



### 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 2023	Average Annual Total Returns						
	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Inception <sup>1</sup>
<b>Composite — Gross</b>	<b>-4.46</b>	<b>12.83</b>	<b>26.13</b>	<b>9.65</b>	—	—	<b>8.94</b>
<b>Composite — Net</b>	<b>-4.65</b>	<b>12.20</b>	<b>25.20</b>	<b>8.84</b>	—	—	<b>8.13</b>
S&P 500® Index	-3.27	13.07	21.62	10.15	—	—	12.76

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

	2019	2020	2021	2022	2023
<b>Composite — Net</b>	—	—	<b>33.24</b>	<b>-22.71</b>	<b>25.20</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

"Everything you hear is an opinion, not a fact. Everything you see is a perspective, not the truth."

—Marcus Aurelius, *Meditations*

Higher rates or lower rates, hard landing or soft, the debates ping pong back and forth on an almost daily basis. It's not hard to find investors who are certain rates have peaked and will surely return to the good old days of near zero. The bond market has endorsed this view for most of 2023 with an inverted yield curve but has walked back this quarter as long rates have surged. Maybe they go higher still. Blowout job numbers tell us rates are not going down anytime soon.

What to do? Some strategists urge investors to buy technology stocks whose multiples will expand in a recession and the ensuing rate-cutting cycle, while others warn that technology stocks are overvalued in a world of 5%-plus risk-free returns. Others say value is going to make a comeback now that the easy money days are over and volatility is the new normal.

We don't know whether rates will rise or fall from here or whether there will be a hard or soft landing. Nobody does. But we can make a few observations:

- The global economy—especially the US—is holding up remarkably well in the face of rising rates.
- Consumers are under strain from inflation, but overall they continue to spend. Credit and debit card spend data show consumer spending back to pre-COVID level trends.
- Savings accumulated during the pandemic appear to be dwindling—most notably in the US, where government support was the most generous in the world—which poses a risk to future spending.
- Earnings season is about to kick off, and we will learn more over the next few weeks.

Economic resilience in the face of rising rates does make us wonder about interest rate policies over the past 15 years. Policymakers were quick to cut rates in the face of any economic hiccup and reluctant to raise them in the face of economic growth, presumably out of fear that even the most modest rate increase would topple the economy. The entire underpinning of the zero-rate regime looks discredited. One must wonder what exactly was achieved over the past 15 years with negative real rates—other than creating massive distortions in risk-taking and incentivizing excessive borrowing. Perhaps recent rate volatility is nothing more than a sign of normalizing markets. For more than a decade, interest rates fell, trillions of dollars of government debt traded at negative yields, governments acted like deficits didn't matter, and technology stock multiples expanded to the moon. Meanwhile, international stocks and value stocks (pretty much the same thing) lagged. The world was a big one-way trade that felt normal because it lasted so long. It wasn't.

At least now there is some traffic going in different directions. Over the past year, the MSCI EAFE Index outperformed the NASDAQ Composite Index. That's not a typo. In the most recent quarter, Japan was one of the best-performing markets in US dollar terms. The IT sector lagged, and the "Magnificent Seven" (Apple, Tesla, Microsoft, Amazon, Nvidia, Meta and Alphabet) did not perform in lockstep. And perhaps, stating the obvious, bonds paying 5% or more are now a real alternative to stocks.

How good of an alternative? Let's examine the S&P 500® Index at a high level. The index trades for 21X earnings or 17X on an equal-weighted basis. Excluding the seven biggest names (Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla and Meta) only reduces it to 19X earnings. Further eliminating the entire IT sector, which collectively trades at 29X earnings, the index only falls to a slightly more reasonable 18X. Interestingly, 132 names in the index trade above 25X earnings, collectively accounting for 43% of the index. There are only 69 companies with a price-to-earnings ratio under 10X, and they account for 7.5% of the index.

