KOVITZ INVESTMENT GROUP
Intrinsic Values®

Investment Commentary
Winter 2016

Market and Performance Summary

We're always happier when we can report to you that we've had a year of strong outperformance – but this wasn't the case for 2015. It's important to recognize that it is inevitable that we will underperform the market from time to time. This simply comes with the territory if your goal is to compound money at high rates of return over many years and to achieve long-term outperformance of the market.

For the quarter ended December 31, 2015, the Kovitz Investment Group® (KIG) Equity Composite (the "Composite") increased 2.8%[1], net of fees, compared to a 7.0% increase for the S&P 500 Index. For all of 2015, the Composite lost 7.0%, versus a gain of 1.4% for the S&P 500. From its inception in January 1997 to the end of 2015, the Composite has compounded at an annual rate of 10.1%, versus a 7.5% annual return for the S&P 500.

While an index is simply a statistical listing of a broad group of companies, we know that it can be a daunting competitor over various time periods despite its rather random construction. Lately, investors who have stuck to a passive portfolio have been more successful than any well-thought-out, actively managed strategy. Intellectually, and logically, we do not believe that can continue indefinitely. Our concentrated, bottom-up approach has historically produced strong, long-term results for our client partners even though the path was certainly volatile at times. After all, to beat the index, you cannot own the index. In the short term, our divergence from the index sometimes works to our disadvantage. But in the long term, this divergence has proven to be a considerable advantage. By owning a portfolio that doesn't mirror the index, the Composite has achieved a 5.3-fold gain since its inception nineteen years ago, versus a 2.9-fold gain for the S&P 500 over the same time period. Put another way, $1 million dollars invested with us 19 years ago would be worth $6.3 million today (after including the effect of our fees), while that same investment in the S&P 500 would be worth only $3.9 million.[2]

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[1] *The equity 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. For accounts with an allocation to bonds, please consult your KIG representative for total return information.*

[2] *Please refer to KIG's "Growth of $1 Million" marketing material for additional information, including relevant disclosures about the Composite, which you can obtain by contacting your financial advisor, or by emailing us at info@kovitz.com.*

To our knowledge, every investor with an enviable long-term track record has had periods of underperformance. Indeed, some of the most revered investors have endured multiple years of underperformance in which they were widely criticized for "losing their touch" or failing to understand some new paradigm. We ourselves clearly remember being chided for not buying Internet stocks in 1999 and again in 2007 for not buying commodities and commodity-related stocks. Following both of these periods, the Composite handily outpaced that of the overall market once the euphoria with those types of assets wore off.

So has something changed this time? Sir John Templeton once said, "The four most dangerous words in investing are *it's different this time*." While each market cycle is never quite the same, the laws of economics will never be repealed and investing will always be about receiving more in value than the price you pay. As long-term investors, our research process emphasizes the appraisal of factors that we believe matter most to a business's long-term success. These include the possession of one or more durable competitive advantages, a strong balance sheet with a sensible amount of debt and low financial risk, cash flows whose timing and amount are reasonably predictable, and the ability of the management team to allocate capital intelligently and judiciously. We believe these attributes are the most reliable predictors of a company's ability to maximize intrinsic value on a per share basis.

However, a large part of our recent underperformance reflects continued strength in a few high growth consumer-facing technology companies (e.g. Facebook, Amazon, Netflix), which, in our opinion, sell at bubble-like multiples of current free cash flow. These stocks, along with a handful of others trading at high price-to-earnings multiples, contributed a disproportionately large share of the S&P 500's return this year relative to their weights in the index. During 2015, the top 15 contributors to the S&P 500's total return accounted for 3.9% of the index's 1.4% total return. In other words, 3% of the index's constituents made up 280% of the index return while the other 97% of the index members, in aggregate, had a negative return. There is never a year where all stocks in an index perform exactly the same, but what happened in 2015 is still in stark contrast to most other years where the contribution to the overall index returns is much more broad-based.

