KOVITZ INVESTMENT GROUP
Intrinsic Values®

Market Insights
Fall 2016

We are excited to share our thoughts with you in this inaugural issue of KIG Market Insights.

Kovitz Investment Group has grown significantly over the last two decades. We are very thankful to our clients for partnering with us along the way, and trusting us to grow and protect your financial well-being. We have always considered our clients to be our investing partners, and we have tried to use our Investor Commentaries as a way to share with you the same information we would seek if our roles were reversed.

The format of our core equity newsletter has remained roughly the same over the last 20 years. However, as our relationship with clients has grown over time, we have received overwhelming feedback requesting a letter that communicates more broadly on your entire financial advisory relationship with KIG, not one solely focused on our Core Equity Strategy. As such, we have decided to create a quarterly communication which shares our broader views and thoughts on topics and events that could impact the various investments and services you receive from KIG. In addition to discussing the Core Equity Strategy, we will look to share our views as they pertain to broad asset allocation, our management of our clients' fixed income and alternative investments, such as real estate and hedged equity, and the comprehensive wealth management and financial planning services we provide to our clients.

As always, we look forward to your thoughts and comments on how we can continue to improve our investment and wealth management commentaries.

Markets Review

The quarter began on the heels of the UK's unexpected decision to leave the European Union. At the time of the vote, the consensus view was that a "stay" vote would prevail, and the surprise outcome touched off a mini-panic where broad-based equities fell approximately 5% in the U.S and foreign markets declined generally just over 10%. Perhaps most surprising was that the panic proved to be short-lived, and equities recovered enough to reach new highs within a month.

As always at KIG, we continued to analyze the fundamental prospects of how an event would affect the investments we own, which could differ meaningfully from how the same event affects capital markets as a whole. We ask whether the event impacts the operating fundamentals of the companies whose equities we own. Has there been a change in the underlying credits of our fixed income portfolios? In our hedged equity and real estate strategies, has anything fundamentally changed?

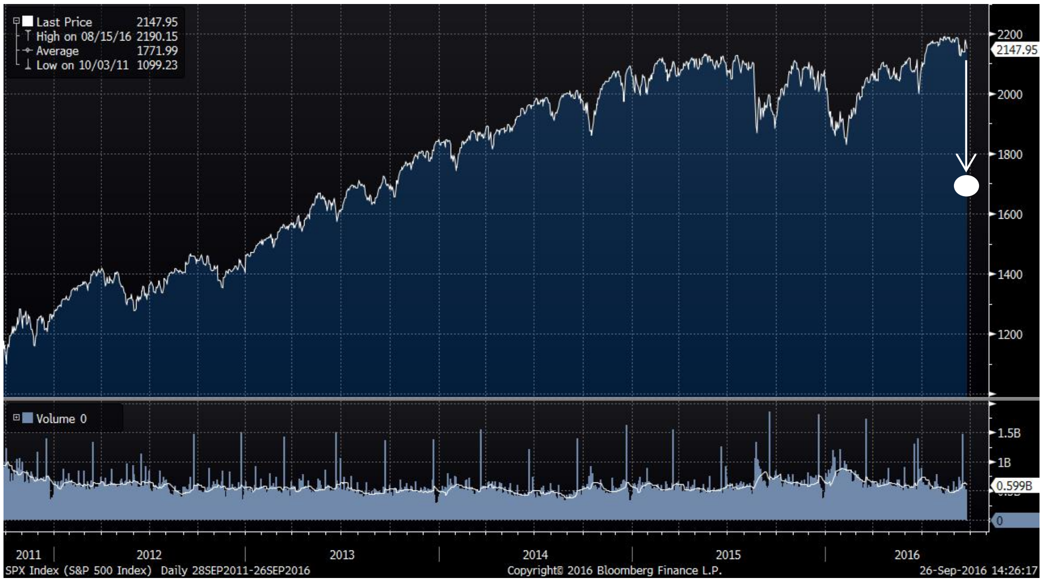
In contrast to this approach, there are many market participants who don't enjoy the benefit of a long-term investment philosophy grounded in analyzing underlying fundamentals, and they can often fall prey to the cycles of greed and fear. Given how swiftly the Brexit-induced panic passed, we view it as simply the most recent example of why maintaining a long-term perspective is the best means available to execute a long-range investment plan designed to meet your specific goals and risk tolerances.

Moving past the Brexit, equity markets went on to exhibit unusually low levels of volatility for most of the quarter, continuing a trend that has persisted for nearly five years. In fact, according to The Wall Street Journal, at one point in August the market had a 30-day stretch that was the least volatile of any 30-day period in almost twenty years. That changed in September, as debate raged over whether or not the Federal Reserve would raise interest rates 0.25%. To judge by the media attention, stocks were safe when they weren't gyrating all that much, and suddenly became quite dangerous after a few days of at least a 1% move in the markets.

To put things into perspective, we find it helpful to look at a five year chart of the S&P 500 as a proxy for stocks as a whole.

