# Antero Peak Strategy

QUARTERLY
Commentary

As of 30 September 2022

## Investment Process

Our investment approach is based on 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.

### 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 Leadership

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 (% USD)

| As of 30 September 2022 | QTD | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr | Inception[1] |
|---|---|---|---|---|---|---|---|
| | | | Average Annual Total Returns | | | | |
| **Composite — Gross** | **-5.72** | **-28.61** | **-19.55** | **8.01** | **14.11** | **—** | **16.32** |
| **Composite — Net** | **-5.96** | **-29.16** | **-20.37** | **6.94** | **12.99** | **—** | **15.18** |
| S&P 500® Index | -4.88 | -23.87 | -15.47 | 8.15 | 9.23 | — | 9.78 |

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

| | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|
| **Composite — Net** | **33.79** | **12.55** | **21.71** | **26.20** | **-20.37** |

Source: Artisan Partners/S&P. Returns for periods less than one year are not annualized. [1]Composite inception: 1 May 2017.

**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. The Strategy'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.**

**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.

*"The greatest of faults, I should say, is to be conscious of none."*
*—Thomas Carlyle*

In the third quarter of 2022, the Antero Peak Strategy (gross) returned -5.7% relative to the S&P 500® Index's return of -4.9% (all returns in USD unless stated otherwise). Like the first half of the year, the investment environment in the third quarter was volatile. Inflation remained at forty-year highs, the US dollar reached twenty-year highs, geopolitical conflict created more volatility and fear in energy markets, and the Federal Reserve followed course by raising rates and stiffening its hawkish language. At the end of the third quarter, the S&P 500® Index declined -23.9%, moving decisively into bear market territory. Meanwhile, earnings estimates remain stubbornly elevated, and the third quarter marked the start of a downward revision cycle that is likely to accelerate as financial conditions further tighten.

Despite this backdrop, we are very optimistic about our portfolio's ability to perform and are grateful for the sustained trust you have all placed in us, having received net inflows for the year. As the earnings revisions cycle progresses, our bottom-up research continues to generate compelling ideas that fit our investment process. On a fundamental basis, we believe our portfolio is fundamentally well-positioned and has the potential for alpha generation over the next 12 months. In this letter, we will discuss the broader investment landscape and expand on some specific investment areas.

## Cognitive Dissonance and Cultural Improvement

Over the years, we have frequently written about our investment process and the fundamental characteristics we emphasize: earnings differentiation, accelerating and inflecting fundamentals, and expanding returns on invested capital (ROIC). We have explained in detail what these criteria mean to us and quantitatively why we care so much about them.

At the same time, we have also been transparent in our tangible and continuous efforts to create a culture of success within the Antero Peak Group—one focused on long-term execution and repeatability. We believe that to do this, our culture must be one where team members emphasize self-accountability, analytical/intellectual honesty and objective decision making. In practice, this mental and cultural framework is very hard to achieve. These abilities, as simple as they sound, are generally things the human brain, by nature, is uncomfortable with and instinctually rejects these qualities for a variety of reasons. Many psychologists would argue that the brain is simply not wired to be fully objective and without bias. For that reason, the quote above from historian and philosopher Thomas Carlyle resonates with us.

This quote was taken from the book "Mistakes Were Made, but Not by Me" written by Carol Tarvis and Elliot Anderson in 2007, which is now on its third edition. This book is a detailed examination of the cognitive dissonance we all fall victim to and the spiral of false justification that occurs given the brain's natural inclination to justify our mistakes. These "intentional blind spots" are something we work very hard to root out in our process.

The macro and fundamental backdrop today has been fast-paced and humbling, and in many ways it is tailor-made to reveal inadequacies in an individual's or investment firms' ability to think objectively in the face of turbulence. Certainly, we have made mistakes. Nevertheless, we see this as an opportunity to continue to improve our culture as we aim to find the most objective basis for our decisions and learn from our mistakes. We continue to work tirelessly in these efforts to improve the stewardship of your capital and to construct a portfolio that seeks to deliver risk-adjusted returns.

