



# Artisan High Income Fund

QUARTERLY  
Commentary

Investor Class: ARTFX | Advisor Class: APDFX | Institutional Class: APHFX

As of 30 September 2023

## Investment Process

We seek to invest in issuers with high-quality business models that have compelling risk-adjusted return characteristics. Our research process has four primary pillars:

### Business Quality

We use a variety of sources to understand an issuer's business model resiliency. We analyze the general health of the industry in which an issuer operates, the issuer's competitive position, the dynamics of industry participants and the decision-making history of the issuer's management.

### Financial Strength and Flexibility

We believe that analyzing the history and trend of free cash flow generation is critical to understanding an issuer's financial health. Our financial analysis also considers an issuer's capital structure, refinancing options, financial covenants, amortization schedules and overall financial transparency.

### Downside Analysis

We believe that credit instruments by their nature have an asymmetric risk profile. The risk of loss is often greater than the potential for gain, particularly when looking at below investment grade issuers. We seek to manage this risk with what we believe to be conservative financial projections that account for industry position, competitive dynamics and positioning within the capital structure.

### Value Identification

We use multiple metrics to determine the value of an investment opportunity. We look for credit improvement potential, relative value within an issuer's capital structure, catalysts for business improvement and potential value stemming from market or industry dislocations.

## Team Overview

Our team brings together a group of experienced credit analysts who are dedicated to a single investment philosophy and process. All team members conduct deep fundamental credit research as generalists with sector tendencies to identify issuers with high quality business models that have compelling risk-adjusted return characteristics.

## Portfolio Management



Bryan C. Krug, CFA  
Portfolio Manager

## Investment Results (%)

As of 30 September 2023	Average Annual Total Returns						
	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Inception
Investor Class: ARTFX	1.46	8.46	10.44	3.80	4.27	—	5.34
Advisor Class: APDFX	1.50	8.46	10.62	3.92	4.41	—	5.49
Institutional Class: APHFX	1.52	8.53	10.72	4.02	4.50	—	5.50
ICE BofA US High Yield Index	0.53	5.97	10.19	1.82	2.80	—	3.70

Source: Artisan Partners/ICE BofA. Returns for periods less than one year are not annualized. Class inception: Investor (19 March 2014); Advisor (19 March 2014); Institutional (3 October 2016). For the period prior to inception, Institutional Class performance is the Investor Class's return for that period ("Linked Performance"). Linked Performance has not been restated to reflect expenses of the Institutional Class and the share class's returns during that period would be different if such expenses were reflected.

Expense Ratios	ARTFX	APDFX	APHFX
Semi-Annual Report 31 Mar 2023 <sup>1</sup>	0.94	0.79	0.70
Prospectus 30 Sep 2022 <sup>2</sup>	0.95	0.80	0.71

<sup>1</sup>Unaudited, annualized for the six-month period. <sup>2</sup>See prospectus for further details.

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. Unlike the Index, the High Income Fund may hold loans and other security types. At times, this causes material differences in relative performance.



### Performance Discussion

Our portfolio outperformed the ICE BofA US High Yield Index in Q3 to extend its lead over the benchmark for the year. The quarter's relative gains were driven by strong security selection across the portfolio's bond and loan allocation, both of which outperformed their respective broader markets during the quarter. The portfolio's performance represented a strong relative return, especially accounting for September's move higher in Treasury rates, which brought steep price declines across most fixed income sectors. The portfolio's allocation to leveraged loans was an outsized contributor, delivering a greater than 7% total return en route to providing more than two thirds of the portfolio's overall return during the quarter, despite an average weight of only 15% of the portfolio. Additionally, when observing contribution by credit quality, CCC-rated credits accounted for a majority of the quarterly return. Contributing factors include CCC's shorter duration posture amid rising rates, higher coupons and a continued supportive backdrop for risk. Insurance brokerage was the highest contributor by industry followed by the service and technology sectors.