As the above chart shows, the recent volatility only feels noteworthy because there has been so little volatility for so long. The above chart is also interesting because it shows the most recent five year period has been a great time for U.S. large cap equity investors. An investor in these equities made roughly 15% annually while experiencing almost none of the gut-wrenching volatility for which stock markets are known. In our minds, this recent period of steady upward movement in stock prices has persisted long enough that it may explain why a stock market now trading less than 2% from its all-time high can be described today as having a heightened level of volatility.

We further observe that a normal stock market decline would usually look something like this:



Importantly, the above chart illustrates what would be considered a normal equity correction which is generally considered to be a 10-19% decline from a high, but one that would still fall short of a bear market (20%+ drop).

Put simply, for the last five years, the below-average level of stock market volatility has suggested the amount of risk facing investors is low. This is a misdiagnosis in our view. The rise in equity prices and decrease in volatility has not been driven by underlying company fundamentals, but rather by the lack of viable alternative investment opportunities. In fact, earnings for the market as a whole have declined over the last 20 months. Generally, when earnings decline, stock prices follow suit.

However, a new acronym "TINA" has become commonplace in the financial press to explain this new dichotomy. TINA, stands for "there is no alternative." We have arrived at this point because interest rates are very low and represent a penalty to savers. When investors buy bonds with 0% yields, they get their principal back, but lose to inflation. When they buy bonds at negative yields, they guarantee themselves a loss! Amazingly, there are approximately $10 trillion (that's Trillion!), government bonds around the globe trading with negative yields. This level of interest rates is undoubtedly distorting investor behavior.

TINA represents an investor's acknowledgement that while stock prices may be historically high and, consequently, the risks facing an investor are historically elevated, an investor is left with no choice but to buy them, given that the primary alternative is the ultra-low yields currently offered by most sectors of the fixed income market. This translates into the acceptance of greater-than-average risk while likely earning below-average rates of return. We discuss this in much greater depth in our accompanying Core Equity newsletter.

How We Position Client Portfolios

Given the environment described above, 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. In doing so, guarding against risk is paramount. In the current environment, investors must decide if they are willing to take on *greater levels of risk* than they have historically accepted for a *lower level of expected return*. Under these circumstances, we will steadfastly maintain our investment discipline and our risk requirements despite those justifying their actions with TINA. 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. All of that said, the last five years have gone very well across our portfolios as we evaluate comprehensively our investments in equities, fixed income, and alternatives, and we continue to like our current portfolio positioning. Specifically:

1. In equities, we remain focused on a portfolio of competitively advantaged businesses trading at much lower valuations than the market as a whole. This is discussed in much greater detail in our accompanying Core Equity commentary.
2. In fixed income, we continue to keep the duration of bond portfolios low. Please read more about this in our accompanying Fixed Income commentary.
3. Across most of our separately managed accounts and our hedged equity portfolios, we are defensively positioned and continue to carry elevated levels of cash while we look for attractive investment opportunities.
4. Where appropriate, we will recommend a shift of investments to include 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

Fixed Income Commentary

It's difficult to get excited about the current state of the fixed income market. Stimulus measures by governments around the globe have pushed interest rates to historical lows. There's over $10 trillion dollars of worldwide debt with negative yields – meaning bondholders are paying to loan their money. To increase their income, investors have been increasing their risk by pursuing various "fixed income substitutes," such as "dividend-paying" stocks, and bidding these securities up to valuations that make little mathematical sense. Meanwhile, the only fixed income topic media pundits seem to be discussing is the Federal Reserve's decision on where to set short-term interest rates.

In this difficult environment, we like our position in high-quality bonds with relatively low interest rate risk. Our bond ladders are constructed with investment-grade municipal and corporate issues ranging in maturity from one to eight years. The laddered strategy to bond investing allows investors to be relatively unconcerned about the future direction of interest rates. The concept is simple: If or when interest rates rise, large sums of cash will be maturing every year to take advantage of those higher rates. If rates remain at low levels for an extended period of time or even fall further, cash invested in the higher yielding longer maturities at the end of the ladder buoy the portfolio's return. We also don't believe we're giving up much yield by not extending past eight year maturities due to historically flat yield curves. As you can see from Exhibit 1, the difference between 10 year and 30 year municipal yields is the lowest since 2007 at roughly 0.70% – meaning investors are being compensated less for the risk of longer maturities.

Bloomberg

MUNSMSML Index (BVAL AAA Muni Yield Curve Slope 10-30 Year)

As a complement to our core bond ladders, we're still finding value in investment-grade non-agency mortgage-backed securities. Through these securities, we continue to invest primarily in securities backed by loans to prime borrowers with mortgage originations before 2005. Every year we become more confident in these borrowers as they have devoted over ten years to making timely mortgage payments and have built significant equity in their homes. In the event any borrowers default, we're solely investing in senior tranches of the securities, and there are subordinate tranches that substantially protect the bonds from suffering a principal write-down. Outside of our confidence in the credit quality of our mortgage-backed portfolio, there's also limited interest rate risk. The majority of our strategy is focused on bonds backed by post-reset adjustable-rate mortgages that are now floating-rate securities. If short-term interest rates rise, investors in adjustable rate mortgages stand to benefit as borrowers' interest rates will increase correspondingly.