## Quarter and Market Review

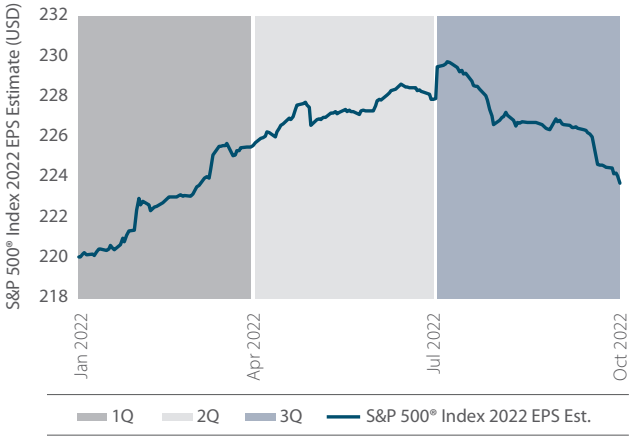
Our portfolio weathered the previously mentioned headwinds with our De-Globalization theme being a notable contributor. This was aided by a combination of substantial upward revisions, in addition to an escalation of the ongoing scramble for global energy security. In this area, Cheniere Energy, NextEra Energy and Quanta Services were noteworthy positive contributors in the third quarter.

On the other hand, a couple of our themes were detractors for performance. The Digitization of Commerce theme was a relative loser and includes laggards in the quarter, like Amazon, Estee Lauder and Visa. Our Network Infrastructure Modernization theme was also a detractor for performance. This theme includes American Tower and SBA Communications, which were punished by particularly acute valuation pressure from the rising interest rate environment as real yields expanded 150bps during the quarter. Across these detractors, fundamentals remain very encouraging, and all the names currently remain in the portfolio.

Foreign currency was also a material factor in the quarter that was apparent across the entire portfolio and market. Due to the strength of the US dollar in the quarter, there was a clear headwind to global companies and a tailwind to those that are purely domestic.

Consistent with the first half of the year, higher quality assets continued to provide little downside risk mitigation throughout the third quarter and have been a headwind in 2022. This is noteworthy given that our bottom-up process has progressively led us to a higher quality, lower beta portfolio, with limited fundamental cyclicality. This dynamic is, in our view, unsustainable and set to reverse. The clear catalyst for this is a needed reset of broader earnings estimates. While slower than expected, this process has begun in the third quarter.

**Exhibit 1:** The Revision Cycle Is Inflecting



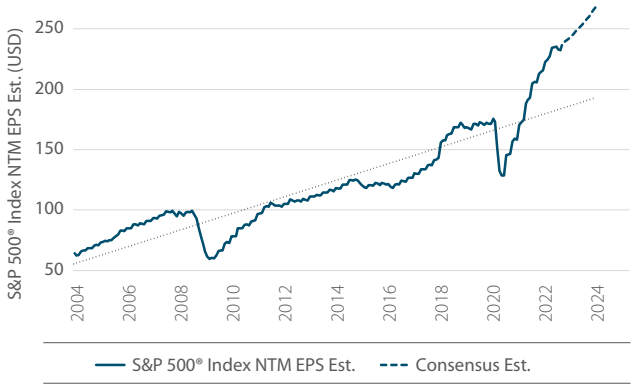

Source: Antero Peak Group/S&P/Goldman Sachs. As of 30 Sep 2022. **Past performance does not guarantee and is not a reliable indicator of future results.**

Reinforcing this perspective is current revisions breadth, which is decisively worsening as most companies are seeing numbers move lower. Ultimately, we think this process is going to take time to fully

work through consensus models. The post-pandemic earnings for the S&P 500® Index remain well above the long-term trendline as demand and inflation have accelerated while pricing has remained strong. We believe the sell side is generally extrapolating current conditions given the reality that things are "still pretty good."

Under the surface, however, financial conditions have tightened materially—companies are now struggling with short-term dynamics of inventory management, transactional debt issuance has been non-existent, currency is a material headwind, and the overall cost of capital has substantially risen.

**Exhibit 2:** Consensus Estimates for the S&P 500® Index Imply Material Risk




Source: Antero Peak Group/S&P. As of 30 Sep 2022. NTM (Next 12 Months). Estimates based on consensus Street estimates.

