Sitting at the top of the rankings for his impressive returns, Artisan's Bryan Krug has surged ahead in high yield

ALEX STEGER

Few managers have navigated the competitive high yield field as well as Bryan Krug.

The manager of the $2.4 billion Artisan High Income fund has been on a stellar run for the past three years, for both total returns and risk-adjusted numbers.

While the asset class has been on a tear since bottoming out in February 2016, Krug's numbers are a testament both to how well he has ridden that recovery and to his ability to avoid losing money when the market dips.

Krug thinks his particular skill lies in the latter. 'If you look at our performance over time, ironically we tend to do a little better in down markets than up markets,' he says. 'We have done well in both... and the reason we have done well is because we have avoided permanent capital losses.'

This apparently risk-averse approach may not seem obvious when glancing at the fund's factsheet, which will tell you that it is overweight CCC issues (29.2%) against the benchmark (8.9%), but Krug argues that this is deceptive.

That's because the ratings are wrong and because he fishes selectively in the CCC pond, Krug says.

'We would argue, quite frankly, that a lot of these companies are mis-rated,' he says. 'The agency may give them a lower credit rating because they may have a higher leverage point. [The agencies] think 5.5% to 7% is high, which it might be. But if the business is worth 14 times and they are loaning at 50% to value, then it

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doesn't seem too high to me.

'So we think they underrate companies like that. We think they overrate some of the commodity market. So the energy space, for an example, was perceived to be a very safe spot by the agencies. Chesapeake [Energy Corporation] had bonds that were BB-rated but were 21 cents on the dollar in Q1 of 2016. Why? Because the commodity over which [it] has no control dropped and the overemphasis [the agencies] had on scale, size, number of years in business and hard asset value didn't hold up until the commodity price went back up.'

Krug assesses issuers in a different way, he says, focusing on their balance sheets rather than their ratings.

'We tend to be attracted to much higher quality businesses and that has resulted in a different composition [of the fund] relative to the index. We have fewer commodity-oriented businesses and more higher up multiple businesses such as software, insurance brokerages and cable – good, solid, durable businesses,' he says.

He owes this focus on balance sheets to his first job in the high yield space, where he has since spent his entire career.

'I originally started as a distressed analyst,' he says. 'There were a few things I found as to why companies end up in distress and one thing you want to avoid as a portfolio manager is mistakes. Often the way we do best is by not losing. I found that people generally had permanent capital losses when companies put a lot of debt on cyclical industries close to the peak of the cycle.'

PLAYING THE FIELD

While Krug generally dislikes energy companies for these reasons, there is an opportunistic sleeve of his portfolio. This saw him buy master limited partnerships (MLPs) such as Williams Partners when their prices dropped dramatically during the first quarter of 2016.

'As prices got lower, instead of reducing our exposure we actually added to it and increased investment into MLPs,' he says. 'Prior to 2016 the fund had no exposure to MLPs, and then we had roughly 7% of the portfolio in MLPs when we were able to buy top-tier assets at discounts.'

Energy remained a large allocation within the portfolio at the end of the second quarter of this year, but was actually a slight underweight. Meanwhile, media at 13.9% and technology and electronics at 10.7% were overweights.

Within media, Krug is a particular fan of cable providers. He says the rise of mobile technology and the shift away from traditional TV habits still benefits these firms.

'It continues to grow; you continue to have pricing ability,' he says. 'To some degree there is a little bit of a hedge. If people cut the cord from their traditional service and go to a skinny bundle, they typically need to up the speed for their broadband. When they do that the cable companies aren't really hurt because the margins on broadband are materially higher than those on TV because they don't have to pay ESPN $7 a month or whatever. It is a very strong, defensible and cash-generative business.'

Krug's focus on software and cable companies marks him out from his peers, as does his willingness to invest in loans as well as bonds. He says this flexible approach to capital structures has benefited the fund, particularly when it first launched in March 2014.

'We are totally agnostic as to where we go,' he says. 'We do our bottom-up research and we look at the overall business and we overlay the relative value of the different pieces of the capital structure, which I think is a very big differentiator.

'When we first launched in March 2014, at our first full quarter, we had 46% of our assets in loans because the pricing on the bond side was just so expensive. The market believed bonds would be bought by central banks and it drove them tighter and tighter and the average yield was 5%. We saw the relative value and had 46% in loans in that period.'

When the bond market bottomed out in March 2016, Krug reduced loans to 13% of the portfolio. Today they represent around 22%.

