

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Small Cap Fund Managers Travel the Globe, Kick the Tires



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### SECTOR — GENERAL INVESTING

**TWST:** Thanks for speaking with us today. To help readers out, can you give us a summary of Artisan Partners, its overall strategies and how it operates.

**Mr. Zhou:** Artisan Partners is a U.S.-based listed boutique asset manager. I don't have the exact numbers off the top of my head, but I think it has close to \$130 billion, \$140 billion AUM under management. It comprises many different funds and many different groups. We are mostly equity focused, but we do have a small portion allocated to fixed income, and we're a very long-term oriented shareholder.

**Mr. Vasagiri:** Just to add, one important feature and characteristic is that Artisan operates as a federation of different strategies. Each team does its own research, is managed completely independently. So, the style, philosophy, strategy, all of that by design is supposed to be unique for each team. We don't share resources across teams. We don't have a house view on a stock or an economy or anything like that.

We emphasize this because oftentimes even when we go meet with companies, they're surprised at why so many different teams from Artisan could be interacting with them. The reason for that is each team almost operates as a completely independent entity, but taking full advantage of the back office and logistics and the platform that Artisan offers.

**TWST:** Is there more differentiation among the small cap group?

**Mr. Vasagiri:** Yeah. And even within small caps, we have a small cap growth team and small cap value team. Our philosophies are different, our time horizons could be potentially different on a stock. It's a feature, not a bug.

**TWST:** I'd like to get into the details of the International Explorer Team. Can you address your strategy, goals, the markets you're looking at, etc.?

**Mr. Zhou:** Anand and I run a non-U.S. small cap strategy. Our definition of small cap is anything up to a \$5 billion U.S. dollar market cap. That still gives us a pretty broad universe to play outside of the U.S.

We belong to the Artisan International Value Group. For anybody that's familiar with the Artisan International Value Strategy, Anand and I deploy the same strategy into the small cap space outside of the U.S.

In terms of investment, the foundation consists of four key tenets that get deployed to the mid- to large-cap space and equally apply to the small cap strategy we're running. Those four key tenets are good management, good business, good balance sheet, and good valuation.

We are looking for businesses, quality businesses, that can earn their return on capital well above their cost of capital and can do so sustainably, and in such a way that can compound their value over time.

But we want to wait for the right opportunities to show up. Typically, we're reacting to bad news happening, and then we can come in and in the midst of market dislocation, we can get those share prices at a 30% discount to our estimated intrinsic value.

And we take a very long-term view and that's why when bad news hits the stock — typically because of short-term earnings fluctuations or a temporary rough patch those businesses run into — we can look past the immediate future and take a longer-term view and hold onto the stock while the stock recovers from the short-term earnings drag and goes on its way to compound its value over a long period of time. We typically take a three-to-five-year time horizon when we enter a stock.

**“If you ask me whether our product really fits into that style box — international small cap value — I would say no. Because what we're really trying to accomplish is to create a wealth creation platform for our clients. It's not a product — it's a strategy for our clients to get exposed to the so-called value factor.”**

Another key feature of our strategy is we are 100% bottom-up stock pickers. There are lots of countries, lots of industries for us to deploy capital into. We never wake up on any given day thinking that we should allocate this percentage to this country or that percentage to that industry. Whatever you see in terms of the number of names we own in our portfolio, the country composition or the industry composition is purely the result of a 100% bottom-up stock selection process.

Anand and I go around scouting the globe, trying to find a small, curated collection of stocks, each of which can stand on its own in the portfolio and with its own unique idiosyncratic risk/reward profile that in the aggregate can compound its value over time and mid- to low-10-digit CAGR over the medium term.

So, we run a very focused portfolio and we're benchmark agnostic in the way that we run this strategy.

Just one last thing. People see us playing in the area labeled international small cap value. Somehow that label is attached to what we do. But we really want to emphasize that we're not trying to check any particular asset allocator's box.

If you ask me whether our product really fits into that style box — international small cap value — I would say no. Because what we're really trying to accomplish is to create a wealth creation platform for our clients. It's not a product — it's a strategy for our clients to get exposed to the so-called value factor.

