



### Investment Process

We seek to invest in high-quality, undervalued companies with strong balance sheets and shareholder-oriented management teams.

### Undervaluation

Determining the intrinsic value of a business is the heart of our research process. Intrinsic value represents the amount that a buyer would pay to own a company's future cash flows. We seek to invest at a significant discount to our estimate of the intrinsic value of a business.

### Business Quality

We seek to invest in companies with histories of generating strong free cash flow, improving returns on capital and strong competitive positions in their industries.

### Financial Strength

We believe that investing in companies with strong balance sheets helps to reduce the potential for capital risk and provides company management the ability to build value when attractive opportunities are available.

### Shareholder-Oriented Management

Our research process attempts to identify management teams with a history of building value for shareholders.

### Team Overview

Our team has worked together for many years and has implemented a consistent and disciplined investment process. Our team is organized by geographic regions, but within those regions we are generalists who look across all industries. We believe this model enables our analysts to become broad thinkers and gain critical insight across all economic sectors.

### Portfolio Management



Daniel J. O'Keefe  
Portfolio Manager (Lead)  
Managing Director



Michael J. McKinnon, CFA  
Portfolio Manager  
Managing Director

### Investment Results (% USD)

As of 30 September 2021	Average Annual Total Returns						
	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Inception <sup>1</sup>
<b>Composite — Gross</b>	<b>-2.74</b>	<b>12.86</b>	<b>34.22</b>	—	—	—	<b>22.72</b>
<b>Composite — Net</b>	<b>-2.92</b>	<b>12.23</b>	<b>33.24</b>	—	—	—	<b>21.82</b>
S&P 500® Index	0.58	15.92	30.01	—	—	—	28.92

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

	2017	2018	2019	2020	2021
<b>Composite — Gross</b>	—	—	—	—	<b>34.22</b>

Source: Artisan Partners/S&P. Returns for periods less than one year are not annualized. <sup>1</sup>Composite inception: 1 March 2020.

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.



### Market Overview

Choosing topics for our quarterly letters isn't always straightforward. But this quarter, thankfully, the subject matter practically pulls up a chair at my desk and grabs the keyboard—I-N-F-L-A-T-I-O-N! Oh, and let's not forget, C-H-I-N-A.

Prices of just about everything are rising. Do we need the qualifier, *just about everything*? We can't think of a single thing that costs less these days. And our readers are likely of the same mind. Recent polls in the US listed inflation as the electorates' largest concern—and with good reason. Price increases are exceeding wage gains, and therefore real wages are falling. Said another way, most people are getting poorer despite a very strong economy. For a world that has seen mostly low inflation or disinflation for the past few decades, this is a shock to the system. It is upending the economy and rippling through the stock market. Consider what has happened in two of the most difficult and competitive industries around. The auto industry, long the poster child for chronic excess capacity and price competition, now has pricing power because there simply is no available inventory. Same with the apparel industry. Markdowns and inventory write downs at apparel retailers are scarce and margins are as strong as we have ever seen in many cases.

What we are experiencing is a supply-side crunch, something we have never seen before—at least not in our careers. Consumers have record levels of cash due to generous government support during the pandemic and fewer opportunities to spend it due to pandemic-induced restrictions. Now that things are opening up, the economy can't satisfy demand for a whole number of reasons, the largest being labor shortages. In the US today, there are roughly 1.4 job openings for every unemployed individual in the country. Similar shortages exist in other economies as well. Workers seem to have gotten used to staying home, and the economic support from government programs has made it financially painless to do so. And they aren't coming back, whether that's because they don't need the money; or they are afraid to assimilate back into the workforce; or they don't have childcare that allows them to go back to work; or some combination of all of the above.

