KOVITZ INVESTMENT GROUP
Intrinsic Values®

Investment Commentary

Summer 2015

Market and Performance Summary

For the quarter ended June 30, 2015, the Kovitz Investment Group® (KIG) Equity Composite (the "Composite") decreased 1.4%*, net of fees, compared to a 0.3% increase for the S&P 500 Index. Year to date, the Composite is flat (+0.0%) versus a 1.2% gain for the S&P.

We continue to seek and hold companies that we believe have an ability to deliver long-term value to shareholders that is not currently recognized by the market. 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 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.

Long-term investing means concentrating not on the daily price movements of a stock but on the value of the cash flows generated by the underlying business. By focusing on a company's underlying fundamental value relative to its stock price and not where the stock price is today relative to a month ago or a day ago, we are using the same thought process that a prudent owner of a private business would use when making day-to-day decisions rather than simply trading pieces of paper. Owning solid businesses that you don't over pay for has proven to be a positive wealth-generating endeavor.

Many investors have turned investing into an exercise in mass psychology, trying to guess better than the crowd how the crowd will behave. That type of thinking, besides not being very intellectually stimulating for us, would leave too much of the ultimate success of our investment performance out of our control. We believe we should be spending our time focusing on the fundamentals of the underlying business by tracking cash flow, making sure competitive advantages remain intact, and keeping an eye on how management is allocating capital. This way, our ultimate success rests squarely with us and is based on our own ability to analyze industries and businesses.

**The returns for your individual account will differ somewhat from the Composite due to slight variations in account holdings, cash position, and other client-specific circumstances.*

The goal is simply to make solid decisions on the basis of justifiable premises, valid logic, and hard evidence, and avoid decisions based on market sentiment, popularity, or emotion.

Below is our standard performance report for the KIG Equity Composite, which now encompasses 18 and one-half years. The chart summarizes both annualized and cumulative performance results from January 1, 1997 through June 30, 2015 for the Composite and the S&P 500. We remind you that your portfolio's composition is significantly different from the broad market indices, so your performance will inevitably deviate from these indices, especially over shorter time periods. We manage your portfolio for long-term results, and we encourage you to evaluate its performance over a multi-year time frame.

We continue to include the "Rolling Period Outperformance" metric we debuted last quarter, which details the percentage of the time the Composite outperforms the S&P 500 on a rolling period basis. For example, there have been 211 one-year rolling periods from January 1, 1997 through June 30, 2015 in which we have outperformed our benchmark 59% of the time, and there have been 103 10-year rolling periods over this same time period in which the Composite has outperformed 90% of the time. The point of detailing this is to remove the vagaries that the selection of any arbitrary end date has on the numbers, and to provide a truer reflection of our long-term performance. As illustrated, the percentage of outperformance increases as the measured time period lengthens, which corroborates our thesis that compounding wealth is a long-term undertaking and not a short-term game.

