all of the securities in the portfolio. The following holdings comprise the top 25 largest holdings as a percentage of the portfolios's total net assets as of 30 Jun 2020: Ardonagh Midco 3 PLC 7.3%, General Electric Co 5.8%, NFP Corp 3.8%, Vertafore Inc 3.2%, TKC Holdings Inc 3.1%, Acrisure LLC 2.6%, Surgery Center Holdings Inc 2.6%, Redology Group LLC 2.4%, Carnival Corp 2.4%, Shearer's Foods LLC 2.2%, Comstock Resources Inc 2.1%, Charter Communications Inc 2.0%, Expedia Group Inc 1.9%, Marriott International Inc 1.8%, VistaJet Ltd 1.8%, Tutor Perini Corp 1.8%, AssuredPartners Inc 1.6%, Midan Intermediate Holdco II LLC 1.5%, Unifi Group LP 1.5%, Core & Main Holdings LP 1.4%, Terrier Media Buyer Inc 1.4%, Hearthsde Finance Co Inc 1.4%, Delta Air Lines Inc 1.3%, Beacon Roofing Supply Inc 1.3%, Park Intermediate Holdings LLC 1.3%. All information in this report is as of the date shown in the upper right hand corner unless otherwise indicated and is subject to change without notice. Portfolio statistics include accrued interest unless otherwise stated. Totals may not sum due to rounding.

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