

## Market Insights Spring 2017

The first three months of 2017 were a case study in juxtaposition. Largely due to optimism tied to potential fiscal stimulus, financial assets have performed well, measures of riskiness have declined, and economic optimism gauges have strengthened. This happy set of results has occurred despite starting from a point of relatively full valuations across most asset classes. This starting point is significant, because the starting valuation of an asset is the greatest indicator of its expected future return *and* the amount of risk taken to earn that return. The starting point in 2017 implied expectations for a pickup in growth, declining risk, or permanently lower interest rates.

The increase in valuation of assets from economically sensitive companies was dubbed “The Trump Trade” as financial markets appeared to focus on the positive effects on equity prices of the new administration’s economic policies, particularly those due to talk of broad tax cuts, the reversal of various regulations across a number of industries, and a large increase in infrastructure spending. Irrespective of political views, less regulation, infrastructure spending, and tax reductions are a generally accepted prescription for a pickup in short-term economic growth. Of course, the key question is what are the odds these policies will be enacted?

The equity market’s reaction has been telling. Stocks<sup>1</sup> have appreciated approximately 6% year-to-date. Concurrently, margin borrowing hit a 58-year high, while the Conference Board’s latest reading of American Household Optimism reached a 17-year high. More so, as judged by the VIX, a measure of volatility and colloquially described as the “fear gauge” on Wall Street, the first quarter of 2017 has been the calmest three months in the stock market in over 10 years. In essence, stocks have gone up, fear is near an all-time low, and people have rarely felt more optimistic about the future. By all appearances, the equity markets are suggesting a high probability that the Trump administration will succeed in enacting its perceived policy goals.

Despite this optimism, political discord appears to have reached a new high, as was starkly illustrated by the recent failed attempt to repeal and replace the Patient Protection and Affordable Care Act (aka “Obamacare”) even though the Republican Party controls the House, Senate, and the White House. This failure suggests, at a minimum, that enacting the administration’s economic policies is hardly the lock financial markets have thus far predicted.

At the same time, the Federal Reserve continued raising short-term interest rates. This is generally viewed as a positive development because it indicates the Fed believes the economy is strong enough to continue growing with less assistance from accommodative interest rate policy and the odds of inflation reaching the Fed’s 2% target are gaining. However, the theme of conflicting indicators

---

<sup>1</sup> As represented by the S&P 500

continued as long-term rates actually *declined* following the Fed's decision. When short-term interest rates are rising while long-term rates are falling, this is known as a flattening yield curve and it generally portends slower future economic growth.

## Current Portfolio Positioning

As we discussed last quarter, we continue to view our primary job as maintaining a disciplined approach to managing our clients' portfolios where valuation is the bedrock of all investment decisions. The current environment contrasts higher-than-average valuations across most asset classes with the potential for fiscal stimulus and a reduction in corporate tax rates. While the probabilities of these actions have been declining, they are still substantial and could ultimately justify the high starting point of valuations.

When future returns are most dependent on economic growth, as opposed to mean reversion of unusually low valuation, we believe it is most important to guard against a permanent loss of capital while opportunistically focusing on high quality opportunities. We are invested side-by-side with our clients and will continue to be more than happy to take a pass on investments with inferior return prospects and elevated odds of losing money. Across our strategies we are positioned as follows:

1. In equities, we remain defensively positioned with cash levels rising as we have been trimming stocks that have reached our fair value estimates. This is discussed in more detail in our accompanying Core Equity commentary.
2. In fixed income, we have begun to modestly lengthen the duration of portfolios as interest rates have risen. As always, we are maintaining very high levels of credit quality and, as always, we refuse to reach for yield at the expense of a possible impairment of principal. Please read more about this in our accompanying Fixed Income commentary.
3. Where appropriate, we continue to recommend the inclusion of some alternatives (hedged equity, real estate, etc.), where a more suitable risk/reward profile might exist. An enhanced risk/reward profile often results as a tradeoff for assuming less liquidity than in the public markets.

