Core Equity Commentary
Spring 2018

Market and Performance Summary

The Kovitz Investment Group (KIG) Equity Composite[2] (the "Composite") declined by 3.9% during the first quarter of 2018. For purposes of comparison, the S&P 500 fell 0.8% during the same period.

The equity market, for which 2017 was the least volatile year since 1965, is no longer serene. Of the 61 trading days during the first quarter, the market closed up or down at least 1% on 23 of them. During all of 2017, there were a total of only eight such days. January's gangbuster start which was fueled by the knock-on effects of the corporate tax cut was met with a February sell-off. The month featured several severe single-day declines and the largest ever one-day increase for the index that tracks volatility. In other words, the market was due for a breather and we got one.

The oft-cited reason for the February reversal was the fear of an overheating economy leading to inflationary pressures and the rise in longer-term interest rates that typically accompany such pressures. Remember, interest rates are one of the primary (if not, the primary) determinant of all asset prices, and higher rates act like gravity pulling prices lower. At these rate levels and even higher, we feel our clients' portfolios are well positioned. While we've pared back some of our financial sector exposure on strengthening prices during the quarter, our still healthy weighting should fare well in a rising rate environment as net interest margins, a primary component of earnings, will likely expand. Also, many of our industrial companies could see increasing demand while passing along any increases in input costs. Importantly, many of the high-multiple momentum stocks we don't own may experience valuation headwinds which would aid relative performance.

Regardless of which way the market winds blow next, we will continue to invest on the basis of value and its relationship to price, while we refrain from trying to time the market based on predictions of macroeconomic data or investor psychology. Many people in the news media and asset management industry believe they can assess and predict many things, such as the markets, the economy, politics, and even quarterly earnings. They cannot. Our base assumption is that markets are unpredictable – in good times and bad – and we aim only to navigate and profit from the inevitable upheaval the equity markets so frequently deliver. We are contrarian and confident in our investment processes, which requires us to filter out distractions and opinions of others and focus on the fundamentals and valuation of each individual business rather than the vagaries of the overall market. In other words, we are right at home in this newly volatile environment as we attempt to patiently compound our clients' capital for the long-term.

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[2] *The returns for the equity portion of your individual account may differ somewhat from the Composite due to variations in account holdings, cash position, and other client-specific circumstances.*

The chart below summarizes annualized performance over various standard time periods ending March 31, 2018 and cumulative performance results from January 1, 1997 through March 31, 2018 for the Composite.

KIG Composite[3]
Annualized and Cumulative Equity Performance (Net of Fees)

	Average Annual Total Returns						Cumulative
For Period Ending 3/31/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
KIG Composite	8.1%	7.1%	9.7%	9.2%	9.7%	10.5%	736.5%

The table below lists the results for the same time periods as above for the S&P 500 and many of the other benchmarks widely held as investments via a style-box approach.

