July 31, 2015

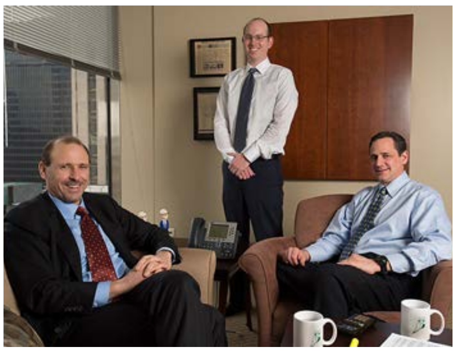
ValueInvestor INSIGHT

The Leading Authority on Value Investing

Uncommon Sense

A key error investors focused on business quality can make is in misjudging the competitive moat, something Mitch Kovitz and team keep to a minimum.

INVESTOR INSIGHT



Kovitz Investment Group
(*l to r*) Mitchell Kovitz, Joel Hirsh, Jonathan Shapiro

Investment Focus: Seek companies that those with shorter-term perspectives consider "dead money" even though the longer-term prospects remain vibrant.

Mitchell Kovitz, Joel Hirsh and Jonathan Shapiro consider themselves great collaborators, but the portfolio managers of Kovitz Investment Group spend a great deal of time working on their own. Says Hirsh: "We try not to overly influence each other's thinking before we've actually had time to have informed thoughts."

This independent ethic has paid big dividends for Kovitz investors. The firm's core equity strategy started by Mitch Kovitz in 1997 has since earned a net annualized 10.8%, vs. 7.7% for the S&P 500 index.

Focused on finding "unappreciated opportunities and avoiding disasters," the team today sees upside in such areas as airlines, infrastructure construction, television media and motorcycles. See page 2

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Investor Insight: Kovitz Investment

Mitchell Kovitz, Joel Hirsh and Jonathan Shapiro of Kovitz Investment Group explain how their process focuses on "avoiding disasters," why they emphasize independent work over collaboration, why face time with management is not a priority, and why they see mispriced value in Quanta Services, Harley-Davidson, American Airlines and CBS.

In one of your investor letters you noted that your strategy is mostly common sense and doesn't feature unique information sources or trading methods. So how has it beaten the S&P 500 by an average 300 basis points per year over 18 years?

Mitchell Kovitz: A key reason we've outperformed the index is because we've ignored the index. Good investment outcomes happen over time when you search for great companies selling at reasonable prices and forget about the crowd. If your process is focused on finding unappreciated opportunities and avoiding disasters, a byproduct of that should be the potential to beat an index populated with a full range of securities.

Our clients allow us to make investment decisions using a three- to five-year horizon – meaning they don't pull out assets when we underperform over the short term, as any value manager who's any good will from time to time. That makes us more indifferent to the timing of returns and allows us both to play in names our competition is ignoring and to pay depressed prices that lower our risk.

What qualifies in your estimation as a "great" company?

Joel Hirsh: We're looking for an easily understood business where we can articulate why there's a competitive advantage and why it's sustainable. Quantitatively that's reflected by things like high returns on capital and by free cash flow that tracks or exceeds earnings. Qualitatively, we ask if we were going to take our entire life's savings and buy just this one company, could we sleep at night for five years with zero liquidity? That's a good way of asking yourself if the competitive advantage is sustainable enough that you can have confidence in your estimation of private market value.

A prototypical example?

JH: CarMax [KMX] comes quickly to mind. The brand is an advantage. The pricing strategy is an advantage. Its auction business helps to reinforce a cost advantage. It has an informational advantage that grows as it gets larger. If you can buy this business at the price you want, we think it's one where you can be very comfortable believing that five years from now the dynamics around it will be very much the same or even better.

ON "DEAD" MONEY:

We're agnostic whether our expected return comes from a smooth 15% per year or from 0%, 0% and then 50%.