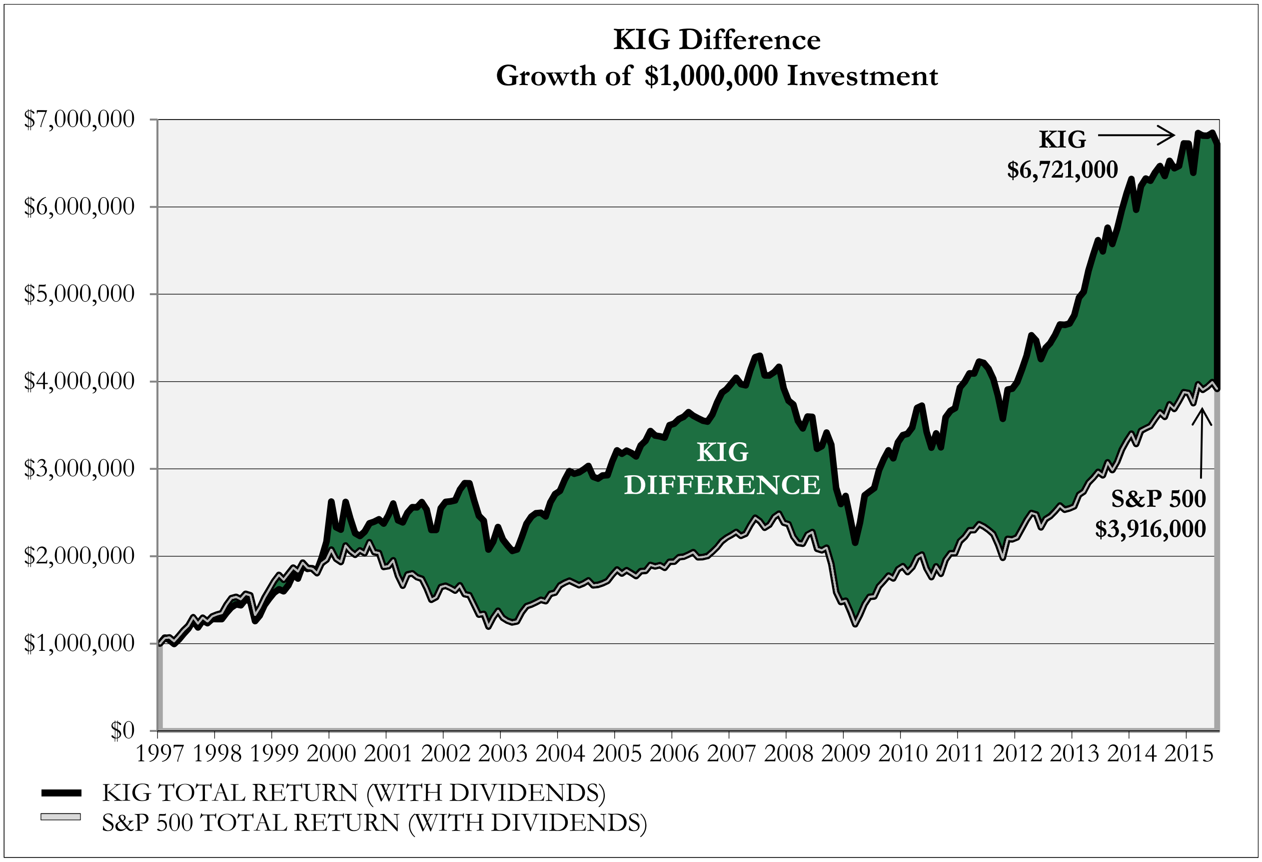
KIG vs. S&P 500
Annualized Equity Performance (Net of Fees)

	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (18.5 Years)
KIG*	3.9%	15.3%	15.7%	7.3%	7.6%	10.8%
S&P 500	7.4%	17.3%	17.3%	7.9%	4.4%	7.7%
Rolling Period Outperform Percentage	59%	74%	79%	90%	100%	NA

KIG vs. S&P 500
Cumulative Equity Performance (Net of Fees)

	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (18.5 Years)
KIG*	3.9%	53.3%	107.2%	102.2%	201.1%	572.1%
S&P 500	7.4%	61.4%	122.4%	113.7%	89.5%	291.6%

Please refer to the disclosure on the last page of this newsletter for additional discussion regarding the performance of the Composite.



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Firm Structure as a Competitive Advantage

We have discussed our investment philosophy a great deal over the years. We have what we believe to be a sound intellectual framework for making decisions and, even more importantly, the ability to keep emotions from corroding that framework. Our process allows us to keep a level head regardless of the market environment, which, in turn, allows us to sell to optimists and buy from pessimists. What we haven't discussed is our unique firm structure and why we believe our asset management/wealth management hybrid structure creates a symbiotic relationship with benefits that ultimately accrue to our clients.

Typically, most firms in our industry are set up as either an asset manager or as a wealth manager. Asset managers offer investment products, such as mutual funds or separately managed accounts, and select securities to build out these portfolios. Alternatively, wealth managers provide comprehensive financial planning advice, including asset allocation, budgeting, estate planning, tax planning, education savings, and retirement planning. Wealth managers also provide investment advice, but the actual security selection is generally outsourced to asset managers.

We've developed our firm as a hybrid of these two models. In our opinion, this affords us the best of both worlds: complete control over the investment process while also providing financial advice. Developing and maintaining solid client relationships based on an appreciation of our financial and wealth management advice on a myriad of financial issues that are extremely relevant to our clients leads to high client satisfaction, which in turn leads to high client trust and retention. High client conviction is the Holy Grail for asset managers with a focus on long-term results as it creates a source of quasi-permanent capital which enables the investment team to implement an investment strategy with a long-term orientation. This combination significantly reduces counter-productive forces such as concerns over matching up to short-term performance expectations and comparisons to short-term benchmark performance. Freed from these destructive forces, we can effectively implement our investment approach and operate in a much less crowded space, giving us the opportunity to make sound investments at attractive prices and skew the odds of long-term outperformance for our client portfolios squarely in our favor.