Nor is it a product from our perspective to get our clients exposed to a particular asset box. We are really here to create this capacity constrained product and own a collection of idiosyncratic businesses.

And hopefully we get more right than wrong, so that in aggregate, the portfolio's value can compound in a nice way over time. That's really what we're trying to do, creating wealth, generating alpha for our clients.

**TWST: You're looking to make money, rather than to just say, “Look, we've diversified in this area” where it becomes part of a story, rather than what are the results?**

**Mr. Zhou:** Exactly.

**Mr. Vasagiri:** Typically, when you put yourself in a capital allocator's position, when they allocate capital, they're trying to fit different portfolio style strategies. They box most of these people into certain positions or in certain categories. What we strongly believe in is that we don't want to be characterized as that. If somebody wants to think of us as small cap, yes we are, but we don't necessarily want to be restricted.

When we invest, our companies have a market cap of under \$5 billion for the most part. There may be an occasional exception where it could be \$5.1 billion or \$5.5 billion, something like that, but for the most part we fish in that because we feel that's the most inefficient part of the universe that's available to us, which allows us to offer an asymmetric risk/reward portfolio with very idiosyncratic characteristics that is to a certain extent non-correlated to the broader factors or geographic ups and downs as well.

**TWST: Does it matter to you whether there are different ways to achieve geographic diversity, generally investing in international companies on foreign exchanges, investing in international companies registered in the U.S., or investing in multinational companies working across multiple geographies, at least on the equity side? How do you look at it? Where do you focus?**

**Mr. Vasagiri:** In addition to the four key characteristics that Beini highlighted, we stay away from commodity companies and commoditized businesses. We look for good management teams, attractive valuations, and strong balance sheets.

In addition to these four key characteristics, there are two things we focus on. The first of these is we have to be a bit more macro aware in our universe. And the reason for that is, just as you said, if you're buying a large cap company, you get the benefits of diversification because they operate in multiple countries.

So, you have the FX diversification, you have diversification of exposure to different countries, geographies, economies, etc.

In many cases, the small cap is usually operating just in one country or one region. You don't get the full benefit of geographic or FX diversification from that franchise. You have to be comfortable not just with the franchise, but you also have to be comfortable with the area or the country or the geography that that business is operating in.

We need to be a bit more macro-aware, and we need to be as comfortable with that country's balance sheet, with the macro risk, political risk, currency risk as with the company itself. That's another element of analysis we do.

If you go into finance and look at the portfolio diversification theory, then after 14 or 15 stocks, you get the benefit of diversification from a market perspective. But within that, when we're looking at these idiosyncratic names, we're looking at companies all over the world. We look at different scenarios of how the world or the events can unfold.

We want to pick a collection of stocks. It's a fairly concentrated portfolio of somewhere between 30 to 40 depending on the time.

We still want to get the full benefit and we want to get these idiosyncratic benefits. Sometimes it could be a special situation, sometimes it could be a mispriced equity, sometimes it's a spinoff that is not well understood.

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So, we take advantage of all of this to get the benefit of diversification. But at the same time, it's not that we are looking specifically to get exposure to every country or every currency to give to our clients.

**TWST: Understood. You're focused on basically opportunities that you can't find in the U.S. and I'm gathering that these are opportunities where companies have some kind of unique offering, a defensible position, something that takes them out of the commodity category so that even though they're small, they have an ability to stay in and grow in value because a large company might not want to take on something that small or it may be that they're so entrenched that it's hard to move them out.**

**Mr. Zhou:** Right. We're really taking advantage of the wealth creation vehicles effectively. Listed wealth creation vehicles that could be run and typically still controlled and run by founding families or occasionally be run by professional CEOs, managers, really capable capital allocators in either scenario that can compound that business's value over time.

And we don't care. It could be a non-U.S. business listed in the U.S. It could be a business whose revenue is coming from one or few countries listed overseas, or it could be a mini multinational company listed overseas. We don't really care. All those categories are fair game for us.

We just want to go out there and find those wealth creation opportunities, hopefully before the market discovers them so that we're not really paying a fair price for the long-term creation opportunities that we identified.