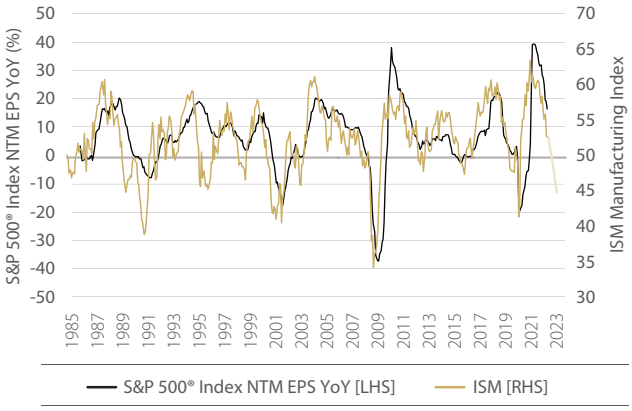
During the quarter, we observed several instances that we think display the rapidly changing backdrop and show how fast company communications can change. This reality reinforces that a sound investment process today must rely on differentiated thinking and independent analysis, and company guidance should be met with a heathy level of skepticism.

**Exhibit 3:** Observable Examples of a Difficult Market Backdrop

| | Q3 Observations |
|---|---|
| FedEx | Implied guidance down about 50% |
| Micron | Revenue guidance reduced 30% |
| Dow, LyondellBasell, Westlake | Chemical bellwethers announce 20% EBITDA cuts |
| SnapChat | From +30% growth to 0% growth |
| ServiceNow | Reduced organic guide |

Further, the ISM Manufacturing Index, which is highly predicative of future earnings and estimate revisions, points to a more difficult environment as the September new order level reached 47—a strong indicator for an overall contraction in the coming months, in our view.

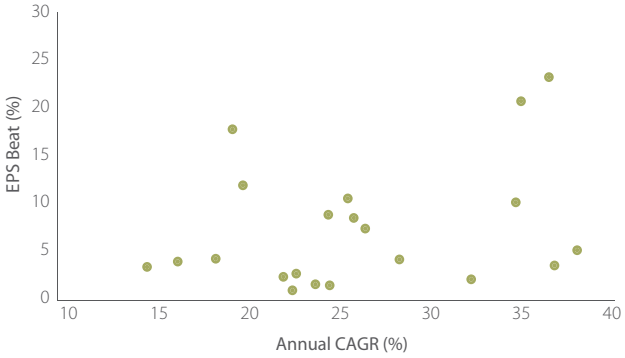
**Exhibit 4:** ISM Manufacturing Index vs. Estimate Revisions for the S&P 500® Index




Source: Antero Peak Group/ISM/S&P/Morgan Stanley. As of 30 Sep 2022. The ISM Manufacturing Index tracks the general state of the economy as it relates to businesses.

Despite the relatively daunting backdrop, our process continues to find ideas. As shown in Exhibit 5, we believe our holdings are expected to revise higher and generate compelling internal rates of return, as the broader market works through an extended downward revision period. We believe this bodes very well for the portfolio over the next 12 months.

**Exhibit 5:** Beat and Expected Outcomes, Antero Peak Portfolio at Quarter End




Source: Antero Peak Group. As of 30 Sep 2022. Represent holdings in the portfolio. Antero Peak forward estimates are based on current holdings in the portfolio. Estimates are based on the team's assumptions and are subject to revision, and there is no guarantee of accuracy. 2022 company growth estimates are based on the team's projection relative to consensus Street estimates. **Past performance is not indicative of future results, and there is no guarantee that estimates will come to pass.**

## Integrated Health Care Insurers—Incentives to Win

The structure of health care today, to us, is clearly bifurcated between companies that have financial incentives to raise the cost of health

care or reduce it. We think over time the structural winners are the cost reducers.

National health care expenditures represent about 20% of domestic GDP at $4.1 trillion. This number is projected to grow at an annual rate of 5.4%—more than one percentage point faster than projected GDP growth. On a per capita basis, Americans spend more than twice the developed economy average and generally have undifferentiated outcomes and are below average in many measures. This represents a tremendous opportunity for differentiated business models that can disrupt the broken status quo.

We see the health care insurance providers that are aggressively moving to vertically integrate the health care value chain as the natural winners. Insurers with scale are in prime position to drive the effort toward "value-based care"—this term represents a gradual shift to a process where patients ultimately pay for overall health care quality, not quantity.