We are certainly not the only wealth managers that are committed to a long-term financial planning philosophy. Where other wealth managers run into trouble is when the investment management is outsourced to asset managers who cannot rely on such quasi-permanent assets to manage. At that point, these outside asset managers are forced to consider the short-term benchmarks that they are ultimately measured against by these outsourcing wealth managers. The aligned interests then break down. Investment management with a true long-term orientation is no longer possible.

Our clients allow us to make investment decisions using our preferred three- to five-year horizon, which is a meaningfully longer time frame than is employed by many of our peers. Stretching out our time horizon allows us to see value where others don't because many of our holdings are purchased lacking a near-term catalyst. We believe being indifferent to the timing of returns affords us opportunities to establish positions in stocks trading at highly depressed prices, thus lowering the overall risk of the portfolio. Additionally, it aids us in paying meaningfully lower prices as we are competing with only a small slice of the entire investor base.

Having an asset base that allows us to focus our energies on unearthing values, as opposed to guessing where markets or individual stocks are going next quarter, allows us to engage in an exercise that we believe holds a higher probability of success. Making decisions in this light gives us an advantage over those who work with fleet-footed capital. Asset managers facing demands for consistent quarterly or yearly returns are forced into a capital allocation strategy based on perceived near-term stock price movements because they are forever operating under the fear that a quarter or two of underperformance will result in an exodus of capital from their funds. These managers may see long-term value in many of the same stocks we do, but may not act on it because their clients could be gone before the value comes to the surface.

At KIG, we are very fortunate to have partnered with an investor base that embraces a long-term view. Our expectation is that by not needing to worry about the perverse incentives inherent in our industry, and remaining focused on our long-term orientation, investment results will continue to be quite rewarding.

Portfolio Activity

As a testament to how difficult it's been to find attractive new ideas, we didn't initiate our first new position of 2015 until mid-April when we purchased shares of **Harley-Davidson (HOG)**. Subsequent purchases of **American Airlines Group (AAL)** and **Precision Castparts (PCP)** and additions to existing positions **Quanta Services (PWR)** and **Jacobs Engineering Group (JEC)** rounded out the activity for the quarter.

Harley-Davidson is a well-known American brand, but the company is also well known to us for its operational excellence, consistent profitability, and strong free cash flow generation. The company's iconic motorcycles have been traversing the roads and highways of the U.S. for over a hundred years and they have come to dominate the market for motorcycles. Oddly enough, this market dominance was an indirect cause of the stock's recent price decline that created the opportunity for us to initiate our position.

The dollar's appreciation against global currencies, and specifically the Japanese yen, over the last couple years has allowed Harley's international competitors to offer steep discounts on bikes sold in the U.S. Harley's response, which we applaud, was to hold the line on pricing in order to protect the price of used bikes owned by their loyal customers and, ultimately, to protect their most important asset – the Harley brand. In the short run, this decision made Harley's products relatively more expensive than many of their competitors. This resulted in Harley losing some market share and, subsequently, in Harley's share price falling 20% since December. This includes a 10% decline on a single day in April at which point we decided to initiate our position.

In our view, Harley's strategy of protecting its brand even at the expense of a few points of market share is the right decision over the long run. Protecting its brand supports its dealer network and its customers and it shows a level of managerial discipline not commonly found in an environment where companies are continually focused on hitting next quarter's earnings and revenue expectations. When presented with the opportunity to purchase shares of a company with a strong brand, a management team that protects the long-term interests of shareholders, a history of strong free cash flow generation and high returns on invested capital, *and* which is trading at a discount to our estimate of intrinsic value based primarily on a likely temporary, currency-related issue, it is not a difficult decision to add it to our portfolio.

Regarding the second position we initiated during the quarter, it may come as a bit of a surprise to see American Airlines now listed among our holdings. Conventional wisdom has held that the airline industry is nothing but a black hole for investors. In the past, intense market share battles have seemingly been the sole focus of airline industry management teams, while high fuel costs, excessive debt, and volatile labor relations made it that much more difficult for the industry to sustain an attractive level of profitability. Indeed, one of Warren Buffett's more memorable quotes was, "If a farsighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down."[1]

However, the situation has changed dramatically over the last few years. Industry consolidation has resulted in four airlines – American, Delta Air Lines, Southwest Airlines, and United Continental Holdings – controlling over 80% of the domestic U.S. market, which has led to a more rational approach to pricing and capacity than has possibly ever been present in the industry. 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, which, in our opinion, is exactly on what a management team should be focused. Combined with the dramatic drop in fuel costs that has occurred over the last nine months, airlines are set to be flush with cash and, possibly for the first time, seem capable of deploying that cash in a manner that will create value rather than destroy it.