As always, please discuss your particular situation with your KIG financial advisor.

Best Regards,

*Kovitz Investment Group*

Kovitz Investment Group

# Core Equity Commentary

## Spring 2017

### Market and Performance Summary

For the first quarter of 2017, the Kovitz Investment Group (KIG) Equity Composite<sup>2</sup> (the “Composite”) appreciated by 3.5% while our S&P 500 benchmark rose 6.1% during the quarter. Over the past one year the Composite generated a return of 23.5% vs. a 17.2% return for the S&P 500.

The reasonably strong showing in equities this quarter masked an underlying tension: Will the Trump administration policies that are generally believed to be positive for stock prices come to fruition, or will they be derailed by political clashes in other areas, such as the debate over repealing and replacing the Affordable Care Act, or by some self-inflicted political controversy? The market has clearly priced in the enactment of some (perhaps more than some?) of the administration’s pro-growth, pro-business agenda under the assumption that Republican control of the House, Senate, and the White House would make the process nearly seamless. As we have all recently witnessed, that doesn’t appear to be the way Washington works anymore. To the extent the administration’s plans get pushed out or watered down, current valuation multiples in the stock market would likely be negatively impacted. Whether or not interest rates will continue rising is another unsettled debate. Generally, interest rates act on asset values like gravity: the higher they are, the more they pull downward on asset values.

Our crystal ball is always fuzzy on matters such as these and that is why we remain focused on the careful and patient application of our investment criteria and valuation requirements. Recall that the KIG equity strategy has been devised with the goal of seeking long-term capital appreciation through high risk-adjusted returns (i.e. taking on less risk to earn commensurate or better benchmark returns). Relying on a fundamental, research-driven process, we strive to build diversified portfolios of equity investments through the purchase of competitively advantaged and financially strong companies at prices substantially less than our estimate of their intrinsic values. The crux of the strategy leads us to be more concerned with the risk of suffering a permanent loss of capital from an investment that was bought at too high of a price. We are less concerned about the risk of missing opportunities, especially those that may be short-term in nature.

Cash balances, which averaged roughly 10% during the quarter, somewhat dampened the Composite’s results in a rising market. Our cash balances wax and wane based on opportunities we see in the market to deploy capital at reasonable expected returns. While steering clear of trying to time the market, we employ this disciplined approach in all market environments. In the current environment, this principle prevents us from “stretching” for average or below-average businesses for the sole purpose of appearing active and keeping cash balances low. We’re just not going to invest your hard-won capital at any price. We were close to fully invested at the time of the election last November and have been trimming back holdings as they’ve risen over the last several months. Since we’ve done more selling than buying over this period, our residual cash balances have grown. As we survey the investment landscape, we mostly see equities that are, at best, fairly valued and very few that offer the significant margin of safety we require to initiate a purchase. In other words, because we are a price-

---

<sup>2</sup> 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.

sensitive investor, it has become a tough environment in which to put new money to work. If we can't find qualifying opportunities that meet our criteria, the default option is to hold cash until stock price volatility gives us an opportunity to deploy capital into qualifying businesses (i.e. high quality companies whose valuations are low in comparison).

Many investors put very little value on cash, arguing that cash's current low yield makes it a poor investment. However, we believe cash's value comes not from its current yield, but from its optionality. In a down market, cash helps mitigate losses and affords one the opportunity to buy when others are selling out of fear. Current market conditions may lead to the kind of volatility and divergence in the markets that present opportunities for disciplined, value-conscious investors. With our current healthy cash allocation, we will be prepared to capture entry-point pricing opportunities as they emerge. The pursuit of investment returns involves incurring risk. Our counter-cyclical approach – owning less, not because of a hunch or feeling about the direction of the market, but because there is observably less worth doing (owning) – mitigates risk. We will own more when the valuations are clearly signaling there are more attractive opportunities.