**TWST: You want a bargain before other people realize that it's a bargain.**

**Mr. Zhou:** Exactly. Think of a well-run U.S. business that you like. It could be from any industry. Today, it might be a giant. It could be part of the S&P 500. It's a well-known name. A lot of people have figured out that particular business's secret sauce. But imagine 20, 30 years ago in the '90s, it was already listed, but it was a fairly obscure name.

I'm thinking about **O'Reilly** — the aftermarket auto parts business listed in the U.S. Really, a great business. But 20, 30 years ago, fewer people really knew about how that whole auto parts aftermarket supply chain worked and why **O'Reilly** really was run better than a lot of their peers.

If you could discover a stock equivalent of an **O'Reilly** overseas and buy into them at a relatively bargain price and hopefully you can hold on to them for many years to come, as long as the fundamental thesis that you underwrote originally does not change, you just ride the wave and that's how we really try to create wealth in our vehicle.

**Mr. Vasagiri:** Just to add one more point. We're not saying that we're finding businesses that don't exist necessarily in the U.S. That may be true in some cases, but what we're trying to find is businesses of as good a quality or even better quality trading at much more attractive valuations. It gives us and our portfolio the ability to generate wealth or substantially above-average returns over time. That's what we're trying to do.

Both Beini and I are invested in large cap names. We've invested in small cap names in the developed markets and emerging markets. We grew up in emerging markets, moved to developed markets and I've seen how companies here have grown and how they're matured.

As Beini said, when we move and look at some of these international markets, many times those ideas or those spaces are still at a much earlier stage.

We have the benefit to a certain extent of what I call time travel, but we do have the benefit where we're going from seeing or already having seen how this movie plays out in the U.S. or in some developed market, and we go to a market that's not as mature, where the companies are still not understood very well.

And we take these insights and apply them and say, “OK, if this pans out, or if this works out this way, then we have a portfolio or we have a collection of stocks that can generate substantial wealth for our investors.”

**TWST: So, basically you can see in a more mature market how things have played out and then use that as a potential model to say, “Does it seem to be working in this direction in this other country?”**

**Mr. Vasagiri:** Exactly.

**TWST: If so, can we use that to help spot the potential winners, even if people don't realize that they're going to be winners at the time.**

**Mr. Vasagiri:** Right. That's just one toolkit. But even within the same market, if you look at — I'll give insurance brokers broadly as a good example. In the large cap space, that space is very well understood, very well researched. There are a lot of analysts covering that space. Everybody knows and understands.

But in the same countries, if you move to the smaller cap end of the spectrum, not very many people understand it because there are no small cap peers, whether internationally or in the local markets, so that space immediately gets a huge discount.

But as the sector is getting consolidated, these small cap companies can become very attractive targets. With that insight, we go in searching for companies. Again, these are just a few of the many different tools we have in our kit.

**TWST: I think you're saying that there's a time lag in development. This used to be something that was true of clothing fashion during the Renaissance. Something would become popular in a capital. It would take many years for what was fashionable in, say, London, to progress its way all the way down to the edges.**

**Mr. Zhou:** Yeah. And it's 500, 600, 700 years later, so that 75 days is now compressed to less than 7.5 hours.

**TWST: Well, hours in terms of information, right. Not necessarily hours in terms of execution, because execution is always much harder and takes much longer to get right.**

**Mr. Vasagiri:** Yes. And just on that point, our insights sometimes could be coming from emerging markets as well. China has been at the forefront of digital disruption in a lot of spaces. We take those insights and look at the companies in the developed market and see which companies are at risk of these potential disruptions.

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So things go both ways for us because we're looking at companies all over the world and, as Beini said, we spend a lot of time kicking the tires and on the ground in different parts of the world. We get insights sometimes that benefit us in investing in emerging markets. Sometimes we get insights from emerging markets that help us in investing in the developed markets.

**TWST: And I'm assuming that when that happens, you're passing that information along to some of your colleagues who might be investing in the developed markets more than you are.**

**Mr. Vasagiri:** Only about a quarter of our portfolio is invested in emerging markets. The bulk of it, over three-fourths of our portfolio is actually invested in developed markets. We are as focused on the developed markets as on the emerging markets. I don't want to give the impression that we're just focused on emerging or frontier markets. That's number one.