Core Equity Commentary
Fall 2016

Market and Performance Summary

For the quarter ended September 30, 2016, the KIG Equity Composite (the "Composite") increased 5.8%*, net of fees, compared to a 3.9% increase for the S&P 500 Index.

While we never put too much emphasis on short-term results (and neither should you), we find this most recent quarterly performance heartening. Not from the standpoint of outperforming our benchmark, but because valuation parameters finally acted as a catalyst for price movement. In other words, more cheaply valued stocks finally did better than more richly valued ones. We have long argued that stock price movements over the last few years were not driven by the valuation of the underlying businesses and did not necessarily mirror the fundamentals or economic prospects of the underlying businesses. Price momentum, where expensive stocks continued to get more expensive and cheap stocks seemed to get ever cheaper, played a bigger role in determining stock price movements than valuation. Investors had also appeared to focus way too much on how much the company decided to pay out shareholders in the form of a dividend. A dividend payment is just a capital allocation decision. The intrinsic value of a company's stock should be based solely on the amount of cash it generates, not on whether management chooses to allocate a larger or smaller portion of that cash towards a dividend. We have felt that this type of investment landscape was unsustainable and we may be at an inflection point where math and economics will finally trump momentum and the chase for yield.

As we wrote last quarter in a section titled "You Don't Own What?", the asset management community had become almost maniacally focused on dividend yields from stocks as compensation for the meager yields which have prevailed in the bond markets over the past 18 months. We argued that this created an environment where traditionally defensive sectors, such as utilities and consumer staples, had become so expensive on a valuation basis that investors in these companies were exposing themselves to a great deal more risk than would typically be associated with the underlying businesses. It seemed to us that this was synonymous with the "Nifty Fifty" era, but instead of paying any price for growth, investors were paying any price for stability and dividends. Our punchline was, "*We would caution that there's danger in thinking you're defensively positioned when you overpay.*" The misconception is that there is somehow a margin of safety inherent in some business or market characteristic (i.e. low volatility, high dividend) rather than in the relationship between a stock's price and value.

However, the love affair with "boredom" may have peaked. As we illustrate below with updated tables from last quarter's Commentary, performance of those stocks we highlighted as being "dangerous" has been quite poor while the performance of the subgroup of stocks we highlighted as being extremely undervalued was quite good. Specifically, the baskets of Consumer Staples and Utilities stocks averaged *losses* of 7.6% and 6.6%, respectively, while the KIG group averaged a *gain* of 11.5% (as a reminder, we selected the ten Composite holdings in the table below because they've

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been trading at PE multiples that represent significant discounts to their ten-year averages in spite of their fundamental strengths). What will become of these equities being held as bond substitutes if interest rates, which have only recently begun to inch higher, actually move higher in earnest? Stay tuned.

Consumer Staples		June 30th Closing Price	Sept. 30th Closing Price	% Change
Altria Group	MO	$ 68.96	$ 63.23	-8.3%
Clorox	CLX	$ 138.39	$ 125.18	-9.5%
Philip Morris International	PM	$ 101.72	$ 97.22	-4.4%
General Mills	GIS	$ 71.32	$ 63.88	-10.4%
Hershey	HSY	$ 113.49	$ 95.60	-15.8%
Kimberly-Clark	KMB	$ 137.48	$ 126.14	-8.2%
Campbell Soup	CPB	$ 66.53	$ 54.70	-17.8%
Colgate-Palmolive	CL	$ 73.20	$ 74.14	1.3%
Kellogg	K	$ 81.65	$ 74.14	-5.1%
Pepsico	PEP	$ 105.94	$ 108.77	2.7%
			Average	**-7.6%**

Utilities		June 30th Closing Price	Sept. 30th Closing Price	% Change
Sempra Energy	SRE	$ 114.02	$107.19	-6.0%
Edison International	EIX	$ 77.67	$72.25	-7.0%
Xcel Energy	XEL	$ 44.78	$41.14	-8.1%
Consolidated Edison	ED	$ 80.44	$75.30	-6.4%
SCANA	SCG	$ 75.66	$72.37	-4.3%
WEC Energy Group	WEC	$ 65.30	$59.88	-8.3%
Dominion Resources	D	$ 77.93	$74.27	-4.7%
NextEra Energy	NEE	$ 130.40	$122.32	-6.2%
Duke Energy	DUK	$ 85.79	$80.04	-6.7%
Public Service Enterprise Group	PEG	$ 46.61	$41.87	-10.2%
			Average	**-6.6%**