At the end of the quarter, your portfolio was invested in what we believe to be reasonably priced, high quality businesses that we believe will compound their earnings at attractive rates for a long time to come. We remain focused on identifying companies with four key attributes:

1. A commitment to maintain a strong financial position as evidenced by a solid balance sheet;
2. An ability to generate sustainable free cash flow based on one or more defensible competitive advantages;
3. Management that intelligently deploys cash balances and free cash flow from operations to grow intrinsic value per share and increase returns to shareholders; and
4. Is selling at a discount to our calculation of intrinsic value.

We further believe that by prioritizing these factors, our portfolio of companies will be positioned to perform better than the market in most types of economic settings.

-----

The chart below summarizes annualized performance over various standard time periods ending March 31, 2017 and cumulative performance results from January 1, 1997 through March 31, 2017 for the Composite.

**KIG Composite<sup>3</sup>**  
**Annualized and Cumulative Equity Performance (Net of Fees)**

For Period Ending 3/31/17	Average Annual Total Returns						Cumulative
	1 Year	3 Year	5 Year	10 Year	15 Year	Since Inception 1/1/97	Since Inception 1/1/97
KIG Composite	23.5%	7.0%	11.3%	6.9%	7.1%	10.6%	673.9%

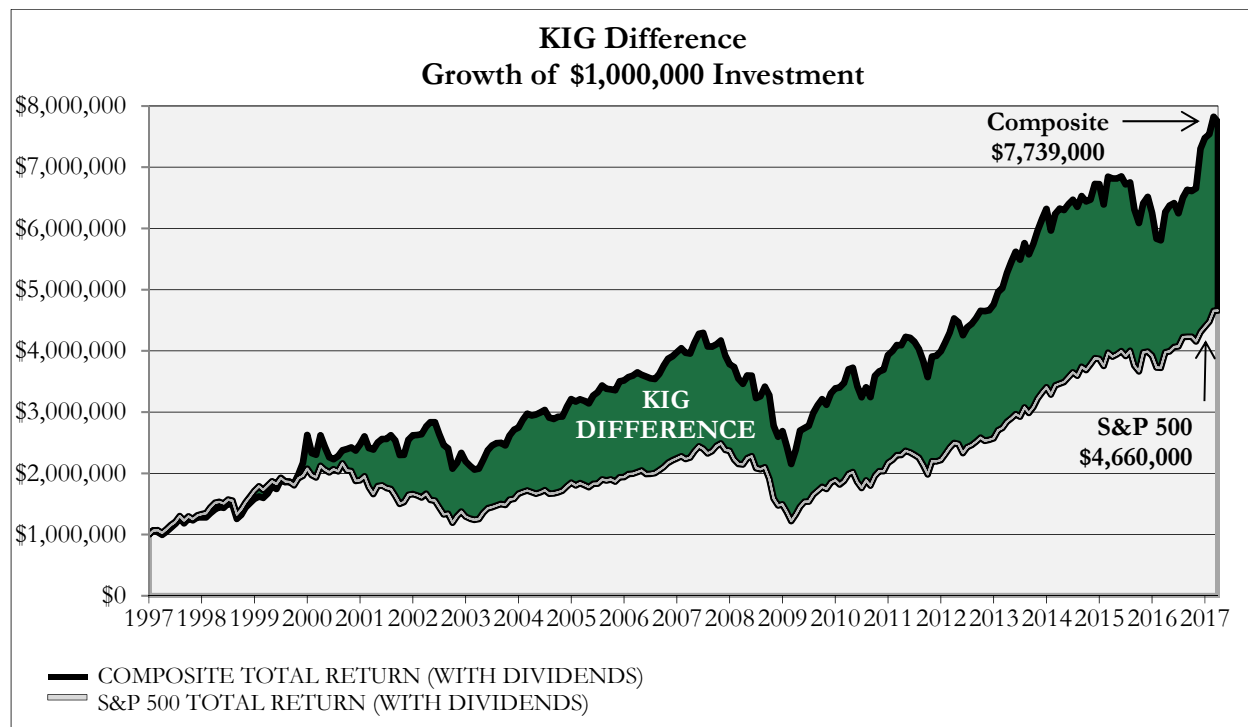
The table below lists the results for the same time periods as above for the S&P 500 and many of the other benchmarks widely held as investments via a “style-box” approach.

