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Now Available: Above-Average Companies at Below-Average Prices

Investors seem to want the safest of bonds or the riskiest of equities, which has generally led to outflows, and opportunities, in high-quality large caps, says Artisan's George Sertl.

Fund Manager Q & A | 10-15-10 | by Liana Madura

George O. Sertl Jr. is a managing director at Artisan Partners and co-manager of Artisan Small Cap Value (ARTVX), Artisan Mid Cap Value (ARTQX), Artisan Opportunistic Value (ARTLX), and the firm's U.S. value separate account portfolios.

Specifically focusing on Artisan Opportunistic Value, Sertl recently answered our questions on the macroeconomic issues facing investors today, enthusiasm for high-quality large caps, and financials. He also commented on the valuation of the Hewlett-Packard's (HPQ) recent acquisition of 3Par.

1. As an equity investor, what's your reaction to the current gloom and doom scenarios that many prominent bond managers are advocating (and, that many investors are agreeing with, at least based on fund flows)?
For awhile now I think it's been pretty obvious that macro issues have been a dominating factor for a lot of investors. And that's understandable; there are a lot of big issues floating around that are legitimate sources of uncertainty. So what a lot of investors seem to have done is run from that fear and uncertainty and rush into the perceived safety of bonds. As value investors, we're doing the opposite. Our job is to invest in companies that are trading at a distinct discount to their underlying worth. In all our years of investing, we've learned that this really only happens when there's fear and uncertainty out there. So we're not running from it, we're going toward it to find the opportunities, to find the stocks that we think have been hit harder than deserved.

Right now, relative to bonds, stocks are the cheapest they've been in a long time. Some think this is justified, that stocks should be trading at a discount given the current economic uncertainties. But even though the economy is still on rocky ground, productivity and margins have been strong and companies have been able to generate strong cash flow. In fact, more stocks are paying dividends that exceed bond yields than at any time in at least 15 years. Probably even a better apples-to-apples comparison is earnings yield. During the last few months the spread between the earnings yield of the S&P 500 Index and the 10-year Treasury yield has hovered at the widest it's been in about 30 years. Looking at a few of our large-cap holdings—Microsoft (MSFT), Wal-Mart (WMT), IBM (IBM), and Johnson & Johnson (JNJ)—these companies are issuing debt at a fraction of their earnings yields. Microsoft and J&J recently issued 10-year bonds for about 3% while their earnings yields are sitting around 8%-10%. So by owning these stocks we're getting current earnings yield at about 3 times what we'd be getting for holding on to their debt for 10 years. In my view, we're being very well compensated for taking on equity risk in large-cap, high-quality stocks.

2. Are your ideas today concentrated in any market segments or spread out evenly?
Our team manages three portfolios, all under one investment philosophy that covers the entire market-cap spectrum. While the general fear and uncertainty in the market has helped us find good investments for each of our portfolios, right now, we're finding the most attractive opportunities in the large-cap, high-quality space.

Since the market bottomed in early 2009, large-cap stocks and high-quality stocks, as measured by superior business economics and high return on equity, have both underperformed as investors that didn't rush into bonds moved into more leveraged cyclical stocks to bet on the economic recovery. Interestingly, investors seem to want the safest of bonds or the riskiest of equities, which has generally led to outflows in large-cap, high-quality stocks. As we've said before, we buy what the market is selling, and we'll gladly take the market-leading, high-quality names at cheaper valuations.

Today we own a number of what we believe are best-in-breed companies. In addition to those previously mentioned, we also hold ExxonMobil (XOM), Applied Materials (AMAT), Accenture (ACN), and Lockheed Martin (LMT). Because of our valuation discipline, we rarely get the chance to own these types of companies, but now we're

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actually buying them at a discount relative to the broader market. Going through the metrics, our portfolio's return on equity is currently a little more than 22% versus less than 20% for large-cap stocks and 4% for small-caps. With the fixed-charge coverage ratio, we're at 14 times versus 11 times for large-caps and 3 times for small-caps, in line with our focus on financial condition. In terms of valuation, our P/E ratio is about 11 times versus 14 times and 15 times, respectively, for the large- and mid-cap indexes. So overall, you're getting a modestly lower multiple for much better-quality stocks. Put simply, the market is valuing above-average companies at below-average prices. Based both on historical trends and logic, this shouldn't last; so right now it's a very attractive opportunity for us.

