Kovitz Investment Group
Intrinsic Values®

Market Insights
Fall 2017

The third quarter of 2017 saw the continuation of many of the same market characteristics we have observed over the last year. First, equities continued to appreciate and now trade at or near all-time highs. Second, volatility (as discussed in our last newsletter) has continued to remain unusually subdued. Third, interest rates remain historically low, and debate continues regarding the prospects for higher rates and a steeper interest rate curve.

In contrast to the placid financial markets, the third quarter was marked by a continued escalation of geopolitical and policy risks. These risks include: rising tensions between the U.S. and North Korea; continued confusion over domestic inflation that is persistently below expectations; uncertainty over the future course of the Federal Reserve's monetary policy, which is compounded by the uncertainty of who will be appointed to be the next leader of the Federal Reserve after Janet Yellen's current term ends; continued risk posed by elevated valuations across most asset classes; and continued risks posed by the polarization of domestic politics.

Normally, these sorts of risks would lead to heightened volatility, but that has been far from the case over the last year. In our opinion, the key issue at hand remains the low interest rate environment. After 8 ½ years of an uninterrupted bull market, it is easy to believe interest rates will forever be low. While there are many arguments to explain the persistence of the low interest rate environment, there are also many reasons to believe it will eventually end. Chief among these is the potential for fiscal stimulus.

While most media coverage of potential tax reform and infrastructure spending is presented through a political lens, we believe the topic should not be nearly as controversial as it seems. The low interest rate environment since the financial crisis has been characterized by a weak demand for money. In other words, even though the price of money, as reflected by prevailing interest rates, has been set at a very low level (think of low mortgage rates, attractive rates on car loans, attractive rates on business lines of credit, etc.), the demand to borrow money has been noticeably weaker than expected. Given this set of circumstances, most economists would agree that fiscal stimulus would increase demand for money and help begin a virtuous cycle of increased economic growth.

This is particularly relevant today because asset prices largely imply interest rates will remain at their current levels for a very long time. While fiscal stimulus could provide the impetus for interest rates to rise, this scenario is not without its own set of risks. Stronger economic growth would help improve the bottom line of most companies, but the starting prices of many asset classes are already reflecting expectations of stronger economic growth, lower corporate tax rates, *and* low interest rates. Therefore, the main risk facing an investor today is that future returns have been pulled forward. If one or more of these factors fails to meet expectations, many assets are simply overpriced and will be susceptible to a loss.

Current Portfolio Positioning

In light of the above discussion, we have continued to maintain our risk management criteria and have not changed the valuations we are willing to pay to invest in any asset class. 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. We are invested side-by-side with our clients and we are more than happy to take a pass on investments with inferior return prospects and elevated odds of losing money. Across our strategies we are positioned as follows:

1. In equities, we remain defensively positioned. We were able to find two new attractive opportunities, which are discussed in much greater detail in our accompanying Core Equity commentary.
2. In fixed income, we also remain conservatively positioned. In reaction to the flattening yield curve, which means the difference in yield between shorter and longer bonds has declined, we have taken the additional step of overweighting near-term maturities in our clients' bond ladders, while underweighting longer-term maturities. Additional background on this decision can be found in our accompanying Fixed Income Commentary.
3. Where appropriate, we continue to recommend the inclusion of some alternatives (hedged equity, real estate, etc.) where a more suitable risk/reward profile might exist. An enhanced risk/reward profile often results as a tradeoff for assuming less liquidity than in the public markets.

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

Best Regards,

Kovitz Investment Group

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Core Equity Commentary
Fall 2017

Market and Performance Summary

During the third quarter of 2017, the Kovitz Investment Group (KIG) Equity Composite[1] (the "Composite") appreciated by 5.0% while its benchmark, the S&P 500, increased 4.5%. Year-to-date through September 30th, the Composite has risen 10.6% vs. a gain for the S&P 500 of 14.2%. Over the past one year, the Composite generated a return of 25.0% vs. an 18.6% return for the S&P 500.

It seems almost surreal that the bull market in stocks, which began in the still dark days of the financial crisis in early 2009, has now lasted for over 8 ½ years. Even more surreal is the fact that in 2017, the market (using the S&P 500 as proxy) has only had one correction of more than 2%. Historically, stocks have averaged at least one 15% correction per year and corrections of 5%-10% have been commonplace. Volatility is non-existent, which is puzzling given geo-political uncertainty and disarray in Washington D.C. Furthermore, with interest rates low, the economy on firm, if unspectacular, footing, and corporate profits strong, this bull market shows no signs of slowing any time soon.