Select KIG Holdings		June 30th Closing Price	Sept. 30th Closing Price	% Change
Apple	AAPL	$ 95.60	$113.05	18.3%
General Motors	GM	$ 28.30	$31.77	12.3%
Quanta Services	PWR	$ 23.12	$27.99	21.1%
CarMax	KMX	$ 49.03	$53.35	8.8%
CBRE Group	CBG	$ 26.48	$27.98	5.7%
Harley-Davidson	HOG	$ 45.30	$52.59	16.1%
Kohl's	KSS	$ 37.92	$43.75	15.4%
Boeing	BA	$ 129.87	$131.74	1.4%
Jacobs Engineering Group	JEC	$ 49.81	$51.72	3.8%
Alphabet	GOOG	$ 692.10	$777.29	12.3%
			Average	**11.5%**

In the meantime, our job is to continue to identify companies that are unappreciated by the market and whose shares are undervalued. A contrarian approach – avoiding recently expensive securities and favoring recently cheap securities – may be uncomfortable in the short run, but it is a sound way to generate outperformance in the long run. Our job is to endure the emotional discomfort of deviating from the crowd, which sets the stage for our style of investing to continue to work over time. The bedrock of our philosophy is that price matters. Our clients would be poorly served if we chose to simply pile into whatever shares had appreciated the most over recent years, ignoring price, valuation, and underlying fundamentals. This is a time when paying calm, careful, and deliberate attention to the changing investment landscape can have a tremendous payoff.

After a seemingly long hiatus volatility returned to the equity markets in September. Peace and quiet had been replaced with restlessness and fluctuation. Until late in the quarter, the equity market was generating one of its lowest volatility readings going back as far as we can remember. The S&P 500 actually went nearly two months without a daily move of 1% or more. Most of the quarter had been eerily quiet, but concerns over the direction of interest rates broke investors' complacent mood in early September. Just the mere fact that money had been pouring into low volatility strategy ETFs should have sounded a siren that calmness and tranquility were nearing a top.

While world-wide events have always had a somewhat mystifying impact on investor psyche, today's environment seems even more confounding (or does it always just feel that way when you are currently in it?). Federal Reserve policy in the U.S., negative interest rates in Europe and Japan, China's impact on worldwide economic growth, terrorism, and a divisive presidential election are just a few of the wild cards that may lead to a prolonged period of volatility.

This is not something to fret over, however. The amalgamation of these conditions has the potential to lead to the kind of volatility and divergence in the markets that present opportunities for disciplined, value-conscious investors. Remember, the lack of volatility has been the primary reason we have had difficulty finding attractive new ideas.

We have never believed that volatility, or the bouncing around of stock prices, is the same thing as risk. Risk, to us, is the chance that an investor will suffer a permanent loss of capital in an investment. If the stock market's action in late 2008 and early 2009 taught investors anything, it was that fear and panic-driven volatility did not mean that investors who were purchasing shares in those dark days were taking on more risk. Instead, they were simply taking advantage of artificially low prices brought on by volatility as the tripling in the market since those lows has proven.

The combination of buying at a sufficient discount to value and having a long time horizon—key elements of our overall investment strategy—makes us comfortable investing in businesses that may be experiencing short-term price volatility. In addition, we believe that our clients' current cash positions, which are higher than normal, may prove to be a significant advantage as events unfold over the rest of the year. We try to deploy as much of our clients' assets as we think prudent given the opportunities we see, and although we haven't seen much over the last couple of years, we will be prepared to capture attractive opportunities as they emerge.

The stock market may continue to trend upward, go sideways, or it may suffer a correction. We do not know. We cannot know. However, over two decades as investors, we have learned that we do not need to know. All we (and our clients) need is a collection of good businesses, patience, and the courage of our convictions. We are highly confident that the value of our businesses will continue to grow over time and that the increased value will inevitably be reflected in higher stock prices.

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

	YTD	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (19.75 Years)
KIG Composite - Annualized*	5.7%	8.6%	4.8%	13.1%	5.8%	7.3%	10.0%
KIG Composite - Cumulative*	5.7%	8.6%	15.1%	85.0%	75.9%	187.3%	561.2%

We benchmark our equity returns vs. the S&P 500 because we think it is the most commonly referenced US equity market index and is generally the pond we tend to fish in for investment opportunities. That being said, we do not limit our potential universe of companies to only those listed in the S&P 500. Oftentimes, a portion of our portfolio will be invested in companies with a market capitalization not quite the size of those in the S&P 500, or perhaps even in companies listed on a foreign exchange (longer-term clients will remember us owning Adidas, which is listed on the German exchange). We bring this up to reiterate that we will invest in companies where we find the

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best risk-adjusted opportunities and not be limited to the companies someone has decided should be included in a specific benchmark. This mix of companies in our clients' portfolios has changed over time and will continue to change in the future.

One of our investment tenets where we feel we differ most from the general equity investing world is we do not subscribe to the idea that you should always own every classification of stock at all times. Price matters. We strive to own stocks that are fundamentally strong and where its current price trades at a significant discount to our estimate of intrinsic value. We will not hold securities that don't meet these criteria in order to fill a certain style box (e.g. small cap stocks, emerging markets, etc.). The commonly held belief is that by being in all the boxes you will either increase your return, dramatically reduce your risk, or both. Our studies of markets over time have shown that this approach has accomplished neither of these goals, and generally produced average or below-average returns with similar risk being assumed. We believe it is a much better strategy to purchase stocks at a significant discount to their intrinsic value and wait. Patience may be the most underrated trait in investing.