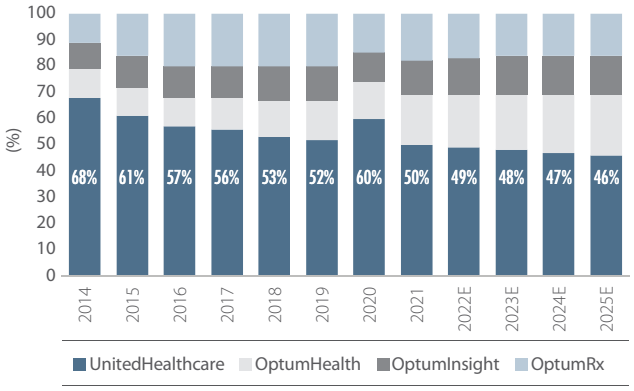
We have been heavily invested in UnitedHealth Group over the last year as an expression of this thesis. We think UnitedHealth has the best combination of assets, leading to a true "snowball effect." This "ball" continues to roll downhill, get bigger and get harder to stop/compete with.

UnitedHealth offers a variety of plans and services to 100 million individuals with over 60,000 physicians. The company's asset base is uniquely positioned to leverage the core business to vertically integrate across its insurance offering of HMO, PPO, Medicare and Medicaid alongside its Optum Health, Optum Insights and Optum Rx units.

Optum is UnitedHealth's health service business—the brain of the operation—working to use information and technology to provide tools to achieve better health and service. With the right incentives, which are aligned with its patients, it can lower overall health care costs without sacrificing care and deliver a differentiated member experience. This creates the potential for a win-win dynamic. There have been shown savings of 15%-30% for payors, government and patients, while generating higher patient engagement rates (Humana notes its member satisfaction scale, known as a "star" rating, rose to 4.4 from 3.3 during the shift to value-based care). The incentive loop is completed by a higher reimbursement for providers as they keep a share of savings to encourage a pivot away from a fee for service model. This creates a truly virtuous cycle centered around keeping patients healthier.

This network effect and scale provide a great barrier to competition as well as a higher revenue quality mix shift over time.

**Exhibit 6:** UnitedHealth Has a Steadily Improving Mix to Higher Multiple Businesses




Source: Antero Peak Group/company filings. As of 30 Sep 2022. Estimates based on the team's assumptions and are subject to change.

Medicare Advantage, the private-sector alternative to traditional Medicare, was created by Congress to encourage health insurers to find innovative ways to provide better care at lower cost. Medicare Advantage penetration levels remain very low at 15%, and commercial engagements are just beginning. The overall value-based care opportunity in Medicare is estimated at >$150 billion.

This should continue to provide consistent growth driven by visible demographic tailwinds. By next year, we expect more than half of Medicare recipients to be in a private plan. This is important as UnitedHealth controls roughly 30% of that market. We think this gives the company an unusually high level of above market growth predictability, upward pressure on its multiple, and the ability to accelerate as the network gets bigger and moves lower on the cost curve.

Within this theme, we also added Elevance Health (formerly known as Anthem) to the portfolio in the third quarter. We believe Elevance is in the early innings of replicating the success of United's integrated value-based care model. As it moves along this curve, Elevance stock should see meaningful multiple expansion as mix improves.

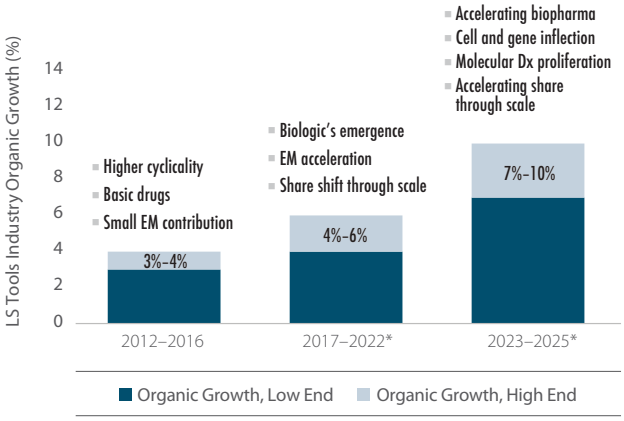
## Life Sciences—Innovation-Driven Structural Acceleration Continues

We are extremely excited about the backdrop for medical science today. COVID, and the wide use of RNA-based therapies, has pulled forward the science of the future. At the same time, the pandemic temporarily crowded out an already strong backlog of innovations as

capacity was used for COVID vaccine development and production. Stepping back from the disruption of COVID, the FDA approved 150 biologics in 2022—nearly twice the amount from five years ago and 4.5X the amount from 10 years ago. Biologics now represent 38% of FDA approvals. Ten years ago that was ~15%. The backlog is also building across gene therapies, so much so that the Biden administration is calling for a 34% increase in the FDA budget, and the agency has already announced 100 new hires to address the backlog of cell therapies. In total, over 3,600 therapies are in the pipeline, of which ~56% are gene therapies, 22% are RNA based and 22% are cell therapies. We think the duration and magnitude of the opportunity is still very underappreciated.

