KOVITZ INVESTMENT GROUP
Intrinsic Values®

Core Equity Commentary
Winter 2017

Market and Performance Summary

For the fourth quarter of 2016, the Kovitz Investment Group (KIG) Equity Composite[1] (the "Composite") appreciated by 13.1% and finished the year with a gain of 19.5%. For purposes of comparison, the S&P 500 rose 3.8% during the quarter and ended 2016 with a gain of 12.0%.

We are pleased with these results and note that they were achieved while the Composite held a fairly large cash balance of approximately 8%, on average, during the year. The implication is that these returns were generated while employing less risk than the overall market (typically, to earn higher returns, investors need to take on even more risk). The build in cash is a direct result of our bottom-up investment style and in no way indicates any top down macro view or attempt to time the market. Rather, it's due solely to the fact that we have had more opportunities to sell current holdings at prices near intrinsic value than to buy new holdings at significant discounts to intrinsic value. We will be ready and eager to deploy cash as genuine opportunities present themselves.

If you recall, the year 2016 began with what had been termed the worst first six weeks in equity market history—the S&P 500 declined more than ten percent from its 2015 close through February 11. In June, the market went down over five percent in just a couple of trading days following the Brexit vote. Yet despite all that unnerving market volatility, the S&P 500 closed out the year near all-time highs. In a sense, the equity market of 2016 was a tutorial on the perils of attempting to time the market, and highlighted the wisdom of tuning out shocking current events and the attendant volatility. During such episodes, it's almost always better for your pocketbook to tune out the noise.

We did just that and many of our formerly untouchable stocks caught a bid beginning in the late summer, which resulted in our Composite outgaining the S&P 500 by nearly 12% over the second half of the year. We have consistently repeated that when you invest as we do by ignoring index weightings and avoiding what is currently popular, returns can and will be lumpy. We have also indicated that because we are agnostic on the timing of the returns, we are able to exploit one of the few edges left in the market. We call it "time arbitrage." Our definition of time arbitrage is being able to extend one's time horizon past that of the short-term mentality employed by most on Wall Street, and thereby exploit the benefits of moving against the herd. It's grounded simply in our willingness to view businesses through a different lens than the majority of investors, which enables

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

us to buy companies with healthy long-term fundamentals at attractive prices because the stocks are temporarily out of favor due to short-term fears. We believe this arbitrage creates big opportunities for those with patience and discipline, and is a real and sustainable edge that is likely to endure as investment timeframes continue to get shorter and shorter.

Besides various market sectors just being overdue for a basic reversion to the mean as we have discussed in our previous commentaries, we believe a main driver of the "delayed gratification" in recent returns was due to the sharp move higher in interest rates that began over the summer and continued to gain steam post-election. The Federal Reserve raised the short-term interest rate target in response to generally positive economic data, but the move in longer-term interest rates was supercharged by the perception that the new administration will push for higher levels of fiscal stimulus in the form of lower corporate and personal income tax rates, increased infrastructure spending, the potential for repatriation of offshore cash at reduced tax rates, and a general reduction in the regulatory environment. Long-term interest rates are very sensitive to inflation expectations and the expected combination of a short-term boost to GDP and increased deficit spending has generated an immediate increase in the outlook for inflation.

In an economy that previously struggled under stubbornly low inflation and a stock market that seemed to imply that interest rates would never move above their current level, new expectations of higher interest rates provided an immediate boost to many of our portfolio holdings in the financial sector, which is our largest sector holding in our portfolios. Going forward, these companies will benefit particularly well if the yield curve continues to steepen (i.e. long term rates rise more than short term ones). Meanwhile, the purported infrastructure spending plans would likely be a boon to many of our other cyclically-related holdings, particularly those in the industrial sectors. We also hold many companies with considerable cash balances outside the U.S. who have heretofore been reluctant to bring it back to the U.S. and pay the full corporate tax rate of 35%. Regardless, we're most grateful that Mr. Market has begun to weigh our companies more appropriately.

The market is currently pricing in better economic results in the coming years than what has been experienced over the past several years. We don't know if the hype surrounding the new administration's agenda will lead to better economic growth or not, but we believe we are well positioned regardless. Ultimately, our Composite's outperformance relative to the market this year was not due to any superior ability we possess in forecasting the outcome of any single election or predicting the policies of a new administration. Our results were due to one of our core tenets of investing. We aim to buy companies at prices that provide meaningful upside if current market expectations come to fruition and that provide substantially more upside if reality differs from the expectation. Our Composite portfolio wasn't overweight Financials and Industrials because we had an opinion on the election. We were overweight those companies because they were priced as if their economic prospects would never improve. Any deviation from that expectation would provide outsized returns relative to a market valuing other companies, such as Consumer Staples and Utilities, as if their economic prospects were and would remain great forever. When expectations changed, the reaction was swift and we were well-positioned.