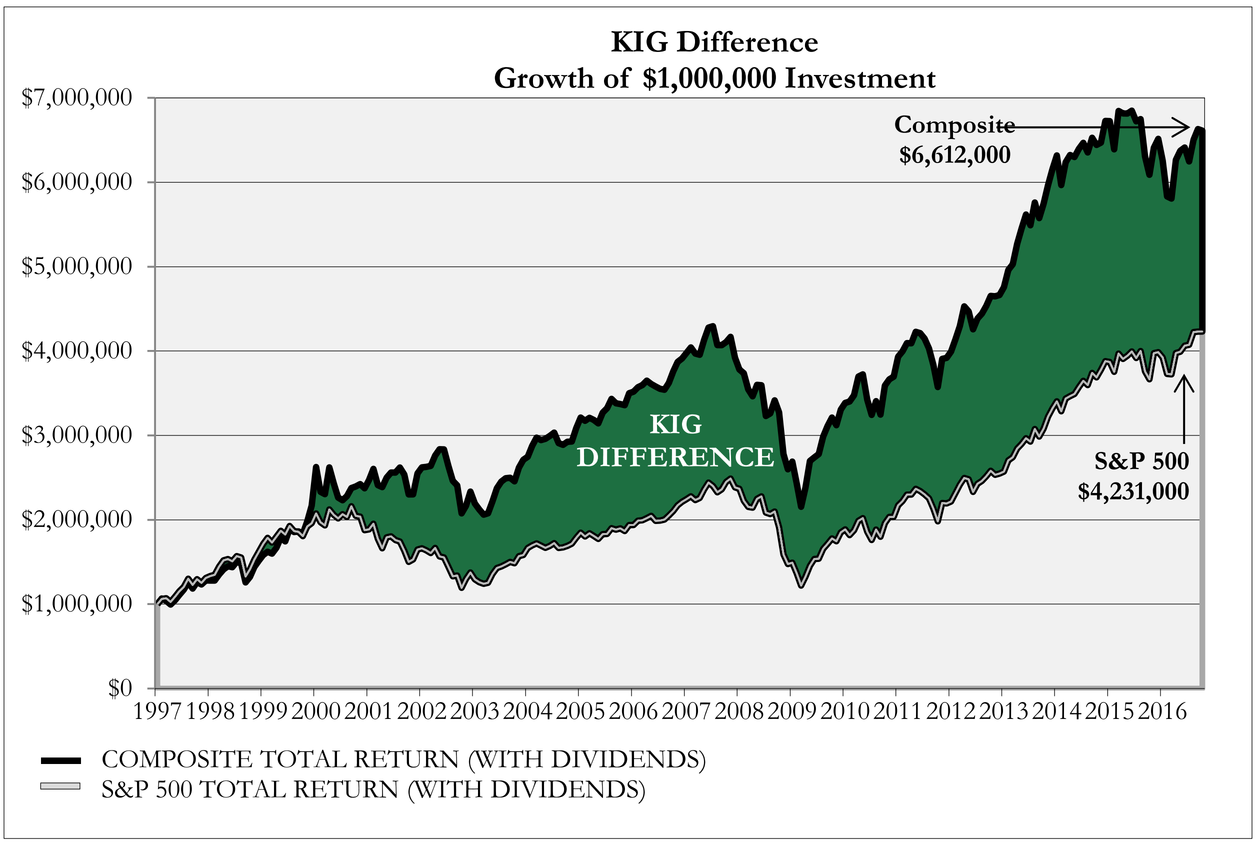
While the Kovitz strategy of being opportunistic has done significantly better than the general style box approach since the Composite's inception, the past 3-5 years have been particularly strong on a relative basis, despite having trailed the S&P 500 during that time. The table below lists the results for the S&P 500 and many of the other benchmarks widely held as investments via a style-box approach:

Other Market Indices
Annualized Equity Performance

	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (19.75 Years)
S&P 500	15.4%	11.2%	16.4%	7.2%	7.1%	7.6%
Small Cap Equity (Russell 2000)	15.5%	6.7%	15.8%	7.1%	9.3%	7.9%
International- Developed (MSCI- EAFE)	6.5%	0.5%	7.4%	1.8%	5.8%	4.3%
International- Emerging (MSCI -EEM)	16.8%	-0.6%	3.0%	3.9%	11.5%	5.5%
Gold	17.3%	-0.7%	-4.6%	7.3%	9.8%	6.3%
Commodities (CRB)	-0.2%	-4.9%	-4.4%	1.6%	4.2%	1.7%

If we compare the index returns listed above, one can see that the S&P 500 has substantially outperformed all but the Russell 2000 since our Composite's inception, but the performance differential is most striking over the most recent 5-year period. During this time, US Large Cap stocks have compounded at 16.4%, while these other markets have dramatically under-performed that return and, in some cases, even experienced declines. Readers of our prior commentaries may recall that we've discussed some of the factors leading to the unusual performance of S&P 500 over the past few years. One of the major anomalies discussed was the benefit to the index's return received from the strong performance of a handful of its constituents that went from being fairly valued to dramatically overvalued. In actuality, most stocks in the index fared much worse than the topline returns suggest. In other words, unless an investor owned only the most expensively valued companies in the U.S. market and had no exposure to international stocks or commodities, that investor underperformed the S&P 500 over the last five years. The more an investor "diversified" into international stocks or commodities, the greater the underperformance was likely to have been. In comparison, we believe our clients' portfolios are chock-full of undervalued, competitively advantaged companies that should fare well, particularly on a relative basis vs. the S&P 500, from this point forward.