We think the Life Science Tools are excellent expressions of this theme. This is partly because they are not singularly exposed to any specific technology. They simply provide the picks-and-shovels to develop and produce these more sophisticated therapies. The powerful multiplier is that the new areas of science require far more advanced technology and expensive picks-and-shovels with much greater quantity. We think this growth is predictable, with positive pricing over time, low product and political risk, and a high barrier to entry.

**Exhibit 7:** New Major Revenue Accelerators Are Emerging




Source: Antero Peak Group. As of 30 Sep 2022. *Future organic growth rates are based on estimates from the Antero Peak Group.

We have exposure through Thermo-Fisher Scientific and Danaher as they have optimized their portfolios to align with these strong trends. They have also acted as industry consolidators and are the dominant players in most product categories. This scale, we believe, has made them nearly impossible to compete against. They are entrenched within pharmaceutical customer operations, from their own employed lab technicians all way to the large, negotiated contracts directly with CEOs. This has created a differentiated go-to-market approach that requires a full product offering and has resulted in these companies being the fastest growers despite being the two largest. We expect this to continue.

## Summary

As we look to the last quarter of 2022 and beyond, we are excited about the portfolio and its overall process fit. As we examine what has happened thus far this year, and as challenging as it has been, we maintain great optimism. The empirical reality is, while our execution has been disappointing to us, our process has largely worked. That is, our best performers, despite the high and consistent level of noise, have been those with rising revisions and accelerating fundamentals, and our worst have been those that either by analytical error or macro disturbance have seen downward revisions and slowing trends. As Carlyle's quote states very simply, recognizing this fact is a key step on the road of continuous improvement.

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

**Investment Risks: Non-diversified portfolios may invest larger portions of assets in securities of a smaller number of issuers and performance of a single issuer may have a greater impact to the portfolio's returns. Use of derivatives may create investment leverage and increase the likelihood of volatility and involve risks different from, or greater than, the risks associated with investing in more traditional investments, including loss in excess of the amount invested. 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. These risks, among others, are further described in Artisan Partners Form ADV, which is available upon request.**

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For the purpose of determining the portfolio's holdings, securities of the same issuer are aggregated to determine the weight in the Strategy. The holdings mentioned above comprised the following percentages of a representative account within the Antero Peak Strategy Composite's total net assets as of as of 30 Sep 2022: Amazon.com Inc 7.5%, American Tower Corp 5.3%, Cheniere Energy Inc 1.3%, NextEra Energy Inc 6.3%, Quanta Services Inc 1.3%, SBA Communications Corp 2.3%, The Estee Lauder Cos Inc 2.0%, UnitedHealth Group Inc 7.6%, Visa Inc 3.6%, Elevance Health Inc 1.0%, Thermo-Fisher Scientific Inc 4.3%, Danaher Corp 4.2%. Securities named in the Commentary, but not listed here are not held in the portfolio as of the date of this report. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities.

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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.



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. Percent of net 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.

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S&P 500® Index measures the performance of 500 US companies focused on the large-cap sector of the market. ISM Manufacturing Index, also known as the Purchasing Managers' Index (PMI), is a monthly indicator of US economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.



**Discounted cash flow** (DCF) is a valuation method used to estimate the value of an investment based on its expected future cash flows. **Return on Invested Capital (ROIC)** is a measure of how well a company generates cash flow relative to capital invested in the business. **Free Cash Flow** is a measure of financial performance calculated as operating cash flow minus capital expenditures. **Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)** is an indicator of a company's financial performance which is calculated by looking at earnings before the deduction of interest expenses, taxes, depreciation and amortization. **Earnings per Share (EPS)** is the portion of a company's profit allocated to each outstanding share of common stock. **Compound Annual Growth Rate (CAGR)** is the year-over-year average growth rate of an investment over a period of time. It is calculated by taking the nth root of the total percentage growth rate, where n is the number of years in the period being considered. **Next Twelve Months (NTM).**

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