This fact pattern has all the trappings of a "buy high/sell higher" market or, as we like to call it, a "greater fool" market. The same 15 stocks mentioned above now trade at over 32 times the current year's GAAP earnings per share, while the S&P 500 as a whole trades at only 16 times. We like growth as much as the next investor; however, we won't pay any price to acquire it. In other words, we will stick to our tried and true method of endeavoring to "buy low/sell high".

The market goes through these periods from time to time where valuations don't seem to matter, but we have seen repeatedly that stock prices eventually reflect the underlying value of corporations. Broadly speaking, our strategy is to own a relatively concentrated portfolio of the very best ideas we can find — essentially, what we believe to be the highest quality businesses with the greatest certainty of upside. We are long-term holders of stocks in companies where we believe the fundamentals are better than their valuations suggest.

However, regardless of how sensible and rational the foundation of our investment philosophy is, it is unable to make any forecast as to the timing of when the returns come. Therefore, we can't predict whether our collection of stocks will outperform our benchmark this coming year or, for that matter, the year following. Nevertheless, based on our historical results and that of other investors following a similar battle-tested approach, we're confident that this strategy works — and will continue to work — over time. One reason why many investors do so poorly over the long term is that it requires psychological discipline to stick with the program when the whims of the market move against them. Fortunately, the nature of the stock market is ultimately to shift money from impatient investors to patient investors.

We are confident that the high level of quality across such a large percentage of our portfolio companies, our extremely capable management partners, and the attractive margin of safety in our companies' stock prices will ultimately be reflected in the stocks' performance, thus rewarding your patience and ours. Despite our frustration with regard to our recent performance, we also remain confident that our philosophy, built on the idea that excess returns go to those who have a long-term perspective and focus on intrinsic value, will position the portfolio for favorable results over longer periods of time.

The path to successfully compounding wealth doesn't revolve around doing whatever is popular today. It doesn't involve grabbing all of those bright, shiny objects that tend to attract short-term investors. It involves buying great companies at highly attractive prices and sticking with them. To do this, we need the discipline and detachment to sit quietly to one side, far from the noise of Wall Street. Operating independently of the crowd requires a particular type of temperament — both for us as the manager and you as our partners. We feel very fortunate to have you as our partners and we will do everything we can to continue to deserve your trust. Keep in mind, past underperformance is not a guarantee of future underperformance.

The following is our standard performance report for the Composite, which now encompasses 19 years. The chart summarizes both annualized and cumulative performance results from January 1, 1997 through December 31, 2015 for the Composite and the S&P 500. Also included is our "Rolling Period Outperformance" metric, which details the percentage of the time the Composite outperforms the S&P 500 on a rolling period basis. 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 one.