Below is a graph of the KIG Composite 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.



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

Portfolio Activity

There was a fairly low level of portfolio activity this quarter, though it wasn't due to any lack of effort. We continue to look for companies that have strong balance sheets, generate significant free cash flow, have management teams that allocate capital to maximize per-share value, and that sell at a discount to our estimate of fair value. These have been extremely difficult to find. Of the many companies we dig into each quarter, we end up concluding that most do not offer any significant margin of safety. Those that do seem to be in sectors where we have significant representation already (i.e. financials and industrials). We continue to delve into the sectors where we have less representation (i.e. healthcare or consumer staples), but we have had limited success finding candidates that offer the combination of business quality and price we require.

As such, we did initiate one new position, **AMERCO (UHAL)**, during the quarter. We also increased our position sizes in two companies, **CVS Health (CVS)** and **CBS (CBS**). On the sell side, we reduced our position in **Jacobs Engineering Group (JEC)** and we eliminated our stake in **Bed Bath & Beyond (BBBY)**.

New Position

AMERCO's primary business is U-Haul, the largest moving truck rental company in the United States providing services primarily for the do-it-yourself (DIY) market. The company also owns and operates a large and growing number of self-storage facilities. The company's management team operates with a long-term focus, continuously enhancing UHAL's competitive advantages and consistently increasing market share at the expense of competitors. The CEO, who has run the company since 1986, is the son of the founder of the company, and the family maintains a significant equity stake of over 50%.

For most of its 70+ year history, numerous well-financed competitors have tried and failed to encroach on U-Haul's ever-growing lead in the DIY moving equipment rental market. Today, the fragmented industry has been whittled down to three primary players: U-Haul, Budget Truck Rental, and Penske Truck Rental. Budget has retrenched its rental equipment segment in recent years, allowing U-Haul to dominate the DIY market with roughly a 50% market share. U-Haul controls this market niche with more than 10x as many locations (i.e. pick-up and drop-off hubs) and 4x as many trucks as its nearest competitor. Of U-Haul's 21,000 locations, approximately 10% are company owned while the remaining 90% are franchised.

While rare to find companies with even one strong competitive advantage, we believe the U-Haul business maintains two distinct sustainable competitive advantages – its brand name and a network effect. The U-Haul name is synonymous with moving and is one of the most recognized brands in the United States. Brand equity translates to a higher value perception in the marketplace, and this perception is reinforced by its large network of hubs and trucks, which results in enhanced convenience for customers while providing a better value proposition to prospective franchisees. U-Haul is able to continually offer a better service at similar prices, differentiating itself and further widening its economic moat relative to its competitors. We believe this established network of pick-up and drop-off points, combined with continued investment in growing its truck fleet, constitutes a durable competitive advantage and a significant barrier to entry that will allow the company to earn a return on capital in excess of their cost of capital well into the future.

The company's growing self-storage business is highly complementary to their core truck rental business and is aided by strong demographic tailwinds that have been powering growth across this industry for some time. The company owns and operates over 1300 self-storage locations that encompass nearly 48 million square feet. If AMERCO's self-storage business were a stand-alone entity, it would be among the largest self-storage Real Estate Investment Trusts (REITs) in the United States. The self-storage business has very attractive economics because its low operating and maintenance costs allow for the generation of substantial free cash flow.

The stock has fallen about 20% over the last couple months after 2nd quarter earnings came in below expectations. However, our belief is that this was only a temporary blip in what has been a somewhat volatile, yet persistently upward sloping earnings path. The company has very limited analyst coverage due to its small float, which could lead to a higher potential for both upside and downside earnings surprises, but we're content to let management continue to operate outside of the pressure of playing the quarterly earnings game. The company currently trades at 13x our earnings estimate for the current year, and 11x our estimate of free cash flow before growth capital investments. We feel these valuations are low on both an absolute basis and relative to the overall stock market.

Increased Position Size

Both CVS Health and CBS continue to perform well operationally. Rather, idiosyncratic industry concerns have pushed the stock prices down to levels we deem attractive.

