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 strategy 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 strategy'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.

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 strategy] 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 strategy 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 strategy, 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 April 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 strategy 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 strategy 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.'

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 Artisan High Income Strategy's allocation to CCC-rated securities is 27.5% relative to the benchmark's 16.1% as of August 31, 2017.

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

(3) Ranking reference is based on a US mutual fund in the Artisan High Income Composite. Please note that the U.S. mutual funds are generally only available to U.S domiciled investors.

Bryan Krug is the portfolio manager for Artisan High Income Strategy. 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.

Investment Results (%) as of 30 Sep 2017	QTD	YTD	1 YR	3 YR	Inception
■ High Income Composite (Gross)	2.59	8.74	11.12	8.73	8.16
■ High Income Composite (Net)	2.41	8.17	10.34	7.96	7.39
■ 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: 1 Apr 2014.

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. Net-of-fees composite returns were calculated using the highest model investment advisory fees applicable to portfolios within the composite. Fees may be higher for certain pooled vehicles and the composite may include accounts with performance-based fees. All performance results are net of commissions and transaction costs, and have been presented gross and net of investment advisory fees. Dividend income is recorded net of foreign withholding taxes on ex-dividend date or as soon after the ex-dividend date as the information becomes available to Artisan Partners. Interest income is recorded on the accrual basis. Performance results for the Index include reinvested dividends and are presented net of foreign withholding taxes but, unlike the portfolio's returns, do not reflect the payment of sales commissions or other expenses incurred in the purchase or sale of the securities included in the indices. Unlike the Index, the High Income Strategy may hold loans and other security types. At times, this causes material differences in relative performance. Returns greater than one year are annualized unless otherwise noted. Composite inception: 1 Apr 2014.

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. 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 in Artisan Partners Form ADV, which is available upon request.

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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%.

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