PUSHING FOR PERFORMANCE

Krug may be the only named manager on the fund but he is supported by a team of five analysts. They meet twice daily, firstly to discuss the broad markets and then to look at specific ideas over lunch.

While each analyst has their own area of expertise, Krug believes a collaborative approach benefits their wider understanding of the strategy, and can lead to opportunities.

'This morning, an analyst had a call with a rental car company. The rental guy said its software company was going to raise prices, and they were terrified. But that piece of information really helped the tech analyst, as that [software] company is in the market and is underplaying the benefit of a price increase that could increase its bottom line by up to 20%,' he says.

The Artisan fund only hit its three-year track record in April this year, but Krug's goes back much further, having been in the high yield space for 18 years. Having previously been an analyst, he joined Waddell & Reed in 2001, and from 2006 until he left for Artisan he managed the firm's Ivy High Income fund.

'I was attracted to Artisan for a couple of reasons,' he says. 'I control the team and we have a team approach, which I think is the most effective way to produce the best outcomes.

'[Artisan] has done a very good job of managing capacity across all the strategies. Capacity is necessary to control the integrity and the alpha generation. I think that is important in the credit space. We are not there yet, but we think it is important.

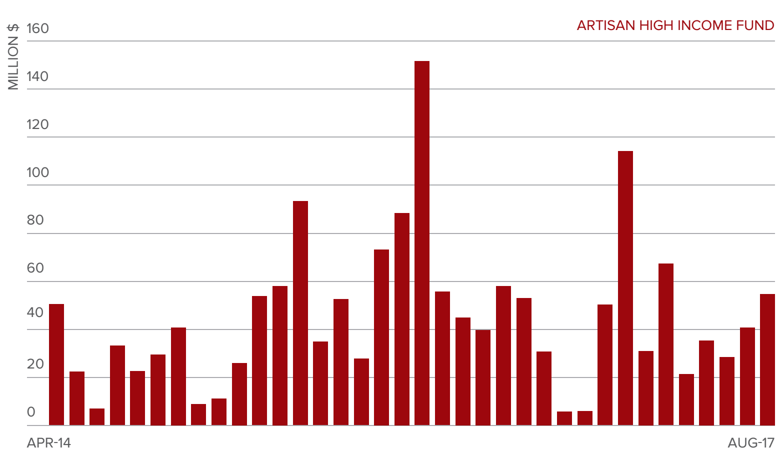
'Artisan is attracted to high value-add strategies. Credit happens to fall into that. Active management can provide meaningful alpha relative to passive products and benchmarks.'

This means that he is also unfazed by the rise of passives, which has kept some managers worried.

'I feel pretty comfortable about the way we manage,' he says. 'There are some managers who are more benchmark-like and that style is more vulnerable if ETFs can improve their performance to replicate an index. But from my perspective it doesn't keep me up at night because our strategy is differentiated. It's not just the asset class, it's the way we manage.'

THE ARTISAN HIGH INCOME FUND HAS SEEN NET POSITIVE FLOWS IN EACH OF THE PAST 36 MONTHS

SOURCE: LIPPER



VERDICT

FRANK TALBOT
HEAD OF INVESTMENT RESEARCH, CITYWIRE

Since the turn of the credit crisis Krug has continually pulled away from the average manager and, more importantly, the high yield benchmark. Outperformance in this sector is extremely rare due to the market cap indices that managers are benchmarked against and the low default rates in recent times. So to achieve it with lower volatility than the peer group average during such an elongated rally is extremely impressive.

Krug seamlessly picked up at Artisan where he left off at Waddell & Reed. It's no surprise that he has had positive net flows for every month of the past three years. The real test will come when high yield has a blip, but if his returns in 2008, 2015 and early 2016 are anything to go by, then investors shouldn't have too many sleepless nights.

Data throughout the publication is as of August 31, 2017.

Clarifications:

(1) The fund's allocation to CCC-rated securities is 27.5% relative to the benchmark's 16.1% as of August 31, 2017.

(2) The fund's allocation to bank loans reached 46% in June 2014 and stands at 20.2% as of August 31, 2017.

Bryan Krug is the portfolio manager for Artisan High Income Fund. This article represents the views of Citywire and Alex Stager as of the date of publication and those views and opinions presented are their own. Artisan Partners is not responsible for and cannot guarantee the accuracy or completeness of any statement in the discussion. This material does not constitute investment advice or a solicitation of any specific investment product or service. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation. Prospective investors should consult their financial and tax adviser before making investments in order to determine whether an investment will be suitable for them. This material is not an offer of any mutual funds mentioned other than Artisan Partners Funds.