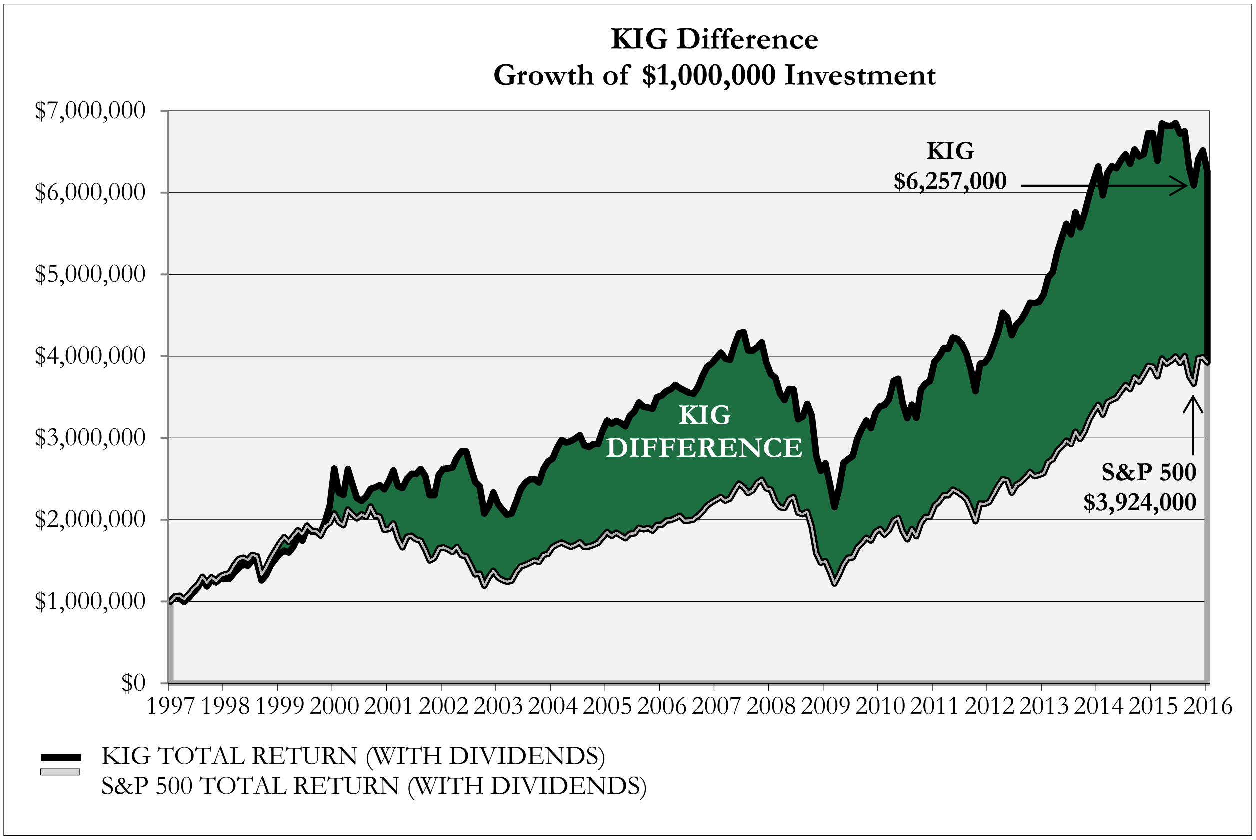
KIG Composite vs. S&P 500
Annualized Equity Performance (Net of Fees)

	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (19 Years)
Composite*	-7.0%	9.6%	9.7%	5.9%	6.4%	10.1%
S&P 500	1.4%	15.1%	12.6%	7.3%	5.0%	7.5%
Rolling Period Outperformance	58%	72%	76%	85%	100%	NA

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

	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (19 Years)
Composite*	-7.0%	31.5%	59.1%	77.8%	153.1%	525.7%
S&P 500	1.4%	52.6%	80.8%	102.4%	108.0%	292.4%

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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Portfolio Activity

We will not compromise on quality and we will not pay fair value for anything. As such, we did not buy any new positions during the fourth quarter.

We consider most equities in our universe of investable companies to be fairly valued to slightly overvalued. The sizeable appreciation in the stock market from its March 2009 lows has left few companies selling at attractive discounts to our estimate of their intrinsic value. Our research efforts, while exhaustive, have uncovered relatively few of the asymmetries between price and value necessary for a company to make its way into our clients' portfolios. Recently, our analytical deep-dives on promising opportunities have typically left us wanting a cheaper entry price. Valuation risk – or the risk of overpaying – is one of only a handful of market risks that is truly within an investor's control; all you have to do is refuse to buy if the price is too high given the fundamentals. Despite the lack of actionable ideas, we don't consider this research time unproductive. We believe it is extremely important to continue to learn about as many companies as possible, so we can be prepared to act if the environment changes. Put another way, we believe it is imperative for us to do our homework ahead of trouble, so we are ready to pounce when prices are more to our liking.