QUALITY	Artisan Opportunistic Value	Russell Top 200	Russell Midcap	Russell 2000
Return on Equity	22.47	19.75	10.01	4.05
Fixed Charge Coverage Ratio	14.12	10.88	5.3	3.29
Companies Rated B+ or Higher by S&P	72%	70%	46%	22%
VALUATION	**Artisan Opportunistic Value**	**Russell Top 200**	**Russell Midcap**	**Russell 2000**
P/E Ratio - Trailing 12 Months	11.19	13.70	15.11	12.95
P/E Ratio - FY1	10.22	12.13	13.49	13.83

Data as of Aug. 31, 2010
Source: Artisan partners/FactSet

3. Artisan Opportunistic Value can invest up to 25% of its assets in non-U.S. securities, yet its current overseas exposure is negligible. When and where do you anticipate starting to look for undervalued opportunities in the global markets?
As bottom-up investors with the flexibility to go abroad, we're always looking for investment opportunities in global markets. As I stated previously, right now we're very attracted to companies in the large-cap, high-quality space. Although we don't currently own any companies that are actually classified outside of the U.S., a number of the companies that we do own—Exxon, Microsoft, Johnson & Johnson, and IBM—all rank among the largest companies in the world, not just in the U.S. The large-cap space in general is actually pretty global. A good portion of the world's largest companies, no matter where their headquarters are, are actually global organizations. These companies generate a significant portion of their sales outside of their home countries, and they're exposed to trends happening all over the world. Within Artisan Opportunistic Value, specifically, we have a lot of international exposure through our large-cap companies. The majority of these companies, though they're classified in the U.S., are generating 50%, 60%, and even 70% of their sales outside the U.S.

This goes both ways—in today's global environment, companies based outside the U.S. are generating a good portion of their sales within the U.S. As an example, within the last year we've owned Nestle (NSRGY) and Unilever (UN), which are both domiciled in Europe. Nestle is a global brand; I would bet that everyone can find something in their kitchen produced by Nestle. Although Nestle would technically be classified as an international stock, it generates almost a third of its revenues in the Americas. That's more than some of the U.S.-based companies that we own. Companies like Exxon, Texas Instruments (TXN), Applied Materials, and Western Union (WU) are just as exposed to international trends as Nestle is, though they're domiciled in the U.S. What this means is that where a company is domiciled is much less important today than it has been historically. So even though we don't currently own any companies that are actually domiciled overseas, we have significant international exposure.

4. While many remained concerned about the future profitability of financials, Artisan Opportunistic Value has significant exposure to the area. What are you seeing that others are missing?
I think a lot of investors are broadly fearful of the financial sector because of recent capital problems—not enough capital at the REITs and banks and too much capital in the property and casualty insurance industry. For the most part, we've steered clear of REITs for valuation reasons. Similarly, we've avoided banks because of all the other issues that will have to be worked through: increased regulation, new capital standards, and margin pressures. What has attracted our interest, though, are a number of P&C companies. Overall, we think the insurance industry is a pretty mediocre industry, but there are a number of best-in-class operators that have distinguishing characteristics.

Right now there are significant headwinds facing P&C companies because of the fear around reduced pricing, as a result of the excess capital in the industry. This fear has created a lack of interest in the industry, leaving some of the good operators trading at or below book value. Roughly during the last 15 years, the P&C industry has traded on average just above 1.5 times book value, with the industry now around book value; this has attracted our attention. When a company is trading below book value, it comes down to a very simple question: Does this business deserve to exist? We argue that the franchise

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operators, the companies that have a nice history of compounding wealth over time, by protecting shareholder capital and not exposing themselves to riskier business strategies, deserve to sell at a premium to book value.