We purchased American Airlines for the simple reason that, at a price of about 7x our estimate of fully taxed earnings per share, it appeared to be trading at the greatest discount to our estimate of its intrinsic value in the industry. Despite this relatively low valuation, we still believed that risk surrounding the unknown future trajectory of fuel prices and whether pricing would remain as resilient as it has been in the face of falling fuel costs warranted both an even cheaper price and lowered expectations of upside.

Therefore, we took a somewhat unorthodox (for us) approach to establishing this position by buying a small position and simultaneously writing a call option. This strategy allowed us to lower our effective purchase price for the shares from approximately $40 to $36 in exchange for capping our upside at $50. As it happens, these levels coincided more or less precisely with where we wanted to buy the stock and what we think it's worth. Should the price of the shares fall into the mid-thirties on their own, we may consider adding to the position without the use of options.

The third position we initiated during this quarter was Precision Castparts. Precision Castparts is a manufacturer of complex metal components and products mostly for use in aerospace and power generation applications. Precision Castparts' products are typically used in jet engines, industrial gas turbines, aircraft components and other end products where a high level of both precision and durability are necessary.

The company has a fairly concentrated customer base due to the nature of the end markets for its products, but its customers typically operate in a duopoly/oligopoly position and Precision Castparts sells to all players. For example, its products are found in both Boeing and Airbus Group planes and in General Electric, United Technologies, and Rolls Royce Holdings jet engines. Long-term relationships with these key customers, amongst many others, and a reputation for quality make Precision Castparts' competitive position in its markets very difficult for competitors to displace. Furthermore, we believe the long-term demand for the end products that Precision Castparts

[1] Warren Buffet, *Letter to Shareholders (2008)*, p.8

provides components for remains robust. Therefore, any difficulties unique to any particular customer will likely be balanced out by another customer increasing its market share and leaving demand for the company's products intact over a meaningful period of time.

After trading near $275 about a year ago, the stock has lost about a quarter of its value due to a number of consecutive quarters where the company's earnings failed to meet Wall Street's expectations. The fact that 15% of the business is tied to energy infrastructure spending that is expected to be down considerably this year only exacerbated investors' negative sentiment toward the company. Not ones to focus on short-term results and with the stock now trading at a below-market multiple of 16x our estimate of the next year's earnings, we believed this was a good opportunity to purchase an above-average company that we expect to grow earnings faster than the market at a price that implies neither of those things is true.

We increased the position size in two portfolio names, Quanta Services and Jacobs Engineering. Both are in the engineering and construction industry and both are part of our basket of energy-related holdings initiated at the end of 2014. While both stocks are within earshot of where we originally purchased them, our conviction regarding their long-term growth prospects has grown stronger. While we continue to believe that certain projects related to oil production could easily get pushed out or delayed due to the decline in the price of the commodity, we believe the shares of each company are trading at a level implying that most of these revenues will disappear and never return. Cancellation of most or all of these projects, many of which have been planned for years and are designed to meet demands of the industry looking out decades into the future, seems like an extreme and unlikely assumption. Meanwhile, the prospects for these companies' projects not related to oil production, which are the source of the vast majority of their revenues, remain strong and are generally unaffected, or in some cases helped, by the lower price of oil.

Quanta is an industry leader in engineering and construction related to power transmission and distribution as well as natural gas distribution infrastructure (i.e., pipelines). The company has established a strong presence throughout the US and Canada, where it serves a multitude of regulated utilities and independent power producers. Quanta is well positioned to benefit from multiple drivers of transmission and infrastructure spend. Interestingly, while overall U.S. power demand is declining, the need for investment in the transmission and distribution of power is high due to multiple factors, including aging infrastructure, growth of renewable energy, coal plant retirement, and regulatory changes. As power generation shifts from coal-fired generators to natural gas-fired and as solar and wind gain share in the overall power grid, the need for transmission and distribution infrastructure investments is growing. According to the industry group WIRES, the United States will see investments of $120-$160 billion per decade through 2030. Transmission investments have grown from roughly $2 billion per year in the mid-1990s to over $15 billion in 2014. We expect Quanta to be a continued beneficiary of this trend as Quanta's long-standing strategic relationships allow the company to generate recurring revenue from its key customers.