During the quarter, we trimmed our exposure to **Accenture (ACN)**, **American International Group (AIG)** and **Walt Disney (DIS)**, which are three of the more fully valued companies in our portfolio. These actions decreased our portfolio's Price-to-Value metric and improved its margin of safety. However, had we not sold a portion of these "winners," the Composite's performance in the quarter would have been *better* since these stocks' prices are all up somewhat from the point of sale. Conversely, we believe our prospects over the next five years would have been *worse* had we not done so. Given this choice, we will always choose the long-term impact over the short-term one.

We exited our position in **Expeditors International of Washington (EXPD)**. The stock had done well, but we felt its full valuation offered little upside as worldwide demand for their freight-forwarding logistic services may have plateaued for the time being. We also sold out of **Viacom (VIAB)**, which did not have a positive impact on our returns. A great deal has changed in the media business since we initially purchased shares in Viacom a little over a year ago and none of the changes have benefitted their competitive position. The most important change, in our opinion, has been the shift in cable and satellite providers to begin 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. The shift to smaller bundles could potentially exclude some of Viacom's important properties such as MTV, VH1, and Comedy Central which are generally not considered "must-have" channels by most subscribers. If this shift were to happen in any major way, the loss of affiliate fees on these networks would have a profoundly negative impact on Viacom's revenues and earnings.

As a result of these actions, the amount of cash held in client portfolios as of the end of the quarter is somewhat elevated relative to normal levels. Keep in mind, we don't target cash levels: It waxes or wanes based on opportunities we are seeing in the marketplace. We don't use cash as a market timing tool, nor do we feel we have a mandate to remain fully invested at all times. We deploy cash only when genuine opportunities arise.

One such opportunity to deploy cash during the quarter was into the shares of a current holding, **Quanta Services (PWR)**. Quanta, which we have written about a number of times in the past, is a specialty contractor providing engineering and construction services primarily related to transmission projects for the electric power industry and pipeline projects for the oil and gas industry. Early in the quarter, Quanta management announced a reduction in its near-term earnings expectations due to margin pressure in their electric transmission business caused by continued regulatory delays on several large projects. About the only thing more unexpected than the announcement was the market's violent reaction to it that resulted in a one-day 30% decline in the share price. While we certainly do not celebrate declines in the value of stocks held in our portfolios, cheaper prices often present opportunities to make investments that we anticipate will reap rewards in future years.

While Quanta was responsible for the largest drag on our performance in 2015, we believe Quanta is well positioned to benefit from multiple drivers in the electric power transmission and distribution sector, including the aging infrastructure of the U.S. electric grid, growth of renewable energy, coal plant retirement, and regulatory changes encouraging investment in the nation's power grid. The company has established a strong presence throughout the U.S. and Canada, where it serves a multitude of regulated utilities and independent power producers.

In our opinion, two powerful secular trends are providing a long-term tailwind favoring Quanta's power services: 1) increasing electricity demand and 2) outsourcing of utility projects. Total U.S. electricity demand is expected to grow by over 25% by 2030 necessitating further utility company infrastructure investments. Additional investment in the transmission and distribution infrastructure will also be required as power generation shifts from coal-fired generators to natural gas-fired ones and solar and wind gain share in the overall power grid. To meet these challenges, the utility industry is expected to spend $180-$240 billion on capital projects related to transmission through 2030 ($12-$16 billion annually, in constant dollars). This is well above the annual spending of roughly $8.5 billion between 2006 and 2010, which was already sharply increased from the decade prior to that. Secondly, roughly half of the 400,000 power industry workers in the United States are eligible to retire in the next 5-10 years, which should lead to more outsourcing to contractors among utilities. Quanta management believes that full service projects are more profitable and the company is positioning itself to be the provider of choice.