Our opportunity seems straightforward with these best-in-class operators. In our opinion those are the companies that are more disciplined in underwriting and those that have a track record of paying attention to balance sheet risk. We've been able to buy the companies that we think of as the best-of-breed, such as Arch Capital (ACGL) and Chubb (CB), and we've been able to do it around or below book value. These companies aren't faced with the types of risks that banks are, yet they're cheaper, so we're comfortable with a pretty heavy exposure here.

5. Did Hewlett-Packard overpay for 3Par? As a shareholder, are you concerned by HP's post-Mark Hurd buying spree?

There have been a lot of headlines about Hewlett-Packard ever since (former CEO) Mark Hurd left the company in early August. And given his reputation on Wall Street, everything HP does for awhile will probably be under pretty intense scrutiny. The bidding war over 3Par is the perfect example. 3Par is a data-storage provider, and we think strategically the deal makes sense, given the increasing need for businesses to store so much data. Regarding price, it probably got a little out of hand. HP ended up paying $33 a share, which values the whole deal at $2.4 billion. What you have to keep in mind, though, is that HP is a mega-cap company, with more than $100 billion in annual revenue. So even if they did overspend by $1 billion, which remains to be seen, that's only about 1% of its market cap and it's less than one month of cash flows.

During the last few years, HP has done a number of smaller acquisitions similar in size to 3Par. 3Com is a good example. 3Com was a networking-equipment maker, and we like that the deal strengthened HP in data-center networking, which looks to us like a pretty decent-sized opportunity during the next few years. Like with 3Com, we think most of HP's deals make sense, though none of them have been a huge move-the-needle acquisition since EDS back in 2008, which we think turned out well. A bigger capital-allocation decision the firm has pursued, that we agree with, is its ongoing stock buyback program. During the last few years, HP bought back between $8 billion and $12 billion worth of stock per year. Right now, it has about $15 billion authorized on about a $90 billion market cap, so that's going to be much bigger than any of the acquisitions HP is doing. We think this large repurchase at around 8 times normalized earnings seems like a very good allocation of capital.

Despite all the headlines around HP, one has to remember that it's a market-leading, financially sound company trading at only around 8 times normalized earnings. Yes, Mark Hurd helped turn HP around in the last five years and had a lot of success with cutting costs, but HP will continue to benefit from that in the future. I think that the company's near-term operational plans are already in place. HP has a high level of recurring sales, it's strong financially, it has good market positioning, and its management team is obviously very capable. Overall, we think the shares are trading at a significant discount to the company's underlying worth, and it remains a large holding in our portfolio.

Liana Madura is an assistant site editor with Morningstar.com.

Average Annual Returns

	(as of 9/30/10)				Expense Ratio[2]
	YTD[1]	1 Yr	3 Yr	Inception	
Artisan Opportunistic Value Fund (ARTLX)[3]	3.01%	10.19%	-6.59%	0.15%	1.32%
Russell 1000® Value Index	4.49	8.90	-9.39	-2.20	
Russell 1000® Index	4.41	10.75	-6.79	-0.56	

Source: Artisan Partners/Russell. [1]Returns are not annualized. [2]For the fiscal year ended 9/30/09. [3]Fund inception 3/27/06.

The performance quoted represents past performance, which does not guarantee future results. The investment return and principal value of an investment in the Fund 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 the performance data quoted. For current to most recent performance information, call 800.454.1770 or visit www.artisanfunds.com.

Investors should consider carefully before investing the Fund's investment objective, risks and charges and expenses. For a prospectus or summary prospectus, which contains that information and other information about the Fund, please call us at 800.454.1770. Please read the prospectus or summary prospectus carefully before you invest or send money.

Value securities may underperform other asset types during a given period. 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. Securities of medium-sized companies tend to be more volatile and less liquid than those of large companies, may have underperformed the stocks of large companies during some periods, and tend to have a shorter history of operations than large companies.