Jonathan Shapiro: Our process begins with what we've identified as our universe of about 400 mostly U.S. companies with the quantitative and qualitative characteristics Joel is talking about. They're primarily mid-cap and above and are businesses we'd like to own if their stock prices ever build in enough margin of safety.

For each company we've identified a multiple we think the stock deserves and apply it to the latest-year's earnings and the next year's estimated earnings. We also do a quick discounted-cash-flow analysis assuming conservative growth rates and discount rates. We then roughly equally weight those three estimated stock values to arrive at a very rough ballpark estimate of intrinsic value. At any given time we're looking closely at the 10 to 20 stocks we don't already own that seem to be trading at the highest discounts. To ultimately make it into the portfolio typically requires that we pay no more that 70% of our final estimate of intrinsic value.

You mentioned targeting unappreciated stocks. What tends to limit appreciation?

JH: A repeating theme in the portfolio is the stock that is considered dead money, with no identifiable catalyst or an identifiable catalyst that is a long ways off. We're trying to be agnostic about whether our expected 15% annual return comes from a smooth 15% per year or from 0% in the first two years and 50% in the third. People put a lot of weight on the smooth 15% and tend not to appreciate the later payoff, even if it might be larger.

MK: Think of financial stocks in recent years. There's plenty of appreciation for their mistakes around the financial crisis and for the tough regulatory environment that has resulted. But we don't believe the market appreciates the competitive strengths of banks like Bank of America [BAC] or JPMorgan Chase [JPM]. That their equity capital is at all-time highs. That loan quality is so high. That interest spreads are going to widen when rates go up – though we don't know when – making earnings power significantly higher. People assume today's environment is the status quo and we don't believe it is.

JS: We'll talk more about this later, but what gave us the opportunity earlier this year to buy Harley-Davidson [HOG] – which we'd followed forever but had never managed to buy – was that the market got spooked because Japanese competitors took advantage of the strong dollar versus the yen to cut prices and take market share from the company in the U.S. We considered it a strong positive that Harley management defended its brand by holding the line on pricing and were more than willing to accept short-term headwinds as the price of entry into what we believe remains a first-class company.

Describe the approach you took last year in responding to lower oil prices.

JH: With oil prices seemingly in free fall, starting in mid-December we bought a basket of oil-services and engineering-and-construction stocks: Halliburton [HAL], Baker Hughes [BHI], Schlumberger [SLB], FMC Technologies [FTI], Jacobs Engineering Group [JEC] and Quanta Services [PWR]. Each thesis was different, but the consistent element was our view that the shares of these high-quality companies with sustainable competitive advantages priced in $50 oil forever, at a time when marginal production costs argued for normalized prices in the $60 to $80 range.

Jacobs, for example, is one of the largest engineering and construction firms in the world. Only a quarter of last year's revenues were related to oil and gas projects – and less than half of that was related to the upstream projects that are most exposed to lower oil prices – while the remainder was in sectors with what we considered stable or improving prospects. The stock price implied that most of their energy projects would disappear and never return, which given the long-term nature of such projects seemed highly unlikely. We knew we may be early – we usually are – but with Jacobs and the others we were extremely comfortable with the risk/reward over a longer time horizon, accepting that earnings might pause or fall over the next year or two.

Your research process puts a lot of emphasis on, as you say, "avoiding disasters." How do you try to do that?

JH: We're big believers in checklists, which are the best tools available to reduce preventable human error. To assess risk, for example, our checklist has questions like: Do we believe, with explicit justification, that there is at most 20% downside from today's price? Is there low balance sheet risk (i.e. judicious use of debt)? Is there low risk of technological obsolescence? Are the cash flows overstated or understated due to boom or bust conditions?

One of the last steps in our analysis is what we call a pre-mortem. It's a mental exercise in which we look out a year or two and assume the investment isn't working out. We then try to come up with all the reasons that could happen. It's a great way to think about potential risks and can expose flaws in our analysis or force us to go back and fill in informational holes.

ON FACE TIME:

We make better decisions on our own work without management trying to persuade us one way or the other.