Jacobs, which has a well-diversified revenue stream spread across multiple industries, provides engineering and construction services to industrial, commercial, and government customers. Jacobs is focused on long-term relationships with its preferred clients as a source of recurring business. Notably, repeat business has accounted for over 90% of Jacobs' revenues over many years and was over 97% in 2014. Jacobs' management believes that its relationship-based business model drives client loyalty, new project opportunities, and better results. The company's focus on sub-$500 million projects helps generate a more consistent revenue stream and lowers the volatility of earnings and backlog relative to some of its peers who rely on the feast or famine nature of bidding for major projects.

Both of these companies have what we consider to be asset-light business models, where capital expenditure needs are limited, resulting in high free cash flow generation relative to reported earnings. Strong balance sheets remain a strategic priority and competitive advantage for each company allowing them to more easily meet their working capital requirements on projects, pursue tuck-in acquisitions, and continue to buy back stock at currently depressed valuations.

We reduced our position size in **Viacom (VIAB)**. The media landscape is changing daily (and quite a bit from where we initiated our position), and Viacom faces many challenges to its business model. Ratings have been declining at its flagship cable stations – Nickelodeon, MTV and VH1 – where the viewing habits of its target demographic have shifted to over-the-top content and mobile offerings. Cable and satellite providers have also begun to tiptoe into the arena of offering "skinny" bundles of channels to accommodate those viewers looking to reduce the size of their cable bills. To date, Viacom has benefitted greatly from being included in the traditional, larger bundles. Valuation keeps us from exiting completely, but we are watching this evolution closely. We are well accustomed to being on the lookout for potential value traps (a company selling at a low valuation, but possessing deteriorating fundamentals), but we feel comfortable with Viacom at a smaller position size.

On the other hand, we remain enthusiastic about the prospects for another media holding, **CBS (CBS)**. We believe CBS is well positioned for whatever lies ahead for the media industry. The CBS Broadcast Network is a highly coveted channel that will likely be included in whatever bundles, skinny or otherwise, that are offered in the future. CBS's aggressive move to first initiating, and then increasing, retransmission fees from cable providers will more than offset declining advertising revenues. CBS's Showtime division is launching its own over-the-top offering with the goal of capturing viewers who have cut the cable cord and are piecing together their own lineup of online offerings. While still untested, this shows that CBS is taking the correct measures to protect and maximize the value of its already valuable assets.

Finally, we increased our position size in **Apple (AAPL)** for those clients that had less than 4%* exposure to the name. We've owned Apple since 2011 and over this time we have continually ratcheted up our intrinsic value estimates due to operating results exceeding our expectations. Despite the fact that Apple is about as well-known and well-followed as any company in the market today, we continue to believe that Apple is a very misunderstood stock. Most investors focus solely on how quarterly iPhone, iPad, and Mac shipments will compare with estimates. While these data may be important to *traders*, there are larger and more important issues that *investors* should be factoring in to determine value. The first is the integration of Apple's hardware/software ecosystem, rooted in superb technologies, into consumers' lives. Consumers appreciate the ability to jump from phone to computer to tablet while working with the same contacts, apps, photos, and media. Getting this right will lead to continued market share gains as Apple loses very few customers to competitors and gains new ones over time. Also, and arguably as important, is the company's fortress-like balance sheet, which includes approximately $150 billion in cash, net of debt. Apple management is returning a large portion of this cash to shareholders through stock buybacks and dividend payments, which we believe will be more important in closing the gap that currently exists between current market value and our intrinsic value estimate than whether next quarter's iPhone shipments will beat estimates or not.

> * Why did we focus on at least a 4% position size? Apple is currently the largest company, by market capitalization, in the S&P 500 accounting for a little less than 4% of index. In our world, if we like a stock enough to own it, and it's included in our benchmark, then the position size in our clients' accounts had better be greater than it is in the index.

We appreciate the faith that you, our partners, have placed in us to manage your capital on a long-term basis. The extended time frame you allow us provides a tremendous advantage as we go about our investment decision making. 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.

Best Regards,

Kovitz Investment Group

Kovitz Investment Group, LLC

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