CVS's Pharmacy Services segment (known as a Pharmacy Benefit Manager or PBM) continues to benefit from growth in its specialty pharmacy business and very strong net new business results from its ongoing 2017 selling season. We believe this is a direct result of the PBM's high levels of service, execution, and competitive pricing, along with its unique integrated model that allows the company to provide differentiated products and services that generate savings, better health outcomes, and convenience. The Retail Pharmacy (i.e. CVS drug stores) continues to experience organic market share growth as well as growth through acquisition, such as the recently completed takeover of all of the pharmacies within each Target store. So why have the shares fallen so much as of late? We believe it is a secondary effect of the backlash against Mylan and the much-publicized criticism of the company for raising the price of their emergency treatment for allergic reactions, the EpiPen, by nearly 400% over the last several years. Mylan's CEO, in her attempt to pass the blame, seemed to imply that it was the pharmacy distribution channel (which includes PBMs and retail pharmacies, among others) that was the primary cause of the increased prices and not Mylan's desire to reap excessive rents from its product's near-monopoly of the segment. We are confident in the value that PBMs provide in reducing the amount of drug spend and that the trend towards the "retailization" of healthcare makes neighborhood drug stores an indispensable option. While we acknowledge that the PBM business model may be considered opaque, we believe that PBMs are part of the solution to helping to lower drug prices, given their ability to utilize scale in negotiating with manufacturers and dispensing pharmacies, as well as their clinical programs focused on lowering drug spend and improving health outcomes. Trading at approximately 15x our estimate of adjusted earnings, which approximates free cash flow, we believe the market is not valuing CVS's unique suite of assets appropriately.

There are a couple areas of investor apprehension regarding CBS. The first concern, which already existed at the time of our initial purchase, is how the proliferation of over-the-top (OTT) services, such as Netflix and Amazon Prime Instant Video, will impact "old media" companies like CBS. Despite the changing landscape, we believe CBS is well-positioned for wherever the industry is headed longer-term. The company has taken an aggressive stance with the multi-channel video providers, such as Comcast, and local broadcasters in boosting retransmission and reverse retransmission fees, respectively. This relatively new source of revenues for CBS is on track to reach $1b in 2016, with a longer term goal of $2b by 2020. Besides driving long-term growth, these types of high margin revenues have the added benefit of making the company less reliant on advertising, which is inherently more cyclical and currently makes up approximately half of total revenues. Furthermore, CBS is intently focused on increasing subscription-based revenues. The company has an extensive library of premium content that it monetizes over multiple platforms. Moreover, keeping up with customer demand and successfully pivoting to where the pay-TV bundle may be headed, the company has launched over-the-top (OTT) services of its own for both its Showtime and CBS networks. In aggregate, both services are gaining traction and have acquired over 2 million subscribers in a relatively short period of time.

The second area of concern, which has bubbled up only recently, is that investors are fearful that CBS will somehow be forced to merge with the troubled Viacom. Through their closely held company, National Amusements, Sumner Redstone and his daughter Shari effectively control both CBS and Viacom through the ownership of super-voting classes of shares. They recently forced the ouster of Viacom's long-time CEO and formally asked the boards of both companies to consider a potential merger where the combined company would presumably be led by CBS's well-respected CEO, Les Moonves. While our preference would be for no deal, we do not believe a combination would be value destroying. The potential synergies between the companies would be large and would likely offset any contraction in CBS's multiple, and Viacom's collection of assets may be worth more in Moonves' hands than they are currently. Valuation is undemanding at 12x our current year's earnings estimate. Any further downside from this point would be hard to substantiate, while the end of uncertainty surrounding these merger rumors, regardless of what happens, may be all that's needed for the market to award CBS a higher valuation that more accurately reflects the company's intrinsic value.

Decreased Position Size

Jacobs Engineering's solid financial results so far this year have led to strong performance in the price of its stock. As the discount to intrinsic value narrowed, we scaled back our position during the quarter. We continue to like Jacobs' business and believe the new management team has the company on course to enhance its future prospects. We simply felt that the company's current valuation warranted a smaller position size.

Eliminated Position

Speaking of smaller position sizes, we took our position in Bed Bath & Beyond to zero. While Bed Bath remains a solid operator of brick-and-mortar stores, we believe its lagging technological capabilities in the face of intensifying on-line competition and ineffective promotional strategies point to further gross margin pressure and continued risk to market share. In short, despite its low valuation, we lost confidence that the company would be able to shape the challenging landscape to their advantage.

Performance Attribution

Positive Contributors

The investments that had the largest positive impact on the Composite's relative performance for the quarter included **Quanta Services (PWR)**, **Apple (AAPL)**, **Kohl's (KSS)** and **Bank of America (BAC)**.

Quanta Services did not necessarily report any market-moving information, yet the stock performed strongly during the quarter. Since there was no apparent catalyst, our theory on the price movement is that investors have gotten more comfortable with the idea that conditions in the company's main end markets, electric transmission and oil and gas pipelines, are improving. Our thesis has been, and continues to be, that these end markets would ultimately improve, but we were unsure of the timing. In a way, this is the essence of our brand of value investing – committing capital to a high quality, competitively strong business that may be undergoing temporary issues that cloud its normalized earnings power. In these cases, the catalyst for price appreciation typically is a low valuation meeting improving fundamentals. By taking a longer time horizon where we are agnostic on the timing may delay return, but we believe it will result in larger compounding of returns over the entire time horizon than had we waited for the uncertainty to clear.