**TWST: When you say developed markets, what do you mean?**

**Mr. Vasagiri:** The U.K. is our biggest exposure. As a region, we have the most exposure to Europe. And we have more exposure, or as much exposure, to just the U.K. as we have for all of emerging markets combined roughly.

**TWST: What are some of the pros and cons of your approach? Because nothing ever works all the way one way or the other.**

**Mr. Vasagiri:** Sure. The pros are that every investor will want to invest in good companies run by good people, clean balance sheets and attractive valuations. Nobody will come to you and say, “Oh, we want to invest in crappy companies run by bad people with highly levered balance sheets and we want to overpay for it.”

**TWST: They never say that, but a lot of times that can happen. Take a look at the money put into some publicly questionable companies that had screaming red flags and people with money who seemingly had worse sense than money were pouring it in.**

**Mr. Vasagiri:** Absolutely. In our universe, the pro is, if you go to the large cap universe, because it's more efficient, it's well covered,

the books written on companies and management teams, etc., there's a lot of information available. So for those markets, those companies, the pricing of that universe tends to be a bit more efficient.

If you're looking at these four key characteristics, then you have to compromise on one or two of them. Yeah, it's a great business, but maybe the management team is mediocre, maybe the balance sheet is slightly levered, maybe the valuation is not as attractive, but still, you can find some upside.

I'm not saying you compromise on all four, but you have to compromise on some of those characteristics, right? Whereas in our universe we can, because, first, it is so large, there are over 50,000 companies in our universe. We can afford to be very picky and selective because we just have to choose 30 to 40 stocks from this universe.

That's the positive. Now, what is the negative? We have 50,000 companies that we need to pick from.

**TWST: And you have to choose 30 to 40 from all of them.**

**Mr. Vasagiri:** Exactly. So, you can call it a huge opportunity set or you can call it a goldmine or minefield.

So we spend a lot of time on the ground doing due diligence on the companies. In our universe, oftentimes when we go meet with companies, these are small companies, whether we are speaking to a company in Italy, which is a developed market, or in Indonesia, which is an emerging market.

These companies tend to be smaller, they're not as well covered, the management teams are not as polished or well versed. So you have to factor all of that in to understand, look through and understand the true value of the franchise and the management teams.

And these are people where there's not a lot of analyst coverage, so you have to do a lot of background checks on these people. How have they allocated capital in the past? Many times, these tend to be family businesses. So how have they acted when times were tough?

It's very common in many parts of Asia, especially in emerging markets, where the business hits a bump, and the family comes and moves stock shares. At the end of the day, you realize the minority shareholders got the short end of the stick because they just use that as an excuse to restructure the business, to move value away from minority investors to the controlling family investors.

So we look at the past history of how a controlling shareholder has behaved in the past when there was a bump. We look at how they've allocated capital. We look at how clean the governance practices are, how many people from the family are involved.

Some of this information you can get from an annual report. But for a lot of it, you have to go not just meet with the management in the conference room, but you also have to sometimes sit with the employees in the cafeteria and have lunch or tea or whatever and try to understand. We look at the cars parked in their employee lot to how



people perceive the management teams at these companies. We do all of that research. That's where the challenges come from.

**Mr. Zhou:** That's exactly where our value add is because it really behooves people covering our investable universe to fly over there, kick the tires on the ground and meet with management, meet with people eye to eye. This is nothing like investing in **Microsoft** or **Apple** or **Amazon** where you can do really 99% of the analysis on people as well as business from your bedroom.

That's why Anand mentioned that investing in our universe is like working through a minefield. You have to be really careful.

Our starting operating assumption when we run into a brand-new business is whether this is a fraud. We have to verify that level of assumption first before we think if it's a quality business or not.

And it's always, as Anand mentioned, people first, numbers second. If we don't feel comfortable with the people involved, we walk away. We don't care how the numbers look on paper or how cheap the valuation is.

**“Now, they might not be at a point where we can pull the trigger immediately. We want to get that 30% discount. We're not buying a great business at a fair price. We want that unfair advantage of buying a great business at that 30% discount.”**

**TWST:** It is always possible to fake numbers, especially, I'm assuming, if you're looking at an exchange where transparency is not as mandated as in the U.S.