A mutual fund's NAV is the value of a single share and is computed daily using closing prices as of the NYSE closing time – usually 4:00 p.m. Eastern Time, but sometimes earlier. Securities for which prices are not readily available (such as when there are significant changes in one or more U.S. market indices) are valued at a fair value under the Funds' Valuation Procedures as described in the Funds' prospectus. When fair value pricing is employed, the value of a portfolio security used by the Fund to calculate its NAV may differ from (and consequently be higher or lower than) quoted or published prices for the same security. Fair value pricing is not employed by market indices.

Quotations of mutual fund performance are calculated using NAV and may be impacted by fair value pricing.

The S&P 500® Index is an unmanaged, market-weighted index of 500 of the largest U.S. companies. The Russell Top 200® Index is an index of about 200 of the largest U.S. companies. The Russell Midcap® Index is an index of about 800 medium-sized U.S. companies. The Russell 2000® Index is an index of about 2,000 small U.S. companies. The Russell 1000® Value Index is an index of those large companies included in the Russell 1000® Index, an index of about 1,000 large U.S. companies, with lower price-to-book ratios and lower forecasted growth values. Index returns include net reinvested dividends but, unlike the Funds' 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. An investment cannot be made directly into an index.

This interview represents the views of the portfolio manager as of 9/29/10. Those views may change, and the Funds disclaim any obligation to advise investors of such changes. For the purpose of determining the Fund's holdings, securities of the same issuer are aggregated to determine the weight in the Fund. The holdings mentioned above comprise the following percentages of Artisan Opportunistic Value Fund's total net assets as of 9/30/10: Microsoft Corp 4.5%, Wal-Mart Stores Inc 4.6%, International Business Machines Corp 4.6%, Johnson & Johnson 4.0%, Exxon Mobil Corp 4.8%, Applied Materials Inc 3.0%, Accenture PLC 4.3%, Lockheed Martin Corp 3.6%, Texas Instruments Inc 2.9%, The Western Union Co 2.8%, Arch Capital Group Ltd 4.4%, Chubb Corp 4.4%, Hewlett-Packard Co 4.2%. Securities named in the discussion above, but not listed here are not held in the Funds 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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Market Capitalization is the aggregate value of all of a company's outstanding equity securities. **Earnings Yield** is a company's earnings per share for the most recent 12-month period divided by its stock's current market price pre share. **Return on Equity** is a measure of a corporation's profitability, calculated as the last twelve months net income before extraordinary items divided by the average total stockholder's equity at the beginning and end of the last twelve month period. It is the average of the current ROE of the Fund or Index's entire portfolio, weighted by the size of the company's position within the portfolio. **Fixed Charge Coverage Ratio** is an indication of a firm's ability to satisfy fixed financing expenses, calculated by divided a company's earnings before interest and taxes (EBIT) plus its fixed charges before tax by its fixed charges before tax plus interest. It is the median of the current fixed charge coverage ratio of the Fund or Index's entire portfolio. **P/E Ratio** is a measure of how expensive a stock is. It is a harmonic average of the price/earnings ratio of the Fund or Index's entire portfolio, excluding negative earners, weighted by the size of the company's position within the portfolio. The earnings figures used for the **Trailing Twelve Months** ratio were reported during the last fiscal year. The earnings figures used for the **FY1** ratio are estimates for the current unreported fiscal year. **Standard & Poor's Earnings and Dividend Rankings**, commonly referred to as Quality Rankings, reflect the long-term growth and stability of a company's earnings and dividends. Basic scores are generated by a computerized system and are based on per-share earnings and dividend records of the most recent 10 years. The scores are then adjusted by a set of predetermined modifiers for change in the rate of growth, stability within long-term trend and cyclicality. Adjusted scores for earnings and dividends are then combined to yield a final ranking, ranging from A+, the highest, to D, the lowest. Not all stocks are ranked, including 17% of Artisan Opportunistic Value Fund, 11% of the Russell Top 200® Index, 22% of the Russell Midcap® Index and 35% of the Russell 2000® Index. **Price-to-Book Value** is the ratio of a company's stock price to its book value of equity per share (book value is a company's assets minus its liabilities).

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