KOVITZ INVESTMENT GROUP
Intrinsic Values®

Market Insights
Winter 2017

We are happy to report 2016 was an exceptional year, with Kovitz results exceeding expectations across each asset class. Furthermore, our financial planning efforts continued to help clients navigate towards their long-term goals as we look towards 2017 and beyond.

The Core Equity strategy[1] had a very strong year, posting a gain of nearly 20% (please see the strategy newsletter beginning on page 5 for greater detail). In Fixed Income, our decision to focus our purchases in bonds with short durations as a response to the ultra-low interest rate environment that prevailed for most of the year paid off as interest rates unexpectedly rose sharply in the fourth quarter. We are now deploying client capital at higher, more attractive interest rates. Finally, our various alternative investment strategies each turned in very strong results. This includes an opportunistic position in high yield closed-end funds which we initiated about a year ago for certain clients. This strategy was also additive to clients' annual risk adjusted results. Importantly, we continue to believe all of these strategies – taken together – continue to be helpful in helping our clients achieve their long-term goals.

Interestingly, 2016 was fraught with opportunity to cause sizeable harm to your portfolio. The year began with a 10.3% decline in stocks[2] in just the first 6 weeks of the year. At the time, the prevalent market view was stocks would likely continue to decline. Of course, the opposite happened, and stocks surged 15% from the February low through June 22nd. It is for these reasons that we take a long-term view and don't try to predict or time the market.

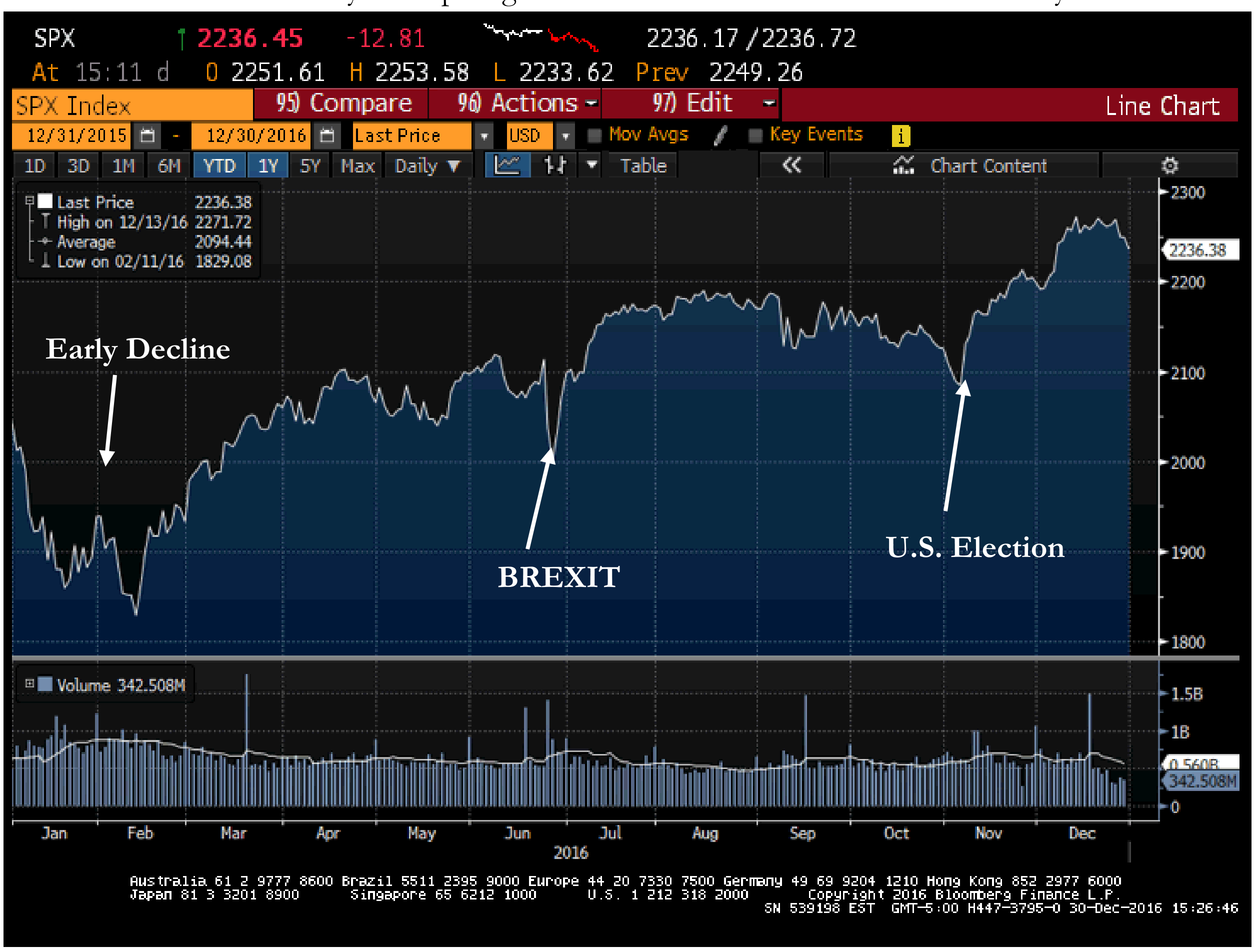
June 22nd may sound like a randomly chosen date, but it is noteworthy because it was the day before the United Kingdom held a referendum vote on whether or not to leave the European Union. For months, polls predicted a "Stay" vote would prevail, and experts declared that a vote to "Leave," as unlikely as it seemed, would almost certainly spell doom for the UK's economy. Yet, on June 23rd, the UK voted to leave the European Union. Shortly thereafter, Google Analytics reported that searches for the phrase, "What happens if we leave the EU?" spiked in the UK on the day *after* the referendum. In a moment that helps prove the old saying, "the truth is stranger than fiction," who could have predicted that the same people who voted to leave would, after the fact, search the internet hoping to find out what it meant to do so? Much as in February, the widely accepted consensus view was that a "Leave" vote would be very bad for financial markets. As it turned out,