**Mr. Vasagiri:** Yes, that's number one. And you have the local accounting practices, local regulations, all of that. You have to factor all of that in and not be biased positively or negatively.

Some of it could very well be a local regulation, which is why a company reports the way they do. But at the same time, if they're very transparent and clear about it and we are able to understand and at the end of the day they're able to generate cash flows and do good things with the cash that the business is generating, then that gives us a comfort.

**TWST:** How have geopolitical and macroeconomic forces had an impact on your work and on the companies you follow over the last few years?

**Mr. Vasagiri:** For the most part, it comes from a risk management perspective. As I think Beini alluded to, we don't start off saying, “OK, let's allocate X to Japan or the U.K. or any country.” It's more from a risk management perspective. We are bottom-up stock selectors and once we do have a stock where we have done a lot of work, then we go look at the foreign exchange currency risk, we look at the political risk, and then we ask if we're comfortable with the country risk.

We came across this one company, a confectionery company, very well-run with a good management team operating in Turkey. But we could never get comfortable with the currency risk or the political risk then. So that gave us it was too hard for us to factor that in or handicap that risk and so we passed on that name.

**TWST:** Makes sense. There can be too much out of our control.

**Mr. Vasagiri:** Right. We want asymmetric outcomes. We don't like binary outcomes. And we don't want our principal to be at risk at any given point of time. And so, if you have a political regime that has a potential to impact your initial investment or your principal

in some way by either confiscating that asset or levying some kind of a special tax or somehow transferring that value from that asset to the state, then we treat it as a risk.

**TWST:** What are some of the better investment opportunities you've been seeing looking forward over the next few years?

**Mr. Zhou:** Anand and I just took a two-week trip in Europe the past two weeks in the second half of September, one week in Italy and one week in London. We had three to four meetings a day, some of them are our current portfolio holdings. But every research trip like that, we always try to meet with new companies.

This time in Italy, we saw some of the freshest opportunities that we've seen on the ground. What struck me was some of what I call hidden champions in the northern part of Italy, around Lombardy, Tuscany, areas where we've seen quite a few of these listed small- to mid-cap industrial businesses that have been doing very well. But they're not on most global investors' or non-U.S. investors' radar screen.

Now, they might not be at a point where we can pull the trigger immediately. We want to get that 30% discount. We're not buying a great business at a fair price. We want that unfair advantage of buying a great business at that 30% discount.

A lot of those well-run industrial small cap businesses we ran into in Italy two weeks ago are trading at a price that we will consider around fair, and they're not running into an earnings rough patch yet. So we can patiently wait on the sideline and wait for that earnings hiccup to happen.

In the meantime, we place that name onto our watch list and just observe on the sideline, to watch its development from the sideline.

There's no general theme like, “Oh, geez, we're looking for ideas in the electric vehicle sector, or we're looking for ideas in the generative AI sector.” We're really here trying to understand the people and trying to understand the business dynamics and competitive landscapes.

So we're not chasing any of the hot trends that you are seeing in the overall investor community. We're really trying to pick spots, those individual businesses that we believe can do well regardless of the macro environment, how that will unfold over the next three to five years.

And just getting back to Italy, it is considered the sick man of Europe, and the macro environment is not really hunky dory for that country ever since the financial crisis. Yet these industrial businesses we ran into, they've compounded their value very nicely at a double-digit rate over the past 10 to 15 years, ever since the financial crisis. And in those particular instances, micro overwhelms macro.

Those are exactly the circumstances where we would like to get involved. Assuming, of course, we can get in at the right price.

**Mr. Vasagiri:** But to take a very 30,000-foot view — this was true when we launched, and which is one of the reasons why we decided to focus on this space. At the time of our launch, there were CNBC articles that were talking about how the large tech companies, the valuations or the market caps — if you just add up the market caps of

some of the large tech companies, that was more than the market cap of all of Europe put together, including the U.K.

The talk gave an indication of the disparity or the difference in valuations and the value that was available in these markets.

