ticker

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Opportunistic and Selective in High Yields: Artisan High Income Fund

An active investment approach can only benefit from market inefficiencies, according to Bryan Krug, portfolio manager of the Artisan High Income Fund. The management team looks for strong business models where a credit improvement is expected over time. A key part of the fund's strategy is identifying value across the entire capital structure with the help of extensive credit research.

Bryan C. Krug, CFA
Managing Director

Bryan C. Krug, CFA, is a managing director of Artisan Partners and a portfolio manager on the Credit team. In this role, he is the portfolio manager for the Artisan High Income Strategy, including Artisan High Income Fund. He has 16 years of investment experience.

Prior to joining Artisan Partners in December 2013, Mr. Krug was the portfolio manager of Ivy High Income Fund at Waddell & Reed from February 2006 to November 2013. Mr. Krug joined Waddell & Reed in 2001 as a high yield investment analyst and was later promoted to portfolio manager. Earlier in his career, he was affiliated with Pacholder Associates as the primary analyst for a distressed portfolio.

Mr. Krug holds a bachelor's degree in finance from Miami University, Richard T. Farmer School of Business.

Would you give an overview of the fund?

Artisan High Income Fund is a relatively new fund, launched in March 2014. It is a below investment grade credit fund, which invests across the entire capital structure. We look for superior business models and employ a bottom-up, research-oriented approach.

What are the core principles of your investment philosophy?

We believe the non-investment grade market is well-built for active management. Our philosophy is that this market has inefficiencies that we can exploit through our process. These inefficiencies are often caused by cyclical, industry or company dislocations. We believe that, through our fundamental credit research and by identifying value across the capital structure, we can generate an attractive long-term risk-adjusted return.

A main differentiator of our approach is that we focus on higher-quality businesses than our peers. We are research intensive and rely on our core names, which are stable, predictable businesses. But when there are market inefficiencies, we are willing to make material investments in opportunistic buckets.

How would you describe your investment strategy and process?

Our strategy is to focus on businesses with high multiples, which we find attractive from a business model perspective. Such businesses include software, insurance brokerage, or transaction processors with higher leverage points and enterprise values. They tend to have lower credit ratings but, over time, we expect material credit improvement.

For the core part of the portfolio, we aim to invest in companies with strong and predictable cash flow and relatively modest leverage, such as HCA Inc., for example.

We also run an opportunistic screen to take advantage of market technicals. We are definitely interested in event-driven ideas. For example, a year ago we invested in Williams Partners, which owns and operates premier energy infrastructure across the U.S. At the time, it was actually a high-grade company expected to be downgraded to high yield.

Our process starts with screening the Bank of America-Merrill Lynch U.S. High Yield Master II Index and the Credit Suisse Leveraged Loan Index. There are about 1,600 names in the indices and we narrow that

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universe down to only about 75 names for the portfolio.

Essentially, we certify yield by price and total return. We slice and dice the companies to examine the opportunity set and to identify the market movers. Then we perform our fundamental credit research.

We spend time modeling each company and understanding its capital and corporate structure. We need to know if a piece of debt could potentially hinder the company's corporate objectives. Then we analyze relative value and combine it with our view on the security. The goal is to figure out the optimal risk-adjusted return, based on the trading of the bond. That gives us confidence to pursue the best business return.

Could you give examples of specific holdings that illustrate your research process?

USI Insurance Services, an insurance brokerage firm, is one of our larger holdings. The company sells property and casualty insurance and health benefits mainly to small and mid-size businesses. Essentially, it is a commission-based consultant for customized plans. We discovered USI on our screen and when we made our initial investment, we aggressively added to the name.

One of the reasons was the very high retention rate of the insurance brokerage industry. That industry provides a mission-critical service that companies need in order to avoid potential liability. These businesses have low, but predictable growth rates and cash flow margins in the low 30% range. Since they aren't capital intensive, they can generate a lot of cash. Finally, the insurance brokerage space represents a very fragmented industry, with hundreds of players, and is being consolidated.

Onex Corporation bought USI four years ago and we bought the security after the deal. We believed they were able to accelerate the company's growth rate through change in operations and to continue to de-lever the balance sheet. That's what the company has ended up doing.

When Onex bought the company, it decided to use financial leverage to enhance the equity returns, so it borrowed money. The only reason for the debt was to leverage the equity returns. We think that's a great use of high yield paper as opposed to a company that's struggling with its business.

We expected a strong risk-adjusted return from the business, since the equity was actually worth more than the total debt. At various points, we have received double-digit yields. Right now it provides a mid-single-digit yield, which is an equity-like return for a fixed income level of risk. Overall, we feel confident about the business and its predictability.

Could you give an example of an event-driven investment?

Initially, we identified Williams Partners through our screens. At the time, there was a concern of fallen angels into the high-yield universe, so we ran a high-grade screen on all the substitutes in the Merrill-Lynch Investment Grade Index for companies yielding over 7%.

A year ago, there were big concerns about energy and about the takeover of the company by Energy Transfer. As part of the transaction, the company had to issue additional $5 or $6 billion debt on the capital structure of both Energy Transfer and Williams Partners, which would be downgraded to high yield.

In our view, Energy Transfer had a couple of options. One of them was to get out of the transaction and the other to cut the dividend to maintain the investment-grade balance sheet.