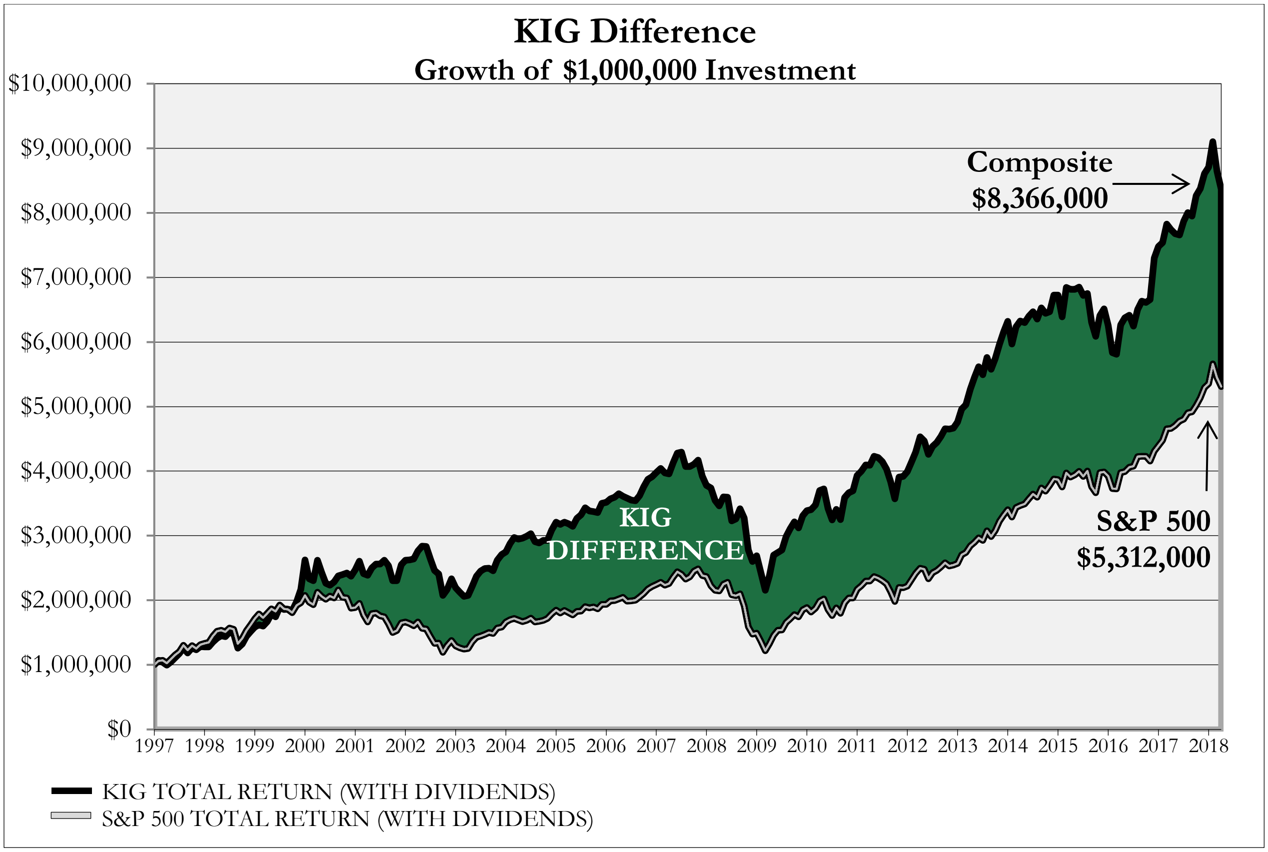
Other Market Indices
Annualized and Cumulative Equity Performance

	Average Annual Total Returns						Cumulative
For Period Ending 3/31/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
S&P 500	14.0%	10.8%	13.3%	9.5%	10.1%	8.2%	431.2%
Small Cap Equity (Russell 2000)	11.8%	8.4%	11.5%	9.8%	11.5%	8.4%	458.7%
International- Developed (MSCI- EAFE)	14.8%	5.6%	6.5%	2.7%	8.6%	4.9%	178.7%
International- Emerging (MSCI -EEM)	24.9%	8.8%	5.0%	3.0%	12.9%	6.5%	282.3%
Gold	5.2%	3.1%	-4.2%	3.0%	8.7%	5.9%	234.7%
Commodities (CRB)	6.4%	-2.1%	-7.7%	-6.3%	0.9%	2.1%	57.0%

Below is a graph of the KIG Composite's cumulative return since inception relative to the cumulative return of the S&P 500 over the same time period. The shaded area represents the Composite's excess return over the benchmark.

[3] *The returns for the equity portion of your individual account may differ somewhat from the Composite due to variations in account holdings, cash position, and other client-specific circumstances.*

Since inception on January 1, 1997, the Composite has outperformed the S&P 500 by an average of 2.3 percentage points annually. That might not sound like much. However, the extraordinary power of compounding is such that this relative outperformance over 20+ years has generated considerable rewards for our clients. In dollar terms, $1 million invested in the Composite at inception would now be worth $8.4 million at March 31, 2018. By comparison, a similar investment in the S&P 500 would now be worth $5.3 million. In other words, an investment with KIG would now be worth 57% more than if one had simply invested in an index fund that tracked the S&P 500.