**Other Market Indices**  
**Annualized and Cumulative Equity Performance**

For Period Ending 3/31/17	Average Annual Total Returns						Cumulative
	1 Year	3 Year	5 Year	10 Year	15 Year	Since Inception 1/1/97	Since Inception 1/1/97
S&P 500	17.2%	10.4%	13.3%	7.5%	7.1%	7.9%	366.0%
Small Cap Equity (Russell 2000)	26.2%	7.2%	12.4%	7.1%	8.4%	8.3%	399.8%
International- Developed	11.7%	0.5%	5.8%	1.1%	5.7%	4.5%	142.8%
International- Emerging (MSCI -	17.2%	1.2%	0.8%	2.7%	9.5%	5.7%	206.0%
Gold	0.1%	-1.5%	-6.2%	5.7%	9.1%	5.9%	218.2%
Commodities (TR/CC CRB)	9.4%	-15.0%	-9.5%	-4.6%	2.0%	1.9%	47.6%

<sup>3</sup> 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.

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.



### Portfolio Activity

As mentioned above, our pursuit of investments that combine quality with a margin of safety has been difficult. The hunt is typically easier when the market is weak and more difficult when it is strong. We recently passed the eight-year anniversary of the market bottom after the financial crisis. Since then, stocks have basically gone straight up with only a few brief periods which could be considered minor corrections. The market recently ended a record run of 109 trading sessions without a daily decline of 1% in either the S&P 500 or the Dow Jones Industrial Average. Disciplined investors' best friend, volatility, has been practically non-existent.

To achieve successful long-term compounding, it is important to be patient and focused on the long-term prospects for businesses. Since most market participants are focused on short-term results, including such things as the impact of changes in near-term quarterly earnings estimates or next quarter's GDP run-rate, opportunities often abound for those who can afford to maintain a longer-term view. When other investors are undemanding, they'll buy anything. Valuation parameters take a back seat, and it becomes difficult for demanding investors to find opportunities offering the required balance of return and risk. In such a situation, demanding investors must be willing to be inactive at times, and this is one of those times.

The KIG Investment Team was not completely dormant, however. We initiated one new position and exited one other. We also trimmed one position that we believe has become more fully valued and increased one position to reflect our conviction in the business.

After being uninterested in the airline sector for a decade or more, we initiated a position in **American Airlines (AAL)** in 2015, and added to it last summer during the brief market freak-out over the Brexit vote in the United Kingdom. Airline stocks have rebounded around 50% since that low point, but, this quarter, we added a second airline, **Delta Air Lines (DAL)**, to the portfolio. At their current valuations, we believe both offer meaningfully more upside than downside on an absolute basis and certainly a better price-to-value ratio than most equities at the current time.

After years of cut-throat pricing competition, undisciplined capacity growth, and labor strife, the airline industry has emerged, in our opinion, as a legitimate business worthy of investment. The basis behind this transformation has come primarily from an industry that has consolidated from more than 10 major airlines to just four today – American, Delta Air Lines, **Southwest Airlines (LUV)**, and **United Continental Holdings (UAL)** – that collectively control over 80% of the domestic U.S. market. This oligopolistic structure has led to a more rational approach to pricing and capacity than has possibly ever existed before. Further enforcing this disciplined competitive approach is that current management teams are committed to generating returns on capital employed in excess of their cost of capital and maximizing shareholder returns. Combined with the dramatic drop in fuel costs that has occurred over the last couple of years, airlines are now generating healthy cash flows. Also, their capital allocation policies have evolved in a manner that they are now creating value for shareholders rather than destroying it.

For instance, over the past two years, Delta has generated approximately \$15 billion in cash flow from operations, repurchased about \$5 billion of its stock, paid out \$900 million in dividends, and reduced its debt by \$3 billion. The remaining \$6 billion was spent on expanding and maintaining their fleet and upgrading IT systems, which are extremely important components in maintaining cost efficiencies and satisfying customer demands.