JS: Related to all this, probably the most important and difficult question we have to answer is whether the competitive advantage can be sustained. Getting that wrong in our way of investing exposes us to the most risk. When you asked how we've outperformed, I'd say a good batting average when it comes to judging sustainable advantage is high on the list.

Can you give a recent example where you concluded you got that wrong?

JS: Coach [COH] would be one. When we initially bought it in late 2013 our view was that the Coach brand was still very strong even though it was temporarily suffering from competition from "hotter" players, like Michael Kors, that would eventually cool off. By the first quarter of this year, however, we concluded in watching Coach's performance and its reliance on its outlet operations that its long-term moat had eroded, that its baseline level of competition had increased, and that getting back to its previous position of strength would be a very long, drawn out and expensive process. As we reduced our estimate of intrinsic value, we thought we had much better alternatives for our money.

Is spending time with management an important part of your research process?

JS: We've concluded we'll make better decisions based on our own work without management trying to persuade us one way or the other. The most important thing management does is allocate capital, and we can fully understand how well they've done that from reading the financial statements, studying the company's history and analyzing what management says on earnings calls and in the press. We think face time with management inherently introduces biases into our process and doesn't make us better investors.

MK: As we were looking into Jacobs Engineering they announced their first share buyback in a long time. That told us a lot – without the need for a conversation – about what management thought about the share price and whether they were prudent stewards of company capital.

How do you think about sizing positions?

JS: We hold between 30 and 40 stocks at a time, with an average position size of around 3% and our top-10 holdings making up 40-50% of the portfolio. In general we believe if we like a stock enough to own it, we should own significantly more of it than exists in the index we benchmark against, the S&P 500. We want our best ideas to have the most impact.

You from time to time use options in executing your long-only as well as your hedge-fund strategies. Describe the rationale behind that.

JH: When we decide to buy something, hedge a portfolio, or short something, we'll look at whether using stock is the best way to do it or if we can structure a better risk/return profile using listed options. The advantages we think we have on the long-only side by having a long time horizon are even more pronounced in the long/short space. When you don't care about the mark-to-market every day along the way, stretching out the time horizon can allow you to use option overlays to maintain greater upside exposure with more protection on the downside.

As an example, in our core portfolio we recently established a position in American Airlines [AAL] by taking a small position in the stock and simultaneously selling a call option. This allowed us to lower our effective price for the shares from approximately $40 to $36, in exchange for capping our upside at $50. As it happens, these levels coincided more or less precisely with where we wanted to buy the stock and what we think it's ultimately worth.

In the hedge fund we did the same trade, but also sold a put option roughly 20% out of the money at a price where we'd be willing to buy more stock straight up. The extra premium further lowers the effective price we pay. Our upside is capped, but at a level we've pre-determined we'll be willing to sell. We will own more of the stock if it falls 20%, but we've pre-determined we're OK with that as well.

Do you do much individual-stock shorting in your hedge fund?

JH: For some time now we've limited our shorting of individual stocks and instead rely almost entirely on listed options to fulfill our hedging program. We try to exploit the difference in premium costs between index and sub-index options and those of options on individual companies. As a result, our hedging has left us more or less market neutral were the market to fall 15-20%, while we maintain a large net long exposure to a 10-15% move up. This has been helpful in a market where shorting individual stocks has gotten significantly more expensive from a pure cost-to-borrow perspective, and where the seemingly most-over-valued stocks have been the ones going up the most.

Elaborate on your investment thesis for Quanta Services.

JH: Quanta provides engineering and construction services, with 70% of revenues coming from power transmission and distribution projects and most of the remainder related to the construction of oil and gas pipelines. It has a strong presence primarily throughout the U.S. and Canada.