Investment Results (%) as of 30 Sep 2017	QTD	YTD	1 YR	3 YR	Inception
■ Investor Class: ARTFX	2.34	7.97	10.07	7.65	7.07
■ Advisor Class: APDFX	2.37	8.11	10.27	7.83	7.24
■ BofA Merrill Lynch US High Yield Index	2.04	7.05	9.06	5.87	5.21

Source: Artisan Partners/BofA Merrill Lynch. Returns less than one year are not annualized. Inception: 19 Mar 2014.

As of September 30, Morningstar Overall Star rating ★★★★★ for Artisan High Income Fund. Ratings are based on risk-adjusted return. The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its 3-, 5- and 10- year Morningstar Rating metrics. (Overall: 5 stars out of 601 funds; 3-years: 5 stars out of 601 funds in the High Yield Bond category).

Expense Ratios (% Gross/Net)	ARTFX	APDFX
Semi-Annual Report 31 Mar 2017[1]	1.01	0.81
Prospectus 30 Sep 2016[2]	1.03	0.84

[1] Unaudited, annualized for the six month period. [2]See prospectus for more information.

Past performance does not guarantee and is not a reliable indicator of future results. The investment return and principal value of an investment in the Fund will fluctuate, so that an investor's shares in the Fund, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For current to most recent month-end performance information, call 800.399.1770. The performance information shown does not reflect the deduction of a 2% redemption fee on shares held by an investor for 90 days or less and, if reflected, the fee would reduce the performance quoted. Unlike the Index, Artisan High Income Fund may hold loans and other security types. At times, this causes material differences in relative performance.

Carefully consider the Fund's investment objective, risks and charges and expenses. This and other important information is contained in the Fund's prospectus and summary prospectus, which can be obtained by visiting www.artisanfunds.com. Read carefully before investing.

Fixed income securities carry interest rate risk and credit risk for both the issuer and counterparty and investors may lose principal value. In general, when interest rates rise, fixed income values fall. High income securities (junk bonds) are speculative, experience greater price volatility and have a higher degree of credit and liquidity risk than bonds with a higher credit rating. The portfolio typically invests a significant portion of its assets in lower-rated high income securities (e.g., CCC). Loans carry risks including insolvency of the borrower, lending bank or other intermediary. Loans may be secured, unsecured, or not fully collateralized, trade infrequently, experience delayed settlement, and be subject to resale restrictions. Private placement and restricted securities may not be easily sold due to resale restrictions and are more difficult to value. The use of derivatives in a portfolio may create investment leverage and increase the likelihood of volatility and risk of loss in excess of the amount invested. 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.

For the purpose of determining the Fund's holdings, securities of the same issuer are aggregated to determine the weight in the Fund. The discussion of portfolio holdings does not constitute a recommendation of any individual security. These holdings comprise the following percentages of the Artisan High Income Fund'stotal net assets as of 30 Sep 2017: Chesapeake 0.0% and Williams Partners 1.0%. Securities named but not listed here are not held in the Fund as of the date noted. The portfolio holdings mentioned are subject to change and the Fund disclaims any obligation to advise investors of such changes.

The Morningstar Rating™ for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual fundsare considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are:100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. Ratings are for the Fund's Investor Shares; other classes may vary.

BofA Merrill Lynch US High Yield Master II Index measures the performance of below investment grade $US-denominated corporate bonds publicly issued in the US market. J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of the USD-denominated institutional leveraged loan market. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

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Definitions

Sharpe Ratio is a risk-adjusted measure that measures reward per unit of risk. The higher the Sharpe Ratio, the better. The numerator is the difference between the portfolio's annualized return and the annualized return of a risk-free instrument. The denominator is the portfolio's annualized standard deviation (population).

Alpha is a quantitative measure of the volatility of the portfolio relative to a designated index. A positive alpha of 1.0 means the fund has outperformed its designated index by 1%. Correspondingly, a similar negative alpha would indicate an underperformance of 1%.

Credit Quality ratings are from S&P and/or Moody's. Ratings typically range from AAA (highest) to D (lowest) and are subject to change. The ratings apply to underlying holdings of the Portfolio and not the Portfolio itself. If securities are rated by both agencies, the higher rating was used. Securities not rated by S&P or Moody's are categorized as Unrated/Not Rated.

Exchanged-Traded Funds (ETF) are securities that track an index, a commodity or a basket of assets like an index fund, but trade like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold.

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