We can draw a few conclusions. Most of the US stock market is very expensive. Perhaps IT sector earnings growth will justify the valuations, but perhaps it won't. Importantly, the weight of stocks in the index that screen as cheap is tiny. Let's offer a hypothetical for the purpose of illustration. If cheap stocks rallied by 50%, they would trade at a mere 15X earnings, and their impact on the index would be only 375bps. After more than a decade of underperformance, the "value" component of the index has been reduced to near irrelevance. Moreover, should those stocks recover to more normal valuations, the scale of outperformance relative to the index (50% versus 3.75%) would be massive. We are not making predictions, merely pointing out how crowded one part of the US market is and how deserted is another.

The recession question is an interesting one. Economists and strategists are terrible at predicting recessions. One is coming, but nobody knows whether it will be in 2024 or years from now. But there is certainly an elevated risk of a recession in the near term. Rates have risen dramatically, and based on historical data, the odds of a soft landing seem long. One significant and perhaps under-reported risk factor for recession is government spending. Deficits in the developed world are extreme. At this point in the economic cycle, governments should be running close to breakeven or even running surpluses. And government debt relative to GDP is alarming. In the US, debt to GDP is at a level not seen since WWII. Will the private sector continue to fund massive government debt issuance? What will happen to deficits as 5%-plus borrowing rates filter into budgets? Governments will have to choose between spending cuts and tax increases, both of which will depress economic activity. Central banks may reverse course and return to money printing in order to finance deficits. That would be inflationary.

A number of our stocks trade as if a recession is a certainty. Citigroup trades at 6.5X earnings and less than half of book value. Harley Davidson also trades at 6.5X earnings. American Express trades at a much higher multiple of just under 13X, but it has a strong position in the secularly growing payments industry. Clearly, the depressed valuation reflects a market assuming recessionary-level increases in credit cost. Heidelberg Materials can be purchased for 7X earnings on the German stock exchange; in a private market transaction, we estimate it is worth more than twice its current market valuation. Each of these stocks could appreciate significantly and still trade at a discount to the market. It would take a severe and long-lasting recession to justify these valuations.

### Portfolio Discussion

Our best-performing stock this quarter was Alphabet, with a gain of 9%. The company reported solid Q2 results across most of its divisions. Importantly, improved operating margins led profits to grow faster than revenues. The company is showing more cost discipline, a trend we're seeing in many technology-related companies. In addition to the solid results, Alphabet shares likely also benefited from a more sanguine view on the impact of artificial intelligence (AI). Alphabet suffered earlier this year as some investors believed Alphabet was behind the curve in AI and might lose its dominance in search to peers such as Microsoft. That fear seems to have receded. Our view has not changed, and we believe that Alphabet will integrate AI successfully into search and other areas of its business.

Progressive was also a strong performer this quarter. The period started poorly for Progressive as shares were down 13% on July 13. The company reported weak prior-year development in its first-half results as well as high costs for catastrophes. Claims inflation has been an industry problem, and investors feared Progressive would be unable to offset rising claims inflation through pricing, which could hurt policy growth. We added aggressively to our position on weakness given our confidence in Progressive's low-cost model and excellent underwriting. Claims inflation is not a Progressive-specific issue, and we felt it would be able to pass on the costs and still retain its competitive advantage given its low-cost model. The company recently reported results that showed the business is recovering margin and still growing policies. The share price has more than recovered the July losses.

Meta added to its string of gains in Q3. The share price is up about 150% this year. Second quarter results were very good: revenue growth is back to double digits, user metrics are solid and show very good engagement, daily active users grew 7%, and importantly, Facebook app users continue to grow across all geographies. Instagram is growing more strongly, but solid growth in the legacy Facebook business is a positive indicator. Importantly, the company has controlled expenses tightly. Headcount was down 14% year over year. Adjusted EBIT grew 44%, and the margin recovered strongly to 38%, from 29% last year.