However, one of the hallmarks of bull markets is that they dull investors' senses. Bull markets breed a certain complacency that leads many to assume more risk in their portfolios. Maximizing returns becomes the priority while risk management takes a backseat. Fear of missing out replaces investment discipline. It can be tempting to forget that nasty downturns happen with some regularity, and there is never a bell rung to announce their arrival before they occur.

With the market trading at elevated levels, many investors tend to justify continued investments on a relative basis. We constantly hear that stocks are cheap when compared to low yielding bonds, or that buying stocks with some kind of dividend yield is better than keeping cash reserves with little or no yield. The acronym "TINA," which stands for "there is no alternative," is sometimes used to describe the rationale for the capital flows into equities.

So what are we doing in the midst of the second longest bull market in history? Since we're a firm where caution is at the heart of each investment decision, we are exhibiting even more caution than usual. Our bottom-up research emphasizes business quality, industry structures, growth opportunities, management skill, and corporate culture. It is further augmented by our assessment of the company's ability to sustain earnings power over economic cycles through an understanding of its competitive advantages, business model, and management's proficiency in the allocation of capital. If a company passes these qualitative screens, our risk management principles will only allow purchase if the shares are trading at a sufficient discount to our estimate of their worth.

We therefore use absolute, rather than relative, methods to estimate companies' intrinsic values. We then use the movement of market prices around these intrinsic value estimates to construct and manage a portfolio of high-quality businesses that have the potential to create sustained shareholder value over many years. When we can't find investments that meet these criteria, our default option is

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

to hold cash, which we continue to maintain at levels higher than normal. We don't view cash sitting around earning negligible returns as an abdication of responsibility. Our primary responsibility is to protect the capital entrusted to us. Growth of that capital is an important, but secondary, consideration. Cash also affords maximum flexibility as it can quickly be channeled into investment opportunities with minimal friction and transaction costs. When – not if – this long-running bull market comes to an end and bargain-hunting comes back into vogue, we'll be happy we have it.

With the ongoing trend towards passive (index) investing and the increasing level of quantitative/algorithmic trading, only a small fraction of trades today are being implemented by humans that make fundamental value judgments regarding companies and their stocks. What should we think about the willingness of investors to subject their capital to a process in which neither individual holdings nor portfolio construction is the result of thoughtful analysis and decision-making, and in which buying takes place regardless of price? We'll stick to our time-tested principles of fundamental value investing that have served us well for more than two decades. To us, it feels like it's a better time to emphasize avoiding losses rather than seeking gains.

The chart below summarizes annualized performance over various standard time periods ending September 30, 2017 and cumulative performance results from January 1, 1997 through September 30, 2017 for the Composite.

KIG Composite[2]
Annualized and Cumulative Equity Performance (Net of Fees)

	Average Annual Total Returns						Cumulative (20.75 years)
For Period Ending 9/30/17	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
KIG Composite	25.0%	8.7%	12.2%	7.2%	9.6%	10.7%	726.6%