Portfolio Activity

Today's combination of a stable economy, low interest rates, and growing cash flows leaves us excited about the fundamentals of many companies, yet we remain wary of asset prices. Said differently, we can find many companies that meet our qualitative criteria, but the prices of their stocks are not sufficiently cheap to warrant inclusion in client portfolios. However, we were able to find three new investments during the quarter that checked both boxes.

Analog Devices (ADI)

Analog Devices is a leader in the design and production of high-end analog semiconductors. These chips bridge the gap between the physical world and digital devices by sensing and measuring physical inputs and converting that information to a digital signal. They create solutions to solve design challenges in the industrial, consumer, communications, and automotive industries. For example, for an automobile tire pressure warning light to turn on, a chip is needed to convert the analog (physical) signal into a digital (0's and 1's a computer can use) signal. The company has close to majority market share in the key segments of data converters and amplifiers, which together account for nearly three-quarters of revenue. High returns on capital, high and stable gross margins, a strong balance sheet, and high free cash flow conversion all point to a very high quality company. We believe the valuation at entry is sufficiently low to provide ample upside with significant downside protection.

Analog Devices completed the acquisition of Linear Technology in 2017. Linear possessed a product line that was extremely complementary to Analog Devices'. While normally skeptical of larger acquisitions, we believe the merger of these two companies has created an analog industry leader across an even wider range of products and with increased customer breadth and scale in all of their business lines.

Management is focused on improving gross and operating margins of the newly combined business. Restructuring activities have helped lower the cost structure, which has enabled the company to generate relatively steady gross margins. We believe increased demand will raise utilization rates and further boost gross margins. Additionally, management has also increased focus on higher-margin products, which continues to improve the margin profile of the overall business.

Goldman Sachs (GS)

Founded in 1869, The Goldman Sachs Group, Inc. is a leading global financial company providing investment banking, securities trading, and investment management services to a diversified client base. The company's primary reporting segments are: 1) Investment Banking (contributed 23% of the 2017 revenues), which is comprised of the Financial Advisory and the equity and bond underwriting business; 2) Institutional Client Services (37%), which consists of fixed income, currency, and commodities (FICC) trading, which includes client execution activities related to making markets in credit products, interest rate products, mortgages, currencies, and commodities, and equity trading, which includes client execution activities related to making markets in equities, commissions and fees, and the company's securities services business; 3) Investing and Lending segment (21%), which includes the company's investing-related activities across various asset classes, primarily consisting of debt securities and loans, as well as equity securities that include private equity and real estate; and 4) Investment Management division (19%), which is comprised of management and other fees related to the company's asset and wealth management businesses.

While investment banking has continued to perform well, low volatility in 2017 led to unfavorable market conditions in the FICC segment, which led, in turn, to lower client activity levels and depressed revenues. This weighed on the stock price and enabled us to take our position at a valuation we considered to be too low. We viewed this setback as temporary and the recent increase in volatility, which should aid this segment going forward, is a demonstration of that.

A past Composite holding, we believe Goldman remains well positioned for growth, given its well-diversified operations and solid client franchise. The company's focus on capitalizing on growth opportunities through various strategic and cost control measures will continue to strengthen the overall business and will help leverage the improving environment. Goldman has consistently enhanced shareholder value with steady capital deployment activities that have included increasing share buy-back activity and dividend levels.

Facebook (FB)

We utilized the recent controversy surrounding improper access and handling of user data to initiate a position in Facebook. While the underlying issue is serious, we don't believe it's likely to have a long-term impact on Facebook's earnings power. As Warren Buffett has said, "There is nothing that we own that doesn't have something in the future that might affect it." The vast majority of businesses will face challenges over time, which is why it's important for us to understand the sustainability of a business' cash flows. There will likely be ramifications for Facebook, including the potential for lower user engagement, loss of future advertising revenue, and increased compliance costs to run the business. However, after taking conservative assumptions into account for revenue growth and margins, the valuation post-sell-off still spelled opportunity. Like all the companies in our investable universe, we have followed this company closely and were prepared to act as the predictable wave of selling ensued following the negative headlines.