Even with this quarter's sound showing, there is still a significant valuation gap between our portfolio holdings, in aggregate, and sectors where we have little or no exposure. The wide valuation disparities that characterize the current market offer significant opportunities for active management; however, the net result of higher markets is that our opportunity set becomes more limited. Our backlog of analyzed (but still somewhat unattractively priced) securities continues to grow. This is akin to having acquired the seeds but waiting until the right season to plant them. In the meantime, we must remain objective and refrain from predicting what a government will or will not do and continue to be guided by company-specific valuation parameters. We relish the future as long-duration owners of high quality companies priced at meaningful discounts to the overall market.

While we never lost confidence that our holdings' growing intrinsic values would ultimately be recognized by the market, patiently waiting for this outcome can be painful in the short-run. 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.

In somewhat of a milestone, the end of this quarter marked the twentieth anniversary of our documented performance history. The chart below summarizes annualized performance over various standard time periods ending December 31, 2016 and cumulative performance results from January 1, 1997 through December 31, 2016 for the Composite.

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

	Average Annual Total Returns						Cumulative
For Period Ending 12/31/16	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
KIG Composite	19.5%	5.8%	13.4%	6.5%	7.2%	10.6%	647.7%

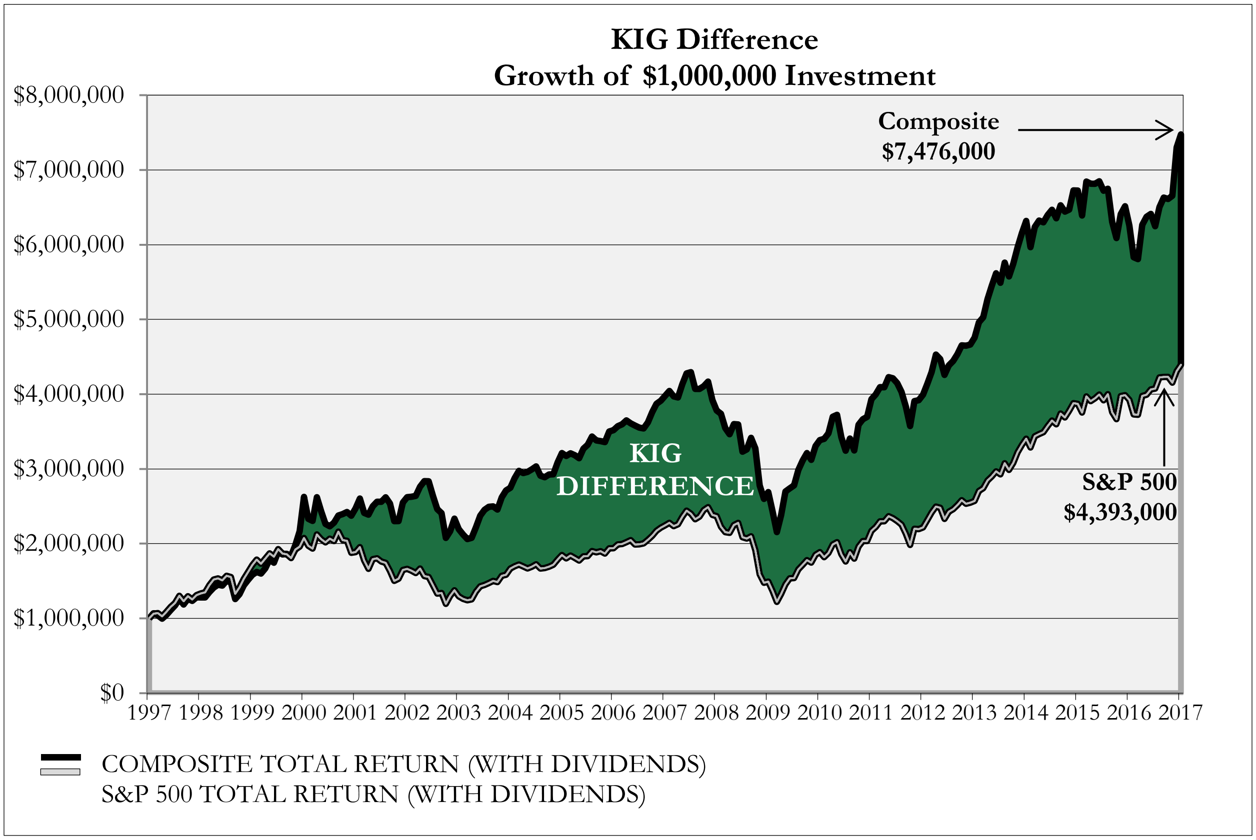
[2] The returns for the equity portion of your individual account may differ somewhat from the Composite due to slight variations in account holdings, cash position, and other client-specific circumstances.