While the stock became attractive after selling off in sympathy to oil prices, the value driver for the company is its power business, where it is the largest player – with 50%-plus market share – in the installation of large power-transmission projects. There are significant tailwinds to this business, including an aging power grid in need of upgrade, the growth of renewable energy, and a regulatory environment that subsidizes increased transmission of electricity from high-supply, low-cost regions to those with shortages and higher costs. Transmission-related capital spending by U.S. utilities has grown from $2 billion per year in the mid-1990s to over $15 billion in 2014, a level we believe is sustainable for at least the next five years. Quanta, with its existing relationships and a strong reputation for completing projects on time and on budget, should get more than its fair share of that.

How bad can it get on the energy side?

JS: The company's near-term pipeline projects are predominantly located in ar-

INVESTMENT SNAPSHOT

Quanta Services
(NYSE: PWR)

Business: Design, installation, repair and maintenance of infrastructure that supports the electric power and downstream energy industries, mostly in North America.

Share Information
(@7/30/15):

Price	**27.78**
52-Week Range	25.34 – 37.49
Dividend Yield	0.0%
Market Cap	$5.88 billion

Financials (TTM):

Revenue	$7.98 billion
Operating Profit Margin	6.2%
Net Profit Margin	3.7%

Valuation Metrics
(@7/30/15):

	PWR	S&P 500
P/E (TTM)	20.6	21.2
Forward P/E (Est.)	13.6	17.8

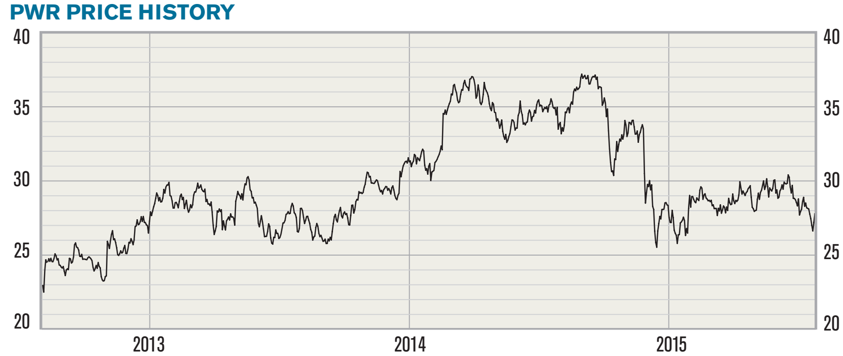
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Vanguard Group	8.1%
BlackRock	4.3%
State Street	4.1%
Citadel Adv	2.7%
1832 Asset Mgmt	2.6%

Short Interest (as of 7/15/15):

Shares Short/Float	1.9%

PWR PRICE HISTORY



THE BOTTOM LINE

Driven by growth in secularly favored power-transmission projects and resiliency in energy-related projects, Joel Hirsh estimates the company within the next few years can earn $2.60 to $3 per share. Using an 18x multiple – below the 20-21x average over the past 15 years – he believes the share price by then can at least double from today's level.

Sources: Company reports, other publicly available information

eas that produce natural gas as opposed to oil, and the price of natural gas has been relatively low, yet stable, for a number of years. That makes it less likely these projects will be reassessed, so we actually expect Quanta to retain much of its currently booked business on the pipeline side. That differs from how the shares are priced, which we'd argue assumes this business goes to zero and stays there.

How are you looking at valuation with the shares at a recent $27.75?

JH: We expect normalized earnings to be $2.60 to $3 per share over the next few years. Given the growth outlook for transmission projects and the quality of the moat in that part of the business, we think an 18x multiple would be reasonable, which would result in a $47 to $54 share price. Historically the multiple has been higher, averaging 20-21x over the past fifteen years.

Does it surprise you that Quanta was recently deemed the "most-loved stock" among Wall Street analysts?

MK: Now you're depressing us. But if that's true, we certainly don't believe it's reflected in the share price.

Walk through your broader bull case for Harley-Davidson.

JS: Harley-Davidson is obviously one of the best-known American brands, but the company is also well known to us as an excellent operator with high, consistent profitability and cash-flow generation. Even with Honda, Yamaha and Suzuki sharply cutting prices to gain share, Harley still has just under 50% of the market for heavyweight motorcycles in the U.S.