We also increased our position in the global commercial real estate services firm **CBRE (CBG)**. Our conviction in CBRE's business model and earnings power has grown stronger over our past year of ownership. The company pairs a cyclical, transaction-based brokerage and leasing business with a more stable revenue stream from its property management business to create a formidable company capable of both weathering industry downturns and prospering when markets are active. In addition, this complementary combination offers ample opportunities for cross-selling and consolidation in the highly fragmented commercial real estate services industry.

We eliminated our position in **CVS Health (CVS)**, which is admittedly quite a departure from our more recent communications where we had been positive on its shares. Our thesis changed due to concerns related to the pharmacy benefit management (PBM) portion of their business, and the potential reduction in what we believed to be normalized earnings power. We had believed the stock to be inexpensive on a valuation basis because we thought the shares had more than priced in pressure from recent market share losses to Walgreens on the retail side of the business and some PBM contract losses. We don't believe this is necessarily the case anymore and earnings power could be materially lower than current levels. PBMs have long been a controversial business as their finances have always been relatively opaque. Our working theory had been that regardless of the opacity, the end result is that they were an important part of reducing the overall cost of prescription drugs for their end clients, which are typically large employers and health insurance companies. We have done much work over

the years trying to figure out exactly how PBMs make their money and trying to isolate the competitive forces that affect their profitability. While we could never get complete clarity, our over-arching theory that they were an important part of the drug industry in saving costs seemed credible, and it was reinforced by the fact they experience low client turnover. However, as politicians and the media apply more and more scrutiny to each and every facet of the prescription drug supply chain, including manufacturers, distributors, PBMs, insurance companies, and pharmacies, we can no longer dismiss the possibility that PBMs may be reaping more profits from the supply chain than some would consider their fair share, relative to the value they add for the end consumer. The layers of the onion are being pulled back slowly and we just aren't sure whether CVS' earnings, whether rightly or wrongly, will hold up under this increased examination.

Finally, we used strength in shares of **Harley-Davidson (HOG)** to pare back exposure as its price moved closer to our fair value estimate.

We appreciate the faith that you, our partners, have placed in us to manage your capital on a long-term basis. In the long-run, we believe your patient capital, alongside of ours, will be amply rewarded for following our investment discipline instead of following the crowd. We would not be comfortable investing your money or our own in any other way.