The pipeline side of Quanta's business has equally strong opportunities. Quanta remains well positioned for the expected build-out of North American energy infrastructure as it controls a broad swath of the North American capacity to build mainline pipelines combined with broad geographic presence and a large skilled labor and equipment base. The INGAA Foundation, an industry group representing the pipeline industry, forecasted in a March 2014 report that there would be more than $640 billion of capital expenditures related to natural gas and liquids pipelines through 2035 (~$30 billion/year). This would include investments related to mainline capacity ($9 billion/year), oil and gas gathering lines ($3 billion/year), new/expanded lateral lines ($2 billion/year), and NGL storage facilities. All of these are addressable markets for Quanta. Quanta's solid positioning in the shale basins generated improved profits in recent years, with growth in 2015 and beyond now driven by higher-margin mainline pipeline work where we believe PWR has outsized industry share and capital investment is increasing.

(Note: The dollar figures above are industry estimates. We take no comfort in them being accurate with any degree of precision. However, we do take comfort that the numbers are directionally accurate and that we made conservative haircuts for modelling purposes.)

While the near-term outlook for Quanta is clouded by permitting delays, we continue to believe that the intermediate- and long-term term fundamentals for the industry and Quanta remain attractive and support normalized earnings per share well above current levels. Most of the research coming out of Wall Street believes that uncertainty related to timing of new awards and permitting approvals could keep shares range-bound until the company sees resolution on some key projects. This may be the type of guidance that certain investors or, more aptly, traders who don't look beyond the next quarter or two find important, but it is of limited significance to us. The result can be falling stock prices for healthy companies that face short-term uncertainty yet retain prospects for a bright long-term future. By taking a longer time horizon where we are agnostic on the timing of such development may delay return, but we believe it will result in larger compounding of returns over the entire time horizon than if we had waited for the uncertainty to clear.

Whether privately held or publicly traded, a business is ultimately worth the cash earnings it generates. Based on our experience, the stock market is generally efficient at pricing companies over long periods of time. However, market reactions often overstate the impact that short-term issues have on long-term business value. While multiple operational challenges have pressured 2015 results, we believe the Quanta management team will deliver tangible improvements to the company's depressed 2015 results. One positive step has been the announcement of a massive share repurchase funded primarily by the sale of its non-core fiber optic leasing business. The $1.25 billion buyback, when completed in early 2016, will retire somewhere around 30% of the shares outstanding. Conceptually, what the retirement of this amount of shares means for future results is that even if net income were to stay flat, which is not our working assumption, earnings per share would still rise by 43% (1 divided by 0.7) for the remaining shareholders.

Over the next several years we remain optimistic that, because of dynamic end-market trends, Quanta is poised to capture large transmission and pipeline project opportunities that offer higher margin potential. As investors, we must try to imagine the future, even if we can't predict it.

We also increased our position in **Leucadia National (LUK)** when the stock began trading at a significant discount to book value during the quarter. Leucadia is comparable to **Berkshire Hathaway (BRK/A, BRK/B)** in that it is comprised of a collection of generally unrelated businesses, and its value arises primarily from the skillful allocation of capital by management. Approximately half of the company's book value is derived from its ownership of Jefferies, a formerly publicly traded investment bank, and the rest runs the gamut from beef processing to commercial loan servicing to wireless broadband service in Italy. A couple of the companies Leucadia owns are exposed to the ongoing rout in North American oil and gas production, yet these make up a relatively small piece of the overall pie. With the stock trading at a 25%-30% discount to our adjusted book value, which incorporates the troubles experienced with their energy holdings and a difficult trading environment for Jeffries, we felt compelled to act.

You are an important part of enabling us to execute our strategy. Your patient capital and shared long-term time horizon allows us to buy competitively entrenched businesses at inexpensive valuation levels, while sellers of these businesses are distracted by short-term results. Managing money is an awesome responsibility and we hope you draw comfort knowing that our interests are completely aligned and that we remain faithful stewards of your capital.

Best Regards,

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