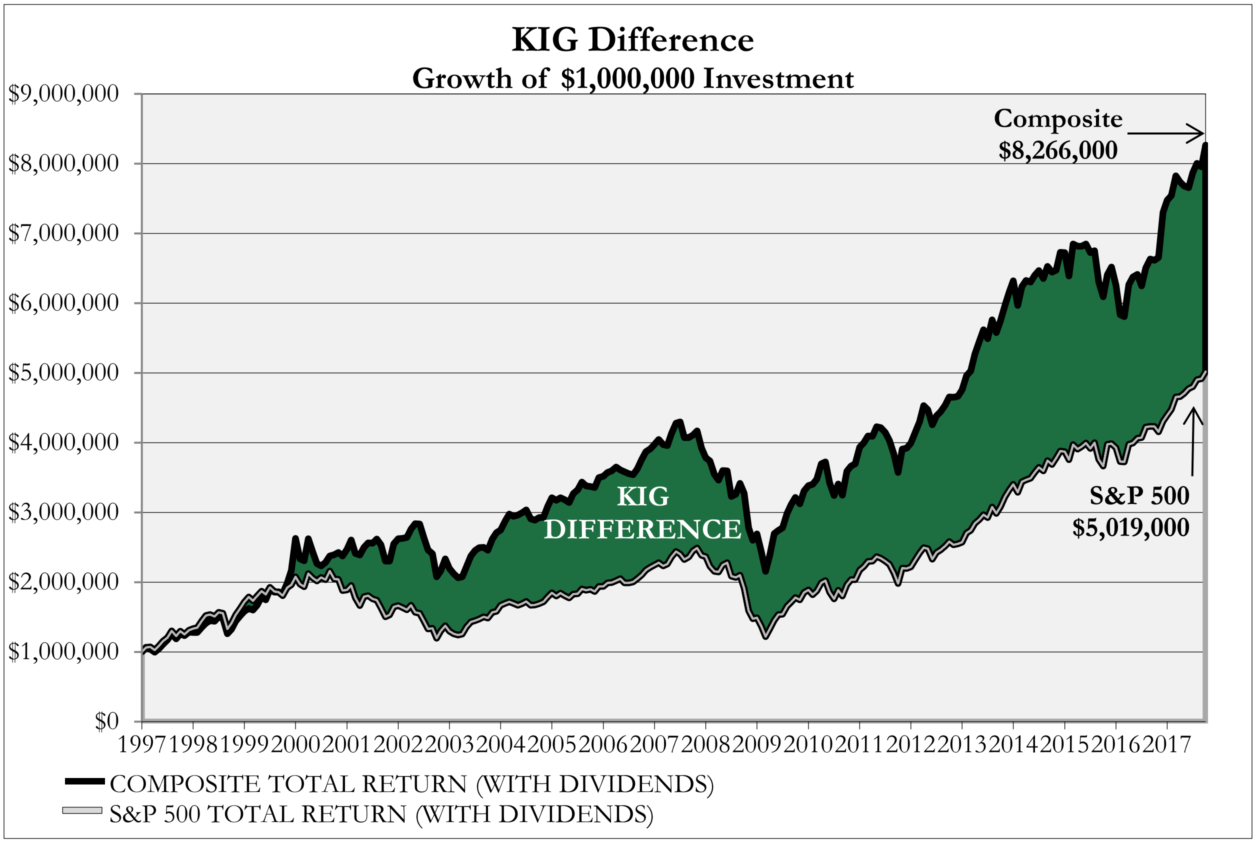
The table below lists the results for the same time periods as above for the S&P 500 and many of the other benchmarks widely held as investments via a style-box approach.

Other Market Indices
Annualized and Cumulative Equity Performance (Gross of Fees)

	Average Annual Total Returns						Cumulative (20.75 years)
For Period Ending 9/30/17	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
S&P 500	18.6%	10.8%	14.2%	7.4%	10.0%	8.1%	401.9%
Small Cap Equity (Russell 2000)	20.7%	12.2%	13.8%	7.8%	11.4%	8.5%	441.1%
International-Developed (MSCI-EAFE)	19.1%	5.0%	8.4%	1.3%	8.3%	4.9%	171.6%
International-Emerging (MSCI - EEM)	22.5%	4.9%	4.0%	1.3%	12.5%	6.2%	250.8%
Gold	-3.4%	1.3%	-6.8%	4.8%	8.8%	5.9%	225.5%
Commodities (CRB)	-1.0%	-12.8%	-9.7%	-5.4%	1.2%	1.8%	46.1%

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

Below is a graph of the KIG Composite's cumulative return since inception (January 1, 1997) relative to the cumulative return of the S&P 500 over the same time period. The shaded area represents the Composite's excess return over the benchmark.



Portfolio Activity

It continues to be a difficult environment in which to invest new capital. Finding qualifying investments that combine business quality with a margin of safety has been challenging. Fortunately, we believe the stocks we continue to hold have sufficient upside, and that our clients' equity portfolio results will not be held back over the long term. We have spent a great deal of research time boning up on companies and industries as we put together a shopping list to take advantage of when stocks go on sale.