We thought the second alternative was unlikely, so we expected the company to get downgraded. Actually, we found a series of bonds that would benefit from such an outcome. Initially, we started to invest when the bond was at the high 70s to low 80s range. We viewed that as a win-win situation, because of the structure we were able to identify.

That company had world-class assets and, at the time we were building the position, it was trading as high-yield despite being rated higher. We liked the business quality. The company had an uneven distribution policy, which it eventually corrected, and the valuation was very attractive. Importantly, the structure protected us from any potential negative outcome from irrational decisions.

How is your research team organized?

In addition to myself, our team consists of five analysts. We have a generalist approach to research with sector tendencies. One of our analysts covers the consumer vertical, which includes consumer products, retail and gaming. Another analyst covers telecoms, media and technology. The third analyst is responsible for basic industries, including home building, building products, paper, packaging and industrials. The fourth analyst covers the commodity verticals, which means energy, metals and mining. And the fifth analyst does healthcare, utilities and chemicals.

Currently, I handle banking, business, insurance and financial services, but eventually the analyst who covers basic industries, will take responsibility for that as well.

How do you make your investment decisions?

We meet on a regular basis—twice a day, every day. First we meet in the morning to go through the movers of the day and to discuss each sector. We also meet at a research lunch, when we have an in-depth discussion of new ideas, updates on existing positions, an overview and relative value discussion on the existing and potential investments.

Ultimately, I am responsible for what goes in and out of the portfolio. I listen to and use the input of the analysts, but I am the final decision maker for the portfolio.

Could you explain the portfolio construction process?

The portfolio consists of core holdings, spread tightening and opportunistic investments. The core part of the portfolio represents high-

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quality companies. Spread-tightening means that we expect to have material credit improvement in trading with a relatively wide yield. The opportunistic bucket is based on technical market parameters and, essentially, is an event-driven play.

The core bucket typically represents 20% to 60% of the portfolio, spread tightening accounts for 10% to 50% of the portfolio, and our opportunistic exposure is limited to 10% to 30% of the portfolio.

We aim to take advantage of different risk profiles. In the core segment, there are plenty of opportunities to make money on improving credit. In spread tightening, we have a longer-term expectation for credit improvement, while in the opportunistic, event-driven names, we try to take advantage of market technicals.

In terms of industries, we have significant over-exposure to software, technology and insurance brokerage. We have material underweights to cyclical industries like metals and mining. Currently, we have 77 issuers.

How important is the benchmark for your portfolio construction process?

Our benchmark is the Bank of America-Merrill Lynch US High Yield Master II Index, but we don't follow it closely. We are not afraid to be materially underweight or overweight in any particular sector. In certain periods, we may have large exposure to software, services and insurance brokerage. Conversely, we have material underweights in other areas such as metals, mining or cyclicals.

Our exposure mostly depends on our fundamental view, so we are benchmark agnostic. We tend to have higher conviction in our names.

In terms of diversification, we have high-conviction positions, and there is a potential tracking error from the indexes because of the way we manage.

Right now, about 38% of the portfolio is in our top 10 issuers. We don't have specific sector limits. I am comfortable with where we are and I wouldn't expect the portfolio to become more concentrated from a sector perspective.

What is your biggest risk and how do you control it?

We believe the biggest risk for the portfolio is credit risk, so we make sure a particular asset class has an asymmetric risk profile.

To avoid permanent loss of capital, we are really careful about making sure we get the right business quality, in the right stable businesses, which can handle the developments in their area.

Many of our peers tend to invest in more cyclical businesses, such as commodities, while our focus leads to higher predictable recurring revenue models. Overall, we worry more about credit improvement than about rate revision.

Do you have your own internal ratings system?

We don't have official internal ratings. We know what the ratings of rating agencies are, but we may agree or disagree with them. Frankly, our process tends to identify situations in which companies are underrated by the agencies because of their current high leverage, but we recognize the value of the security because of our fundamental credit research.

Ironically, the agencies tend to put a lot of value on hard assets. As a result, some commodities businesses like energy exploration & production are actually given higher ratings than their volatility would have dictated over the last years. T

Artisan High Income Fund

Company	Artisan Partners
Symbol	ARTFX (Investor Class) APDFX (Advisor Class) APHFX (Institutional Class)
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Source: Company Documents

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Brian Krug is the portfolio manager for Artisan High Income Fund. This article represents the views of **Ticker Magazine** and Brian Krug 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.

Average annual total returns for the fund and benchmark as of 31 Dec 2016:

Artisan High Income Fund – ARTFX

14.52% (1YR) 6.10% (Since Inception). BofA Merrill Lynch U.S. High Yield Master II Index: 17.49% (1YR), 4.08% (Since Inception).

Fund Inception - 19 Mar 2014. For the fiscal year ended 30 Sep 2016, the Fund's expense ratio is 1.03%.

Past performance does not guarantee and is not a reliable indicator of future results. Investment returns and principal values will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than that shown. Call 800.344.1770 for current to most recent month-end performance. 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. Performance may reflect agreements to limit a Fund's expenses, which would reduce performance if not in effect. Unlike the Index, the 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's total net assets as of 31 Dec 2016: HCA Inc, 1.74%, Williams Partners LP/ACMP Finance Corp 3.99%, USI Inc 5.21%. 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.

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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