Central bankers tell us all of this is transitory. Though their definition of transitory seems to stretch with every passing day. They argue that supply will rise to meet demand and inflationary pressures will fade as workers come back to the office, the shop floor and the docks. Perhaps. The risk is that the wage levels required to induce workers will continue to press higher and create a wage inflation spiral. One thing we must note: GDP in the US has recovered to pre-pandemic levels despite millions of workers sitting on the sidelines. That's largely due to the government's enormous borrowing and spending as well as the Federal Reserve's massive money printing. But it has also been enabled by the productivity gains of the IT revolution, Zoom being a great example. These productivity gains have helped suppress inflation for decades, and they may very well continue to do so post pandemic. Time will tell.

What does the stock market think? It depends on the day of the week. In the first quarter of this year, the market favored the economically sensitive or cyclical industries that are the hunting grounds of most value investors. Growth darlings regained momentum as the Fed sold hard its "transitory" inflation narrative, and assumptions of low inflation and low rates regained widespread acceptance. In the last couple of weeks, favor seems to have shifted back to value as the transitory assumption seemed harder and harder to justify in the face of persistent signs of inflation. Indeed, interest rate rises are now looming on the horizon in the UK as well as the US. This upcoming earnings season is going to be very interesting. We will gain insight into how companies are balancing the incredible demand driving a strong revenue environment with the inflationary pressure on costs.

And we mustn't forget China. Most markets around the world were flattish. The US was up a smidge, Europe up a smidge in local currency and Japan actually up mid-single digits, recovering some recent underperformance versus the rest of the world. But China was down 18% in local currency, and the widely owned bellwether technology giants were down much more than that, including our stake in Alibaba.

A few factors are at work here. Another COVID-19 wave is slowing the Chinese economy after a swift rebound in the back half of 2020 and early 2021. The imminent collapse of Evergrande, a large real estate developer, has also rattled markets. But most importantly, President Xi Jinping and the Communist Party have taken a more assertive regulatory tone that has spooked investors. For example, China's government issued regulations in July that essentially wiped out the entire for-profit education industry overnight. In so doing, China damaged its implicit contract with capital markets and triggered severe reactions from investors as they extrapolated these actions to other industries. The impact on the technology industry was particularly acute, as the government was already in the process of issuing new regulations for technology firms. These regulatory interventions have reminded investors that the Chinese government can in effect do whatever it wants. Some prominent investors proclaimed in effect that China is now un-investable. We disagree.

We hold a fairly nuanced position on recent government actions in China. The Big Tech regulations coming out of Beijing are arguably sensible and certainly not irrational. Regulations have centered around market dominance, monopolistic business practices, anti-competitive acquisitions, data security and compensation for gig-workers. These are all legitimate issues that regulators around the world are also grappling with and could result in a more stable industry long term.

In fact, we find many parallels between the new regulations in China and those being discussed in the West. The anti-monopoly actions in China are similar to anti-trust actions currently being litigated in the US. China's Personal Information Protection Law has echoes of Europe's General Data Protection Regulation (GDPR) legislation. The

actions taken on behalf of gig-workers in China are addressing issues also raised by California's failed Prop 22 last year.

In many ways, the anti-Big Tech rhetoric coming from US politicians and regulators could even be viewed as more alarming. US Senator Ted Cruz has described the industry as being "drunk on power." Current FTC Chairwoman Lina Kahn has suggested a public utility model for Internet companies that would require them to provide non-discriminatory access to their platforms.

Even the extreme actions taken against the for-profit education sector have parallels with actions taken in the US. Grizzled market observers like ourselves will recall the Obama administration implementing sweeping regulatory reforms in 2015 that sent the shares of for-profit education companies down 80%-90%. Important differences exist between the two events, but China is not the first country to crack down on the for-profit education industry.

The big difference, of course, is that China's regulatory tools are far more efficient, with little legal precedent or reliable legal guideposts. Big changes to laws and regulations move slowly in democratic societies, and the West has struggled to piece together regulatory frameworks for Big Tech. Meanwhile, China's government can implement them with blistering speed and resolve. Each model has its pros and cons, but we haven't seen much coming out of Beijing that hasn't been also proposed by politicians or regulators in the West.

### Portfolio Discussion

Our top contributors to performance this quarter were Alphabet, Booking Holdings and Marsh & McLennan.