This is not the first time Facebook has come under fire and it likely won't be the last. Facebook's management must act quickly and will need to take significant action, so they don't risk losing user trust. However, the network effect of this powerful platform has persisted throughout the company's past scrutiny and there has been no measurable impact on its growth as a result. Our feeling regarding this latest incident is that this too shall pass and this dominant digital advertiser will regain its footing.

Increases/Decreases in Position Sizes

In order to optimize the value of our portfolio, we are always questioning our key assumptions, our overall thesis, and the relationship of price to our assessment of fair value for each position. We maintain a conservative and fact-based orientation, adjusting the portfolio as we go along, security by security, to optimize profit potential and reduce risk. This ongoing process results in concentrating the Composite portfolio in our highest-conviction ideas. To that end, we used weakness in the price of many of our current portfolio holdings during the quarter to increase position sizes.

We increased the Composite's position in **CBS (CBS)** and it is now one of the Composite's top 5 holdings. The television/cable industry is going through secular challenges as it deals with declining subscribers, movement to skinny bundles, and competition from so-called "over-the-top" competitors, such as Netflix and Hulu. However, not all media companies are equally disadvantaged. We would argue that CBS is positioned extremely well for the new era. The CBS broadcast network has many shows that are consistently ranked among the highest rated on television, and its sports rights to the NFL and NCAA basketball still attract large audiences that advertisers covet. Showtime remains a creative powerhouse, and its stand-alone streaming service, along with CBS All-Access, have approximately 4 million subscribers combined. CBS is also still in the middle of the process of increasing the retransmission and reverse-retransmission fees it receives from its cable partners and local station affiliates, respectively. This high-margin revenue has facilitated the reduction of advertising as a percentage of CBS's overall revenue.

In spite of these positives, the investment community remains concerned, perhaps understandably so, as clarity into the future world of media remains murky. However, these concerns have pressured the valuation of CBS's stock to a level where its valuation prompted us to take action. Investor pessimism can overshoot and leave a stock trading at a level that incorporates a wide margin of safety. Another way of saying this is that even if all the negativity was warranted, the downside appears extremely limited from this point forward, in our opinion. If what we described above is more indicative of CBS's future position, earnings will continue to grow and its low multiple will be re-rated higher.

We also increased the Composite's holdings of **Henry Schein (HSIC)** and **United Parcel Service (UPS)**, both of whose shares have dipped on the concern that Amazon.com (AMZN) may encroach further into their business. Based on its operating history, we would never be flippant about a threat from Amazon. However, each of these companies has strong competitive moats that we believe will likely insulate them from any permanent impairment of their earnings power. In Henry Schein's case, the sales force of this distributor of dental, medical, and animal health products acts in a consultative manner with its customers, providing a true differentiator to Amazon's primarily buy-online model. For UPS, the scale and scope of its global package delivery operations create barriers to entry that even Amazon would have trouble replicating without $10s of billions worth of investments. Even Amazon has limits. Again, current valuations lead us to conclude that the potential reward outweighs the risk in these two high quality companies.

Finally, we increased **Carmax (KMX)**, **Jacobs Engineering (JEC)** and **Walt Disney (DIS)**.

To provide ammunition for all our new purchases, we pared back client exposures to some of our best performing stocks over the past year. Among those trimmed were **Bank of America (BAC)**, **Boeing (BA)** and **JP Morgan (JPM)**. We also sold down some of our clients' smaller positions, primarily **Schlumberger (SLB)** and **Cheesecake Factory (CAKE)**.

We appreciate the faith that you, our partners, have placed in us to manage your capital on a long-term basis. Your patient capital and shared long-term time horizon provide a tremendous advantage as we go about our investment decision making process. Managing other people's money is an enormous responsibility and we hope you take comfort in the fact that we are doing the exact same thing with our own money as we do with yours.

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