Aramark was our weakest performer this quarter. The company reported strong Q2 results. Revenue grew 15%, and operating margins expanded. Both the contract catering and uniforms divisions showed good progress, and the company raised its guidance for the year. We suspect the share price performed poorly for a couple of reasons. First, the company has a fair bit of debt, and interest expense will increase if the debt is refinanced at today's higher rates rather than paid down. However, the company is focused on debt reduction and does not pay a large dividend, giving it ample resources to pay down its debt. Second, the company spun off its uniform business to shareholders at the end of the quarter. This business is more cyclical than the catering business, and it came to market with a high degree of financial leverage. With fears around a recession, we believe investors steered clear of Aramark for lack of interest in the uniform business. We immediately sold our shares in the uniform business, Vestis, given its cyclicity and leverage. As of this writing, Vestis' shares were down more than 20%.

Axalta Coating declined 18% in Q3. Shares rose strongly in the prior several months, and we meaningfully reduced our position during that time as the shares approached our fair value estimate. The United Auto Workers strike will reduce auto production rates, which will have a knock-on effect on Axalta's coatings business with original equipment manufacturers. In addition, strong oil prices will likely lead to more raw material inflation, which Axalta will need to pass on through higher prices. We are confident that it will do so.

American Express shares declined by 14%. Company results continued to be excellent, but shares were weak due to fears of a recession or a meaningful slowdown in the economy. Credit quality is normalizing after below-normal credit provision levels coming out of the pandemic. The company has an excellent brand, outstanding underwriting and a premium cardholder base that is the envy of the payments industry. It is well positioned to grow, and the current valuation reflects short-term fears over the direction of the economy, rather than the long-term upward trajectory in American Express' earnings power.

We added Henry Schein to the portfolio this quarter. Schein is the world's largest distributor of dental supplies, equipment and related services. It is also the second-largest medical supplies distributor to physicians and alternative care sites. The dental industry is attractive, with favorable demographics due to aging populations, rising awareness of the importance of oral health in developing markets and increased adoption of new technology. The customer base remains fragmented, with approximately 200,000 dentists in the United States.

However, Henry Schein is more than just a distributor of other companies' products. It has expanded its core distribution business to become an essential partner for its customers. It is the largest practice-management software provider, used by 40% of all US dentists. It provides value-added services to dentists around repairs, equipment

maintenance, insurance reimbursement and financial services. Perhaps most importantly, it has vertically integrated into manufacturing and is now making some of its own dental products. This includes private label but also extends to branded dental products in key growth areas, such as implants and endodontics. These products and services have better growth rates and meaningfully higher margins than its core business. Expanding its product mix should provide a nice tailwind to profit growth.

The company's financial performance is currently distorted by the lingering impacts of the pandemic. During the pandemic, there was significant demand for protective equipment like latex gloves and COVID test kits, which boosted its revenues and profits. These excess profits are now normalizing, which has put pressure on reported profit growth and share price. Beneath the surface, we see a healthy business with good underlying growth and a favorable outlook. We are happy to look beyond this temporary period of slower growth and estimate we are paying 12X–13X earnings for a high-quality franchise with high single-digit underlying profit growth.

### Conclusion

The portfolio is attractively priced today not only on an absolute basis but also relative to the broad market, which appears expensive to us. Importantly, the quality of the businesses we currently own is quite high. There is uncertainty around a potential recession and the path of interest rates. There is always uncertainty in the world and in the markets, interrupted occasionally by the illusion of certainty. We feel quite content with our large personal investment.

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### ARTISAN CANVAS

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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 Strategy Composite's total net assets as of 30 Sep 2023: Alphabet Inc 5.7%, The Progressive Corp 5.3%, Heidelberg Materials AG 5.0%, American Express Co 4.7%, Meta Platforms Inc 4.7%, Harley-Davidson Inc 4.1%, Aramark 4.0%, Axalta Coating Systems Ltd 3.8%, Henry Schein Inc 3.3%, Citigroup Inc 2.9%. Securities named in the Commentary, but not listed here are not held in the portfolio as of the date of this report.

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