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

Other Market Indices
Annualized and Cumulative Equity Performance

	Average Annual Total Returns						Cumulative
For Period Ending 12/31/16	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
S&P 500	12.0%	8.9%	14.7%	6.9%	6.7%	7.7%	339.3%
Small Cap Equity (Russell 2000)	21.3%	6.7%	14.5%	7.1%	8.5%	8.2%	387.8%
International-Developed (MSCI-	1.0%	-1.6%	6.5%	0.7%	5.3%	4.2%	126.4%
International-Emerging (MSCI -	11.2%	-2.6%	1.3%	1.8%	9.5%	5.2%	174.6%
Gold	7.7%	-1.9%	-6.5%	5.3%	9.1%	5.5%	194.0%
Commodities (CRB)	9.3%	-11.8%	-8.8%	-5.4%	1.8%	-0.1%	-1.0%

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



Portfolio Activity

Despite our research team's best efforts, we did not initiate any new positions during the quarter. 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. Finding candidates that meet the first three criteria has always been somewhat difficult, but it is the fourth criteria – price – that has been the major impediment. As we have lamented on more than one occasion recently, bargain priced stocks are tough to come by these days. We continue to delve into the sectors where we have less representation, but have had limited success finding candidates that offer the combination of business quality and price we require. As mentioned above, we continue to like what we currently own from a quality and price standpoint and trust we will get opportunities to deploy our excess cash in due time.

We didn't stand completely still during the quarter as we increased our position sizes in **CVS Health (CVS)** and **McKesson (MCK)** who both act as important mechanisms in the pharmacy sector (CVS in retail pharmacy and pharmacy benefit management and McKesson in drug distribution). Health care and companies related to the pharmaceutical industry, in particular, have woefully underperformed the market this year. While we are currently unenthusiastic about the prospects for drug manufacturers (even though there may come a point where valuations start to look attractive despite business challenges), current valuations of these two companies have gotten way too cheap, in our opinion, for the quality, scale, and unique suite of assets each of these businesses possess. Earnings growth has slowed for each, but we believe the factors causing this, such as low levels of drug inflation and certain competitive pressures, are transitory and earnings power is likely higher than what is being booked currently. We can never predict the timing of when prices will rise or fall, but we can take advantage of price volatility when we own companies with stable values, such as these two.

We exited our position in **American International Group (AIG)**. . We held it in the Composite for approximately four years and its price compounded at a rate in the mid-teens over that time period (dividends added roughly another 1% per year). As price and value converged, our margin of safety narrowed, and we sold AIG with the expectation that we will reallocate the proceeds into more discounted names.

We also sold out of our position in **Kohl's (KSS)**. We would not classify it as a good investment because the annualized return over the entire period in which we owned it, although positive, was less than that of the overall market during the same period. In our opinion, Kohl's management has done an admirable job in keeping Kohl's stores relevant in an increasingly difficult environment for brick-and-mortar retailers. The convenience of online shopping has drastically changed shopping habits and it is increasingly difficult to drive physical traffic to your store base even though Kohl's has actually excelled in adapting to this changed world. The problem, which may seem counter-intuitive, is that online sales at a company with a large physical presence, unless the online sales are purely incremental to previously store-based sales, reduce the company's overall margins as shipping costs and increased technology costs add to the expense base. While Kohl's continues to produce a significant level of free cash flow, online competition continues to increase as a percentage of overall sales and to believe fair value is meaningfully above the level at which we sold requires us to believe margins are likely to hold steady or even increase from here. This is an outcome we deem to be less likely now than we did even 3 months ago. As investors, it is remarkable (and a bit frightening) to us that retail, once an area where we typically found great value, has become practically uninvestable. To be clear, most of the major, publically traded retailers are not going away, but the major challenges of decreasing customer traffic, margin degradation, and changing consumer preferences from material goods to experiential products make us wary of the sector.

Finally, we used post-election strength to pare back our exposure to a handful of names, including **Bank of America (BAC)**, **Jacobs Engineering (JEC)** and **Quanta Services (PWR)**. As equity managers focused on price and value, we seek to increase the size of our positions when the market disagrees with our long-term view, and do the opposite when the market ceases to provide us with as large of a margin of safety. These three stocks epitomize such behavior. As the market failed to recognize each company's normalized earnings power, we reviewed our thesis, worked through our upside/downside scenarios, and then took action by substantially increasing our position. Performance gains tend to experience a fair degree of lumpiness. This year (and primarily in the fourth quarter), the market's view caught up to our own and we were able to substantially reduce our position sizes in each.

Key Contributors/Detractors to Results

For calendar year 2016, the individual positions that impacted Composite performance the most during the year were:

Top 5 Contributors		Top 5 Detractors	
Company	**Percentage Return***	**Company**	**Percentage Return***
Quanta Services	72.1%	**CVS Health**	-17.8%
Halliburton	61.7%	**McKesson ** **	-15.7%
CBS Corp	36.6%	**Walgreen Boots Alliance**	-1.0%
Jacobs Engineering	35.9%	**Coca Cola**	-0.3%
Valmont Industries	34.4%	**Walt Disney**	0.7%

* Including impact of dividends

** Measured from initial purchase in April, 2016

Largest Current Positions

As of December 31, 2016, the Composite's ten largest positions were:

Company	Ticker
Berkshire Hathaway	**BRK.B**
Quanta Services	**PWR**
Apple	**AAPL**
JP Morgan	**JPM**
Bank of America	**BAC**
CBS Corp	**CBS**
Boeing	**BA**
General Motors	**GM**
Halliburton	**HAL**
CVS Health	**CVS**

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.

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Past performance does not guarantee future returns.