[1] Represented by the Kovitz Investment Group Equity Composite.
[2] Represented by the S&P 500.

equities fell only 5.3% in the two trading days following the vote, and the most surprising thing of all was when equities regained nearly all of their pre-Brexit value within another three days.

Next the U.S. elections came into focus, where a chronology very similar to the Brexit vote unfolded. Both the expert political consensus and the implied market consensus was that Hillary Clinton would defeat Donald Trump by a large margin. Much like Brexit, it was believed that a surprise Trump victory would result in a significant market sell-off and extreme volatility. This prediction held through the exit polls. Again, in shocking fashion, the consensus prediction turned out to be wrong. Not only did the low probability candidate win the election, but stocks rose dramatically through year-end.

Perhaps even more importantly, the yield on the 10-year Treasury bond spiked from 1.88% to 2.45% by the end of the year. As has been discussed many times over the last 5 years, interest rates have been held stubbornly low, and the risk of deflation has been very real. There can be no greater surprise in 2016 than a victory by a candidate that was predicted to spell doom that has instead caused the stirring of Adam Smith's "animal spirits." The increase in appetite for risk taking behavior is thought to be the main reason interest rates have moved up, and, if it persists, this could be the beginning of interest rates normalizing. Hopefully, this uptick in anticipated growth and inflation will ultimately help greater levels of economic activity materialize.



As the above 2016 financial markets recap reveals, many market participants remain enamored with the idea of predicting the future and making investment decisions based on those predictions. If it were possible to do so with a likelihood of repeatable success, we would gladly employ this method. However, a careful study of the greatest investors throughout history shows none of them have employed such a method. Unfortunately, the 24-hour news cycle promotes the business of making short-term predictions, while it decidedly ignores the ramifications of those predictions often straying far from reality. As 2016 so aptly illustrates, the only thing more unpredictable than the future is the short-term reaction of financial markets to future events.

In this year alone, investors following the consensus would have sold out of equities in January before stocks moved up substantially. Then they would have bought back in, only to sell on a surprise Brexit "Leave" vote, and then compounded the mistake yet again by selling on a Trump victory. Our effort to guard our clients against this behavior is our number one goal as your financial advisor. Each of these short-term, consensus-following decisions would have undoubtedly felt good at the time because there would have been plenty of testimonials out there saying it was the "smart" thing to do. However, in each case, significant damage would have been done to an investor's asset base, and by association, their ability to fund their long term goals.

While our ability to predict the future remains as elusive as everyone else's, in its place we continue to utilize what we have found to be a highly repeatable process grounded in maintaining our investment discipline. We value assets across all asset classes and only when the valuation becomes cheap enough do we accept the risk of owning those assets. Over time, this investment discipline skews the odds heavily in our favor. While we never know the timing of when returns will come, we believe that maintaining this long-term view is the best process to guard against permanently losing money while producing above-average returns over time.

Current Portfolio Positioning

As we discussed last quarter, 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. The current environment remains highly unusual, where lower-than-average interest rates have caused higher-than-average equity valuations. Even more unusual, it is possible fiscal stimulus in the form of corporate tax cuts, personal tax cuts, repatriation of overseas cash, and infrastructure spending could ultimately justify the high starting point of valuations.

In such a paradoxical environment, we believe it is most important to guard against a permanent loss of capital while opportunistically focusing on high quality opportunities. We are invested side-by-side with our clients and we will continue to be 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. Cash levels remain elevated as we have been trimming stocks that have reached our fair value estimates. We remain focused on a

portfolio of competitively advantaged businesses trading at significantly 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 have begun to lengthen the duration of portfolios as interest rates have risen. As always, we are maintaining very high credit quality levels and do not believe in reaching for yield at the expense of a possible impairment of principal. Please read more about this 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,

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