### Investing Environment

With the exception of longer dated, more rate-sensitive BB-rated bonds, credit markets continued to produce positive returns in Q3, supported by a stable backdrop for credit valuations and the continuation of investor support. This was particularly evident among lower rated and cyclical sectors. High yield bonds (as measured by the ICE BofA US High Yield Index) returned 0.5% in Q3 in the face of steep rate increases, for a 2023 YTD return of 6.0%. CCC-rated bonds continued to lead the market higher, with gains of +2.8% for the quarter, while more rate-sensitive BBs (-0.3%) lagged. Across the capital structure, leveraged loans (as measured by the Credit Suisse Leveraged Loan Index) thrived, returning 3.4% in Q3 for YTD gains of 9.9%. Loans remain one of the strongest performing US fixed income segments, besting both investment grade and high yield for the quarter and YTD. Gains were primarily due to higher carry and a continued dynamic of excess demand versus supply of loan paper. In addition, hawkish Fed rhetoric repriced front-end interest rates materially higher; during the quarter, Fed members reiterated their commitment to proceed cautiously, warning a near-term policy pivot is unlikely. Rates rose across the yield curve, further reflecting a higher-for-longer policy environment.

High yield market spreads drifted around the low- to mid-400s—slightly lower than the historical average and only marginally tightening during the quarter. However, given higher risk-free rates, outright yields are higher than historical averages, particularly versus the decade after the 2008 recession.

Current spread levels imply a view of strong financial health and low overall default risk among the issuer base. Attractive yields—and by extension, total return opportunities—remain despite a high grading of the high yield market and a highly supportive technical dynamic

resulting from limited new issuance and an increase in “rising star” upgrades.

We believe there is a compelling case to be made today that leveraged credit markets have the potential to play their most important role within diversified portfolios since the 2008 global financial crisis. The post-GFC market environment brought with it a low-return period for credit investors. For many years, prospective returns on credit were generally not competitive with those delivered by equities, real estate and alternative strategies. Now, higher prospective yields are here, which have the potential to make a meaningful contribution to investor portfolios of all kinds. To illustrate this point, in early 2022, high yield bonds yielded in the range of 4%; today, the overall high yield market yields closer to 9%, while loans are 10%. This higher expected return has encouraged institutional investors, such as pension plans and endowments, to reconsider the leveraged credit asset class as an increasing portion of their strategic allocation, now that the asset class can more reliably contribute to reaching their long-term required returns or actuarial assumptions. High yield fixed returns today exceed, in many cases, required returns for investors without the need to take extended duration, liquidity or equity drawdown risk. In summary, equity-like returns are achievable from credit, during a time when the equity risk premium is near its historic lows.

During the quarter, new issuance continued to bring to market some of the highest amounts since late 2021 and early 2022. On a quarterly basis, Q3 high yield bond issuance totaled \$41.1 billion, following \$55.1 billion in Q2 2023 and compared with \$40.5 billion in Q1 2023 and an average of \$26.6 billion across the four quarters of 2022. Year to date, high yield issuance totals \$136.6 billion, which compares to over \$90 billion priced over the first nine months last year, an increase of over 50%. Loan issuance totaled over \$122 billion during the quarter and over \$257 billion year to date, though a majority (nearly \$200 billion) was related to refinancing/repricing.

Both high yield bond and leveraged loan default rates decreased to six-month lows in September. The 12-month trailing par-weighted US high yield default rate including distressed exchanges decreased nearly 30bps from August to September, ending the month at 2.11%. Further, high yield default rates have increased only 46bps from the start of the year. During 2023, defaults have increased the most in loan-heavy or loan-only capital structures, given their sensitivity to higher funding costs. Despite broader economic concerns, high yield balance sheets remain in a good spot to weather any headwinds—leverage is at a more than decade low and interest coverage only slightly below an all-time high. Pockets of earnings weakness are evident, but most of the year's default volumes have been credit-specific, driven by higher input costs and unsustainable capital structures. Overall, we expect defaults to trend higher toward long-term averages of 3%–4% but fall below the peaks of prior default cycles.

## Portfolio Positioning

Changes to portfolio positioning were minimal during the quarter. Much of the portfolio's repositioning occurred throughout 2022 as we focused on swapping a portion of our floating rate exposure amid relative strength in favor of uniquely discounted and dislocated high yield bond opportunities. This repositioning caused our performance to lag in the latter half of last year as investors moved up in quality due to slowing growth fears. However, it has contributed to much of this year's outperformance as near-term default risks fade and as investors seek out total return opportunities among more dislocated capital structures.