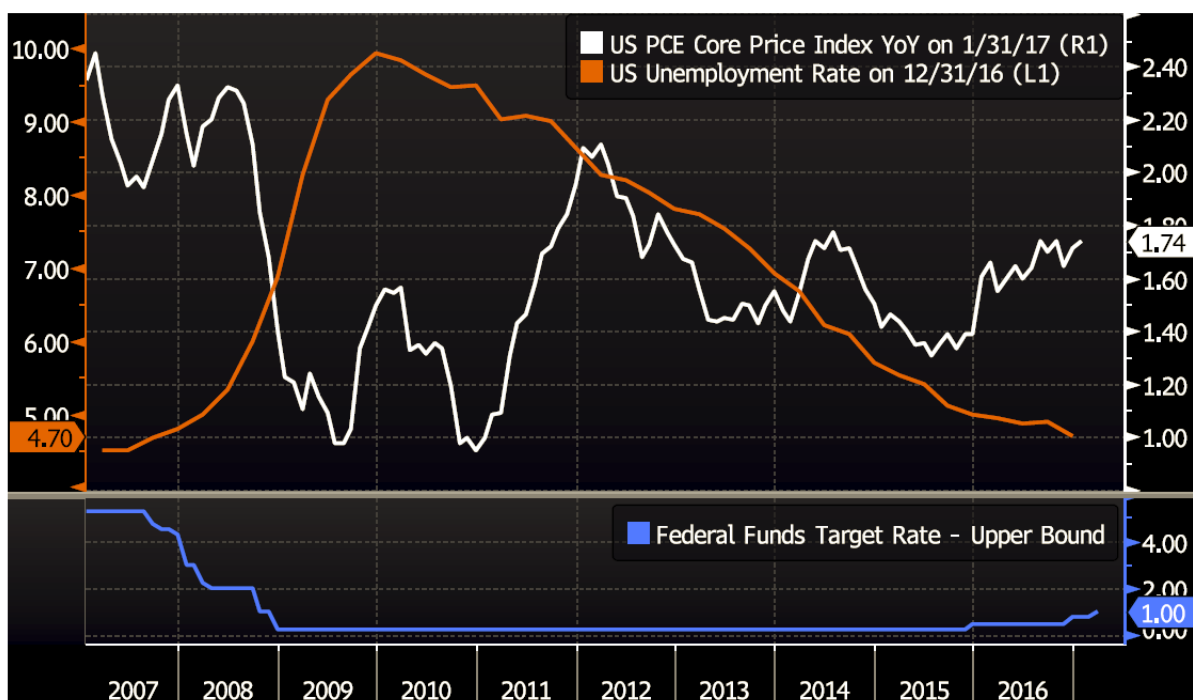
## Fixed Income Commentary Spring 2017

Bond yields ended the quarter roughly in-line with their level at year-end 2016. However, one area of the fixed income market that experienced significant change was short-term government bonds maturing in one year or less. Three-month Treasury bill yields increased 49% from 0.51% to 0.76%, and the one-year Treasury yield surpassed 1% for the first time since 2008. These increases were a direct result of the widely expected Federal Reserve (“Fed”) decision to increase the federal fund’s target rate, the interest rate at which banks lend to each other, from 0.75% to 1%. The Fed anticipates two more rate hikes this year, and the financial markets seem to agree.

The Fed adjusts the federal funds rate to tighten (raise rates) or loosen (lower rates) bank lending policies and, in turn, influence the amount of leverage and growth in the economy. This monetary tool helps the Fed fulfill their so-called “dual mandate” to maximize employment and moderate inflation. The Federal Reserve is currently targeting 2% for long-run annual inflation rates and estimating 4.7% as the normal rate of unemployment. Exhibit 1 shows how inflation and unemployment rates have changed over the last ten years. The unemployment rate is currently at the Fed’s long-run goal of 4.7%. The inflation rate is 1.7%, which is below, but trending towards, the 2% inflation target. As long as employment holds steady, the inflation rate’s future path should dictate how much, or how little, the Fed considers raising rates from this point forward.

Exhibit 1

PCE YOY Index (US Personal Consumption Expenditure Core Price Index YoY SA)  
 EHUPUS Index (US Unemployment Rate (%))  
 FDTR Index (Federal Funds Target Rate - Upper Bound)



In the short-run, the increases in the federal funds rate will continue to increase short-term bond yields and, therefore, have a negative impact on bond prices. That being said, we believe long-term

bond investors should embrace rate hikes. Further normalization of interest rates will increase the yields at which we can purchase bonds in the future and should also have a moderating effect on inflation, which is one of the largest risks to a fixed income investor.

To illustrate inflation risk, Treasury bonds maturing in 30 years are currently yielding roughly 3%. After taking into account an assumed tax rate of 35%, an investment in one of these bonds would return close to 2%. If future inflation rates surpass the Fed's inflation target of 2%, inflation would wipe out this after-tax return and leave the investor with the choice of being locked into negative real returns for the remaining 30 years until maturity, or selling the bond at a price well below the purchase price. As Ronald Reagan once said, "Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man." Any investor in 30-year Treasuries today would think the same should the double-digit inflation that plagued the economy during Reagan's early years in office ever return.

At Kovitz, we believe our bond strategy is well positioned to handle the current monetary environment. Our municipal and corporate bond portfolios are currently capped at eight year maturities, meaning roughly half of all clients' bond portfolios can be redeployed into potentially higher rates within the next four years should rate hikes continue. We are also assuming minimal inflation risk by avoiding long-term maturities. We also believe our clients' non-agency mortgaged-backed portfolios are arguably even better positioned. The majority of these bonds are adjustable-rate with their coupons pegged to various short-term rates – meaning, future rate hikes will lead to higher interest income for these investors.