That said, we took initial positions in two companies during the quarter: **PPG Industries (PPG)** and **Cheesecake Factory (CAKE)**. PPG is the largest global supplier of protective coatings. While "coatings" encompasses a broader definition, it would not be unfair to say simply that PPG makes paint for many different uses. Their primary end markets are new and maintenance construction (43% of sales), automotive manufacturers and after-market (33%), aerospace and ships (9%), and general industrial uses, which consists mainly of packaging coatings (15%). The business has undergone a dramatic shift over the past decade, evolving from a mixed chemicals/coatings platform into an almost pure coatings business. As a result, margins and returns on capital have improved in a stair-step pattern. We believe PPG is a high-quality business with durable competitive advantages, such as high switching costs and brand equity. The business also demonstrates pricing power, scale in distribution, and continual innovation in products and application. PPG generates strong free cash flow (FCF), and management has demonstrated an ability to balance its use between investing for growth through attractive acquisition activity in a still fragmented industry and value-enhancing share repurchases. We do not believe its valuation at our initiation price of 16x FCF reflects these attributes.

The Cheesecake Factory is, in our opinion, an extremely well-run restaurant and bakery with excellent unit economics, strong cost controls, and a brand that makes its restaurants a destination for great food (and cheesecake!) in a fun atmosphere. The stock has fallen out of favor as the casual dining industry, in general, has experienced rising food and labor costs. Cheesecake has also been tainted by the fact that many of its stores are located in or near malls where online shopping has contributed to decreasing foot traffic. An old investment saw states: "There are only two types of companies: those that are having problems and those that are going to have problems." Our historical results are based on, more often than not, correctly identifying when a good company is suffering from temporary, rather than permanent, problems. We firmly believe Cheesecake is in the former camp, and the valuation is such that further downside is limited as we wait for results to improve.

We did not exit any positions during the quarter, but we trimmed our **Leucadia (LUK)** position as it briefly traded near our intrinsic value estimate.

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

Fixed Income Commentary
Fall 2017

The Federal Reserve ("Fed") and the bond market remained at odds this quarter. In September, the Fed reiterated its plan to raise the federal funds rate one more time this year to 1.5%, and announced that it will officially start unwinding its $4.5 trillion balance sheet in October. In theory, both announcements should hurt bond prices since short term bond yields are expected to increase when the federal funds rate goes up, and one of the largest bond holders in the world, the Federal Reserve, has now turned into a net seller. However, the bond market's reaction has been relatively muted. The market is only pricing in a 70% probability that the Fed follows through with another rate hike this year, and longer term yields are largely unchanged since the Fed originally unveiled its plan to unload the bonds on its balance sheet this past June. The yield on the thirty-year Treasury bond increased by less than 0.1% over that period.

One trend that has persisted this year is the "flattening" of the yield curve. In a "normal" yield curve environment, short-term rates are lower than long-term rates since investors expect to be compensated for the extra risk of locking in yields for longer maturities. When the yield curve flattens, the difference between short-term rates and long-term rates shrinks. In September, the yield difference between ten-year Treasuries and one-year Treasuries fell to 0.8%, the narrowest gap since the 2008 financial crisis (illustrated in the following chart).

Flat yield curves are typically found in recessionary environments. Expected economic growth rates and inflation rates are depressed, so long-term bond yields reprice lower accordingly. However, current market conditions do not fit the standard mold. The economy is on relatively healthy footing, and the ten-year Treasury is already trading for a lowly 2.2% yield as of quarter-end. In this case of a flattening yield curve, the main driver is that short-term rates are rising towards today's already low longer-term rates as the Federal Reserve has tightened monetary policy (caused short-term interest rates to increase) over the course of the year.

Due to the meager incremental yield offered by the market for assuming incremental interest rate risk, we decided to modestly shorten the duration of our bond ladders in September. If interest rates remain at current levels, clients should start noticing a heavier concentration of purchases on the shorter end of our eight-year bond ladders, as opposed to the longer end.

As interest rates rise, fixed-rate bond prices fall, and vice versa. Duration is a measure of that interest rate sensitivity, so we're assuming less risk by shortening our duration. As is customary in the investment world, less risk typically means less return. Yet the main driver of our decision is that the current bond market's juxtaposition of rising short-term interest rates, while long-term rates falter, has created a rare opportunity to substantially decrease interest rate risk without sacrificing much return. Specifically, if the current environment persists, we believe we can reduce the duration of our clients' bond ladders by roughly 20% to 3 years while only foregoing 0.1% of yield across a typical portfolio. While we don't attempt to predict how interest rates will move in the future, we strive to seek out opportunities that we believe will improve the risk-adjusted returns of our clients' bond portfolios. We believe making this small sacrifice in yield in exchange for this degree of reduction in portfolio risk represents just such an opportunity.

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