The portfolio's loan allocation (15%) remained unchanged, while bonds (75%) declined marginally quarter-over-quarter amid a growing cash position (10%). The increase in cash was largely a function of inflows as well as a desire to keep dry powder on hand to quickly execute should high-conviction ideas experience price volatility. Our bond allocation continues to be concentrated in lower dollar price structures that can help cushion against market deterioration while providing greater total return potential through a combination of price appreciation and yield. Likewise, our loan allocation offers a material yield advantage and can act as ballast during periods of elevated rate volatility. Across sectors, we continue to favor non-cyclical market segments characterized by predictable free cash flow that have a unique ability to weather future volatility. As such, we ended the quarter with 35% of the portfolio concentrated in insurance, media and telecom. These sectors tend to be characterized by strong business quality and more defensive business models.

Our recreation and travel allocation is mostly composed of our cruise lines exposure, which remains the top contributor to fund performance YTD from a sector perspective, led by Carnival and Norwegian. Having seen tremendous appreciation in their bond and loan prices on the back of a recovery in their business models, we're likely closer to the end than the beginning of our journey with the sector. We foresee an opportunity to be sellers to investment grade managers ahead of anticipated upgrades. We remain distinctly high conviction in the insurance brokerage sector, evidenced by our portfolio weighting of nearly 14%. The market remains prejudiced against more levered business models, even with strong cash flow performance, which creates an opportunity for us to generate higher returns.

Strong price performance from UK-based insurance brokerage firm The Ardonagh Group powered the issuer into the portfolio's largest 10 issuers at the expense of high-end retailer Nordstrom Inc—a top detractor for the quarter, primarily due to the long duration nature of our holdings as rates rose steeply.

## Perspective

Credit markets have rallied this year and remain resilient, even amid increased volatility from episodic events such as the banking crisis in Q1, a continually hawkish Federal Reserve and multi-decade highs in

interest rates. We remain ever vigilant, continuing to focus our portfolio on quality businesses with strong credit fundamentals.

This vigilance has a direct impact not only on what credits we invest in but also their percentage weightings, which are a function of conviction. Rising debt costs and its impact on weaker businesses are top of mind, but business quality comes first for the team. We remain comfortable with the fundamental standing of the issuers we've selected, while closely monitoring any deterioration. Corporate profitability has been very strong overall, and this bodes well for credit fundamentals.

Underneath the surface, dispersion remains. Against a backdrop of slowing growth and normalizing default rates, we continue to believe elevated single-security dispersion creates a unique environment to generate alpha through credit selection. As the potential for volatility increases in an environment with more restrictive lending standards and higher borrowing costs, we will use growing dispersion as an opportunity to strategically invest in credits with attractive risk-reward profiles.

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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 calling 800.344.1770. Read carefully before investing.

Current and future portfolio holdings are subject to risk. The value of portfolio securities selected by the investment team may rise or fall in response to company, market, economic, political, regulatory or other news, at times greater than the market or benchmark index. A portfolio's environmental, social and governance ("ESG") considerations may limit the investment opportunities available and, as a result, the portfolio may forgo certain investment opportunities and underperform portfolios that do not consider ESG factors. 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. Use of derivatives 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 and less developed markets, including frontier markets.

ICE BofA US High Yield Index measures the performance of below investment grade \$US-denominated corporate bonds publicly issued in the US market. Credit Suisse (CS) Leveraged Loan Index is an unmanaged market value-weighted index designed to mirror the investable universe of the US dollar-denominated leveraged loan market. New issues are added to the index on their effective date if they qualify according to the following criteria: loan facilities must be rated "BB" or lower; only fully funded term loan facilities are included; and issuers must be domiciled in developed countries. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

This summary represents the views of the portfolio managers as of 30 Sep 2023. Those views may change, and the Fund disclaims 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. These holdings comprise the following percentages of the Fund's total net assets (including all classes of shares) as of 30 Sep 2023: Carnival Corp 4.0%; NCL Corp Ltd 3.0%; The Ardonagh Group 2.1%; Nordstrom 1.8%. Securities named in the Commentary, but not listed here are not held in the Fund as of the date of this report. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities. All information in this report, unless otherwise indicated, includes all classes of shares (except performance and expense ratio information) and is as of the date shown in the upper right hand corner. Portfolio statistics include accrued interest unless otherwise stated and may vary from the official books and records of the Fund. This material does not constitute investment advice.

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