Alphabet stock rose 9% this quarter. Results for the second quarter were simply incredible. Revenue was up nearly 60% year over year which was down 2% due to COVID-19 induced economic weakness. Still, on a two-year basis (compared to 2019) revenue grew more than 25% annualized. For a business that generates more than \$60B of revenue per quarter, the growth is extraordinary. Revenue has not grown this quickly since 2013 when the company was much smaller. Businesses are returning with vigor to the advertising market, and digital marketing is clearly their preferred outlet. Profits tripled with the EBIT margin almost doubling from 17% to more than 30%. The stock is no longer obviously undervalued, but the growth, the duration of that growth and a reasonable cash adjusted valuation continue to offer us good value.

Booking Holdings stock was up 8%. Travel is perhaps the only remaining area of the economy that remains depressed compared to the pre-pandemic period. International travel is barely possible at worst or extremely difficult at best due to restrictions and vaccine requirements. Domestic travel is farther along the recovery path but has been slowed by the surge of the delta variant. Revenue for Booking remained more than 40% down in the recent quarter compared to the same pre-pandemic quarter two years ago. And profitability remains extremely depressed. We estimate an underlying

EBIT margin of low single digits in the recent quarter compared to margins in the 30s before the pandemic. So while the results themselves were not great, they held some encouraging signs about the future. Gross room night bookings were down just 12% versus pre-pandemic, an indication that as restrictions ease, there is enormous pent-up demand for travel. It may be difficult to imagine right now, but there is a strong argument to be made that once all restrictions come down and the virus goes endemic, travel will surpass pre-pandemic levels.

Marsh & McLennan stock was also up 8% on strong results. Revenue grew at a double-digit rate, and margins expanded meaningfully. Last year's comparison was soft (revenue down 2%), but Marsh is performing strongly even on a two-year basis compared to pre-pandemic. This is due to the economic recovery but also due to the disruption of the failed merger between its two largest competitors, Aon and Willis Towers Watson, in our view.

Our largest detractors this quarter were Alibaba, Samsung and HeidelbergCement.

Alibaba declined about 14% post our purchase this quarter, hit by the regulatory concerns we discussed above. The share price has been almost cut in half from its peak and sits roughly where it was in 2017 when the company generated about one-fifth of its current revenue levels.

Alibaba is China's largest e-commerce and cloud company. Overall retail sales in China are growing 9% per year. Within that, e-commerce penetration is 25% and rising. This creates an e-commerce market growing in the mid-teens. Its cloud business is also a secular grower, driven by rising penetration of outsourced IT infrastructure, like what's happening in the US and Europe.

Alibaba is the dominant player in both markets. Its e-commerce business has massive scale with over 800 million active customers and \$1.1T in gross merchandise volume. This gives it ~65% market share of e-commerce and 20% of total Chinese retail spending. This is 3X larger than the second-largest player in China, and more than 2X Amazon's global e-commerce business. In cloud, Alibaba has a 42% market share, which again is 3X the second-largest player in China, and makes Alibaba's cloud business the third largest globally, after Microsoft and Amazon. There is a strong moat around the business which comes from its scale and the network effects endemic to marketplace e-commerce businesses.

The current profitability is burdened by a slew of loss-making investments. These include investments in traditional retail, food delivery, international markets in Southeast Asia, logistics and others. These have served to significantly depress the group's margins over the past few years. Despite these investments, the business remains nicely profitable and cash generative.

The shares have been pressured by concerns of regulatory actions and competition. Both concerns are valid, and profits won't grow this year as a result. But longer term, we believe profit growth is inevitable given the market growth and Alibaba's market positions. There is potential to grow faster than the market by increasing the take-rate from ~4% today (about 1% commission and 3% advertising) to closer to global norms. For context, we estimate Amazon's take-rate is closer to 30%—this includes 8%-15% commission rates, additional services (logistics, storage and other) and advertising of 4%-7%. While the take-rate isn't perfectly comparable for several structural reasons, there may be room for Alibaba's to rise. In addition, the investment losses should eventually fade (or at least scale), which would improve profits.