This newsletter has been prepared by Kovitz Investment Group Partners, LLC<sup>®</sup> (KIG), an investment adviser registered under the Investment Advisers Act of 1940, and is a quarterly newsletter for our clients and other interested persons. Within this newsletter, we express opinions about direction of the market, investment sectors and other trends. The opinions should not be considered predictions of future results. Discussion in this newsletter relating to a particular company is not intended to represent, and should not be interpreted to imply, a past or current specific recommendation to purchase or sell a security, and the companies discussed do not include all the purchases and sales by KIG for clients during the quarter. A list of specific recommendations made by KIG over the past year can be made available upon request. In addition, please note that any performance discussed in this newsletter should be viewed in conjunction with complete performance presentations that we update on a periodic basis. Such presentations are available at [www.kovitz.com](http://www.kovitz.com), or by calling us at 312-334-7300. Information contained in this newsletter which is based on outside sources is believed to be reliable, but is not guaranteed or not necessarily complete.

Past performance does not guarantee future returns.



**KOVITZ INVESTMENT GROUP**  
*Intrinsic Values®*

**Mary Anderson, MBA**

312.334.7355  
manderson@kovitz.com

**Joel Hirsh, CFA**

312.334.7307  
jhirsh@kovitz.com

**Jason Petite, CFA**

312.334.7311  
jpetitte@kovitz.com

**Jenny Boyke, MAS, CPA, CFP®**

312.334.7316  
jboyke@kovitz.com

**Debbie Hopkins, MBA, CFP®**

312.334.7325  
dhopkins@kovitz.com

**Mark Rosland**

312.334.7322  
mrosland@kovitz.com

**Marc Brenner, JD, CPA**

312.334.7302  
mbrenner@kovitz.com

**Kate Jonynas, CFP®**

312.334.7309  
kjonynas@kovitz.com

**Peter Rudman**

312.334.7327  
prudman@kovitz.com

**David Castro, CFP®**

312.334.7361  
dcastro@kovitz.com

**Mitchell Kovitz, CFA, CPA**

312.334.7301  
mkovitz@kovitz.com

**Ted Rupp, MBA**

312.334.7317  
trupp@kovitz.com

**Andrea Cohen, CFP®**

312.334.7312  
acohen@kovitz.com

**Sanford Kovitz, JD, MBA**

312.334.7352  
skovitz@kovitz.com

**Rich Salerno**

312.334.7304  
rsalerno@kovitz.com

**John Conway, CRPC®**

312.334.7343  
jconway@kovitz.com

**William Lee**

312.334.7335  
wlee@kovitz.com

**Jonathan Shapiro, CFA, MBA**

312.334.7324  
jshapiro@kovitz.com

**Ed Edens, MBA, CFP®**

312.334.7333  
eedens@kovitz.com

**Melissa Mabley Martin, CFP®**

312.334.7328  
mmabley@kovitz.com

**Jesse Stumpf, CFA**

312.334.7320  
jstumpf@kovitz.com

**Amanda Falkum, CFP®**

312.334.7351  
afalkum@kovitz.com

**Bradford Madison, CTFA**

312.334.7347  
bmadison@kovitz.com

**Bruce Weininger, CPA, CFP®**

312.334.7334  
bweininger@kovitz.com

**Skip Gianopoulos, JD, LLM, CFP®**

312.334.7303  
sgianopoulos@kovitz.com

**Christopher Nicholson, CFP®**

312.334.7319  
cnicholson@kovitz.com

**Patrick Wiese**

312.334.7305  
pwiese@kovitz.com

**Leonard Gryn, CPA**

312.334.7360  
lgryn@kovitz.com

**Jack Nicholson, MBA, CFP®**

312.334.7323  
jnicholson@kovitz.com