That's true even today, and that's even more true in the smaller cap part of the universe because they're not beneficiaries of automatic capital allocation through passive vehicles. There are not very many small cap passive strategies, and so they don't get automatic inflows through this movement to passive that actually benefits the large cap more.

The inefficiencies have actually increased. That gives an advantage to stock pickers like us who are willing to travel to these parts and meet with these companies and kick a lot of tires to unearth a few names that have really idiosyncratic asymmetric risk/reward opportunities.

**TWST: Anything else you'd like to say to the audience?**

**Mr. Zhou:** I would just like to get back to that earlier point. This is not a value factor exposure platform and this is not a product for someone to tick that international small cap value style box. We're really here trying to create wealth for our clients, building alpha over time without taking undue risks.

The way that we really do it is to go out there and find a small, curated collection of small businesses outside of the U.S. run by really capable people with a conservative balance sheet where we believe their value will compound nicely over time.

We want to do that, discover them, hopefully well before the market discovers them, so that we can get in at a pretty attractive valuation multiple.

We believe that what we are doing here is something very unique. It's very differentiated. Because when you look at our competitive landscape, a lot of our peers, they are running a very diversified portfolio in our universe. It's not uncommon to see a non-U.S. small cap strategy with a triple digit. And that's not really the game that we're trying to play here.

Whenever I see a highly diversified portfolio, I often wonder why bother with your 50th idea? If you've really done your homework and have very strong conviction on your top 10, 20, 30, 40 names, there's no reason to bother with your 50th best idea.

The other thing is, what differentiates us from our peers is our organizational focus. Oftentimes our peers are running the small cap product on the side, either as a side job or as a stepping stone for future promotion within their organization.

When you look at how we're set up within our group, within Artisan, this is what me and Anand do 100% of our time. You're looking at two highly experienced portfolio managers, full-time dedicated to this product with zero distraction, and with all the trading compliance, legal stuff handled by the Artisan backbone platform that Anand mentioned at the beginning of the call.

So I think it's a very unique setup, and it's a very differentiated strategy that we're doing here.

**Mr. Vasagiri:** Maybe if I can add two more points very quickly to what Beini said. Focus clearly is a big differentiating factor. The second part, I think it was Charlie Munger who said, show me the incentives and I'll show you the outcomes.

We often take that view when we're interviewing companies, management teams — we look at how their incentives are structured. This is the only thing we do. We're not distracted by anything else or any other strategy.

We did not choose it just because we didn't have any other options. We've worked in large cap space, in the large cap space, small cap space, emerging, developed, everything. And so, we chose this space because for both of us, what gives us most happiness or joy or kick is the ability to deliver alpha.

And so, we are not focused on AUM, which is why we chose a capacity constrained strategy, because we feel we can add substantial alpha only if we constrain the capacity and focus on generating alpha as opposed to growing our asset base. So that's number one. That's by design.

The second part is both Beini and I have a substantial portion of our personal wealth invested in this strategy. We have our skin in the game, and our incentives are well aligned, even from that perspective.

And the last part, that may be a little underappreciated by many people, is when you have your personal wealth, a material portion of your personal wealth invested in a strategy or investment, is that then you don't take risks that don't really pay you very well. You tend to develop more of an absolute return mindset.

We are benchmark agnostic, and we are comfortable not having any exposure to energy companies or some commodity companies, even if we feel there's a rally in commodities, etc., because our goal is to protect and grow the wealth, our goal is not to outperform a particular chosen benchmark. We have all of those as well, that act as incentives and that allow us to focus and just deliver returns for the capital that is entrusted to us.

**TWST: Thank you. (EBS)**

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S&P 500® Index measures the performance of 500 US companies focused on the large-cap sector of the market.

**Correction: Artisan Partners currently holds \$136 billion AUM as of 9/30/2023.**

**Return of Capital** is a return from an investment that is not considered income. **Compound Annual Growth Rate (CAGR)** is the year-over-year average growth rate of an investment over a period of time. It is calculated by taking the nth root of the total percentage growth rate, where n is the number of years in the period being considered. **Foreign Exchange (forex or FX)** is the trading of one currency for another. **Valuation multiple** is a theory based on the idea that similar assets sell at similar prices.

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