The valuation is simply hard to ignore. We estimate that the core business is trading at 12X unlevered earnings—an exceptional value for a market-leading company with secular growth. Importantly, this embeds significant ongoing losses in new business initiatives that are reducing profits by around 40%. Put another way, the profits would be 70% higher if these loss-making initiatives fade, scale or eventually become profitable.

The risk, of course, is China's uncertain regulatory environment. As outlined above, we believe that the proposed regulatory interventions have been mostly rational and in-line with what is being discussed in other parts of the world. Alibaba's business primarily operates in uncontroversial areas like e-commerce, logistics and outsourced IT infrastructure, which should be reasonably aligned with the government's social objectives. This contrasts with some other areas like video games, news feeds and celebrity-driven content, which are being directly targeted by some of the government's more paternalistic actions. While we fully expect new regulations to impact Alibaba, we do not believe its business value will be impaired.

There are clearly major uncertainties and unknowns. We feel we are being compensated through multiple layers of safety due to the valuation, the potential for ongoing embedded losses to fade, the net cash balance sheet and the underlying growth in the business.

Samsung shares declined 13% during the quarter despite very strong business performance. Profits are near an all-time high and have risen 34% year to date. The primary reason for the weak share price performance is a concern that the market for memory semiconductors is at its peak. Our research suggests otherwise. Demand for memory products remains strong across most end-markets. Customer inventory levels are reasonable, and supplier inventories across the industry are very low. We expect pricing to remain stable through the end of the year and into 2022. The core of our investment thesis revolves around the industry structure for memory chips. There are three players in this industry, all of whom are operating rationally and working to match supply with demand. We believe that this will mute the historical boom and bust cycles of the memory industry. Samsung is trading at 6X-7X EBIT, which remains an exceptional value in all but the most dire scenarios for the cycle.

HeidelbergCement was down about 13% this quarter. Heidelberg is one of the largest aggregates and cement companies in the world. Aggregates in particular is a very valuable and attractive business, as evidenced by the valuations of pure-play aggregates companies such as Martin Marietta and Vulcan Materials, which trade at multiples of 30X to 40X earnings. Heidelberg sells for 7X earnings. That is not a typo. Results from Heidelberg recently have been good, the balance sheet is very healthy and the company recently announced a 1B euro share repurchase program—the first in its history. We believe the share price weakness is related largely to concerns over rising energy prices as energy is a meaningful input to the manufacture of cement. We expect the industry to act rationally and raise prices to compensate. We added to our position.

We added two new holdings to the portfolio this quarter—Alibaba, which we already discussed, and Axalta Coatings.

Axalta Coatings is one of the world's largest manufacturers of automotive and industrial coatings. Its crown jewel is its automotive refinish business, which is estimated to be about two-thirds of profits. These are coatings that are sold to independent body shops and multi-shop operators that specialize in repainting damaged or crashed cars. Axalta is the global leader in this business. The value Axalta adds here is high. Paint as a percentage of the total cost of repair is small, yet essential to the attractiveness of the car and the satisfaction of the end customer. In addition, auto repair shops depend on the paint matching and mixing expertise that Axalta provides. For these reasons, the business has very strong pricing power. Sales volumes are a function of miles driven, the number of autos on the road and the number of auto accidents, all of which combine to produce fairly steady growth across different economic environments.

The next largest piece of revenue and profits is the industrial coatings business. This has been the company's fastest growing business. They sell all kinds of coatings into a range of applications including HVAC equipment, shelving and industrial components, among others. The industrial coatings space is extremely fragmented, which allows a scale player such as Axalta to gain share.