Apple's stock price performance was the beneficiary of low expectations. Early (very early) indications of the iPhone7 launch are that it is tracking ahead of expectations, which may be due in part to the ongoing struggles of its primary competitor, Samsung, who is undergoing an embarrassing recall of its latest phone due to battery issues. While investors seem to focus solely on quarterly iPhone sales and whether or not the improvements to each successive version of the iPhone are sufficiently "game-changing," we have long believed that the key to estimating the company's intrinsic value is the strengthening of the Apple ecosystem. The Apple ecosystem, where all its devices seamlessly tie together, has led to extremely high retention among current Apple product users and it continues to drive market share gains at the high end of the device market. Service revenue also continues to become a larger share of overall revenues. The company is valued by the market as a hardware manufacturer, but the effectively recurring revenue stream the company has created deserves to be valued more like a consumer staple.

Speaking of low expectations, Kohl's reported earnings that beat expectations due to sales declining less than expected, higher gross margin, and strong inventory management. Kohl's management team has done a respectable job adapting to the new omni-channel world retailers face by continually improving their online presence, keeping brick-and-mortar customers engaged with an effective buy-online-pick-up-in-store program, and offering a somewhat differentiated product (a combination of in-demand national brands combined with a variety of proprietary private-label brands). While still a challenging environment, these positives combined with a still undemanding valuation of less than 10x our free cash flow estimate lead us to believe Kohl's still offers more upside if it can continue the momentum reported this quarter while downside appears to be minimal at these prices.

Many of our bank holdings rose strongly during the quarter despite the Federal Reserve maintaining interest rates at current levels. The reason, in our opinion, is two-fold. First of all, while the Fed's targets directly impact only the short end of the yield curve, the long end of the curve rose sharply from the Brexit-induced lows reached in late June. This has caused the yield curve to moderately steepen, which should benefit banks' net interest margins in future periods. Lower net interest margins have been problematic, and any increase will benefit earnings growth across most of the financial sector. Secondly, we think that valuations had been (and still are) extremely low and that over time will revert higher. We've talked about the many and varied reasons for this in past newsletters (see *Spring 2016 Commentary*, "Banking on a Return to Rationality"). Bank of America, despite being our best performing bank stock in the quarter, still sells for less than its tangible book value. We expect this gap will continue to narrow. Besides the anticipated benefit to earnings from higher interest rates, the bank has a great deal of flexibility in its cost structure. Potential expense reductions within the company's control include further branch consolidation, lower occupancy costs, technology efficiencies, and the ongoing grind down in legacy costs. These pave the way for continued improvement in its efficiency ratio over the next several of years. Coupled with improvements on the revenue side from both loan and fee growth, this creates strong positive operating leverage. The banking sector will continue to face headline risks, but they also have many additional avenues to create value for shareholders.

Negative Contributors

The investments having the most negative relative impact on the portfolio included CVS, **McKesson (MCK)**, **Walt Disney (DIS)**, and **Walgreens Boots Alliance (WBA)**. The reasons for weakness in CVS were discussed above and Walgreens Boots has been caught in the same headwinds.

McKesson, which we initially purchased last quarter, saw its price rise sharply into its quarterly earnings report, but then it began to falter as drug distributors were also ensnared in the EpiPen controversy. Recently, company management also disclosed that brand name drug pricing was not going to increase as much as anticipated in the near term. This is not surprising given that serial drug price increases have become a political football. Drug manufacturers are likely seeking to "fly under the radar" and not draw attention to themselves during the election season. Interestingly, while the distribution of branded drugs makes up approximately 65% of McKesson's revenue, it is far less profitable than the distribution of generic drugs and contributes less than 15% to their gross profit. Generic drugs have also experienced their own disinflationary pressures, but, if you recall, our initial buy thesis was that the generic issue was well known and fully discounted in the valuation. This was the primary reason McKesson's stock went from $225 to $165, where we made our initial purchases.

Walt Disney has become somewhat of a battleground stock. The bulls point to the company's wonderful collection of assets, which include: its resorts and theme parks, including one recently opened in Shanghai; movie studios, including Pixar, Marvel and Lucasfilm (Star Wars franchise), and the resurgent Walt Disney Animation (Frozen); monetization of intellectual property through consumer products; and a collection of broadcast and cable assets, including ESPN, Disney Channel and ABC. The bears seem to focus exclusively on the changing media landscape, including cord cutting/shaving, and the impact it could have on ESPN, the company's heretofore cash cow. While we are firmly in the bull camp on a long–term basis, we do recognize the challenges ESPN faces in overcoming a slowly shrinking cable audience and its ability to continue to fund the high cost of its sports content rights. However, as things always are in investing, it comes down to what's reflected in the price. At its current price, we feel the ESPN issues are almost fully discounted while the potential upside from many of its unique assets is being ignored.

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 provides 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.

Best Regards,

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