The final piece of the business is what they call Mobility, which provides paint to automotive and light vehicle original equipment manufacturers (OEMs). Axalta is number one in commercial vehicles and behind PPG in light vehicles. The small number of global suppliers balances out the strength of the large OEM customers. As a result, margins are more attractive than most auto OEM suppliers. We have seen estimates that have put EBITDA margins close to 20% at various points in the cycle. The transition to electric vehicles (EVs) should also be a positive for Axalta given that an EV requires two times the amount of coatings as an internal combustion car. The business is currently depressed by constrained production capacity in the industry due to COVID-19. We believe there is a meaningful cyclical bounce-back opportunity in this business.

Despite operating in an attractive industry, Axalta trades at a significant discount to its peer group. PPG and Akzo Nobel, for example, sell for 20X earnings or more while Axalta trades at around 13X our earnings estimates. Both PPG and Akzo have architectural paint businesses that are very attractive, but, on the other hand, auto refinish is the largest part of Axalta's profits and this is one of the best areas in the coatings industry.

We believe Axalta's history explains much of the discount. Axalta was sold to Carlyle Group in 2013 in a carve-out transaction with Dupont and subsequently went public in 2014. It has been the subject of multiple takeover offers as well as activist investor engagement and speculation since then. These approaches certainly highlight the value and desirability of the business, though it is our belief that the presumption of Axalta as a consolidation prize hampered its focus on maximizing its value as an ongoing entity. In other words, when a company is always for sale, it may have difficulty attracting talent and may not focus on long-term value creation. We believe all that has changed under current CEO Robert Bryant, who took over in 2018. Robert has ruled out a sale and has outlined a strategy to turn Axalta into a "value compounder." He has brought in management talent and is focused on growth, margins, cash flow and return on capital. Management incentives have been changed to align with the strategy.

Certainly, the current inflationary environment is creating headwinds for Axalta, with raw material costs rising faster than it can offset price increases. But we believe that this is merely timing. Axalta has the pricing power to pass along higher costs, and it will do so over the next few quarters, though margins will likely take a hit in the interim.

To conclude, we believe this is an attractive value at the current price. There are multiple levers of value creation including a bounce back in the OEM business, margin upside from the current CEO's margin strategy and ultimately a narrowed discount to its peers.

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For Institutional Investors – Not for Onward Distribution



# Artisan Select Equity Strategy

Quarterly Contribution to Return (% USD)

As of 30 September 2021

Top Contributors	Average Weight	Contribution to Return	Ending Weight
Alphabet Inc	6.08	0.49	6.18
Booking Holdings Inc	4.34	0.36	4.58
Marsh & McLennan Cos Inc	3.37	0.28	3.04
Advance Auto Parts Inc	4.69	0.12	4.86
American Express Co	4.99	0.11	4.72
The Bank of New York Mellon Corp	4.74	0.11	4.58
BAE Systems PLC	1.79	0.09	1.83
Novartis AG	2.33	0.03	0.00
Expedia Group Inc	4.00	0.03	4.36
Cash Holdings	8.60	0.00	7.33
Visa Inc	1.60	-0.01	0.00
Citigroup Inc	4.68	-0.01	4.85
Southwest Airlines Co	1.90	-0.05	2.05

Bottom Contributors	Average Weight	Contribution to Return	Ending Weight
HeidelbergCement AG	4.76	-0.64	4.69
Samsung Electronics Co Ltd	4.84	-0.62	4.73
Alibaba Group Holding Ltd	1.58	-0.56	3.76
Harley-Davidson Inc	2.44	-0.49	2.46
FedEx Corp	1.58	-0.45	1.41
DENTSPLY SIRONA Inc	4.50	-0.37	4.37
Axalta Coating Systems Ltd	1.97	-0.28	4.94
The Progressive Corp	3.52	-0.28	3.49
Facebook Inc	5.88	-0.15	5.72
Anthem Inc	5.98	-0.13	6.18
Danone SA	3.56	-0.11	3.61
Berkshire Hathaway Inc	5.34	-0.10	5.35
Sprouts Farmers Market Inc	0.92	-0.06	0.91

Source: Artisan Partners/FactSet. Performance is historical and is not a reliable indicator of future results. As of 30 Sep 2021. 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.