As I mentioned earlier, we think the company holding the line on pricing at the expense of a few points of market share is the right decision over the long run. It protects the brand, shows support for a loyal, dedicated dealer network that we consider a competitive advantage, and fortifies prices in a vibrant market for its used bikes. It shows a level of managerial discipline not commonly found in a world where the emphasis is increasingly on hitting next quarter's earnings.

Are there other longer-term issues to worry about with Harley, such as its traditional customers aging out of the market?

JS: This is not a new concern and we believe the company is doing the right things both from a product and marketing perspective to expand sales to younger riders and in more urban and international markets. These are long-term initiatives and we don't have any unique insight into their ultimate success, but we're confident in the strength of the brand and in Harley's proven ability to innovate on the product side.

U.S. car sales are back above peak levels of ten years ago but motorcycle sales aren't. Does that say anything about the secular trend line?

JS: What we think it says is that cars are more of a necessity than motorcycles, and that overall future demand in developed markets will be more GDP-driven than

INVESTMENT SNAPSHOT

Harley-Davidson
(NYSE: HOG)

Business: Manufacture, marketing, distribution and financing of premium-priced heavyweight motorcycles as well as related parts, accessories and general merchandise.

Share Information
(@7/30/15):

Price	**58.59**
52-Week Range	53.04 – 70.41
Dividend Yield	2.2%
Market Cap	$12.03 billion

Financials (TTM):

Revenue	$6.00 billion
Operating Profit Margin	19.9%
Net Profit Margin	13.2%

Valuation Metrics
(@7/30/15):

	HOG	S&P 500
P/E (TTM)	14.9	21.2
Forward P/E (Est.)	14.5	17.8

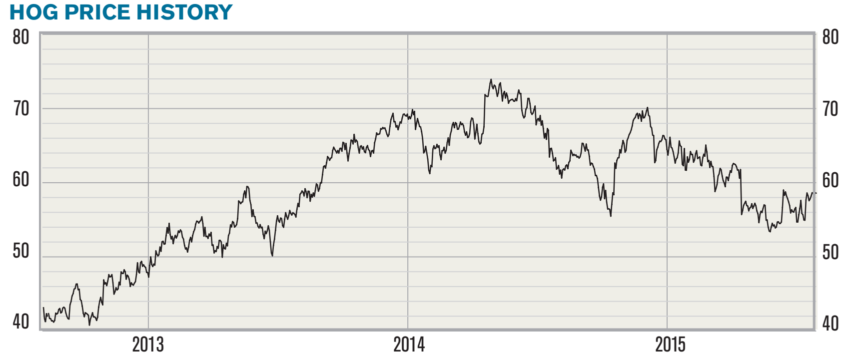
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Vanguard Group	8.0%
Wellington Mgmt	5.5%
Fidelity Mgmt & Research	5.5%
Baillie Gifford	4.7%
State Street	4.4%

Short Interest (as of 7/15/15):

Shares Short/Float	5.7%

HOG PRICE HISTORY



THE BOTTOM LINE

The company's recent market-share losses in the U.S. have damaged its stock price, but signal nothing more than temporary competitive incursions driven by the strength of the dollar versus the yen, says Jon Shapiro. At what he considers a reasonable 16-18x multiple on his $5 EPS estimate two to three years out, the shares would trade at $80-90.

Sources: Company reports, other publicly available information

anything else. There's potential beyond that in developing countries, where expanding income levels are likely to bring incremental first-time and move-up buyers into the market.

I'd mention here that the company in recent years has done a lot to increase its manufacturing efficiency and flexibility and to reduce costs. That will continue to have a positive impact on profitability regardless of unit growth trends.

How inexpensive do you consider the stock at today's $58.60?

JS: Absent a recession, we don't expect things to get much worse than the $4 consensus earnings-per-share estimate for this year. With a normalization of the currency situation, modest margin improvement as production expands, and continued share buybacks over the next couple of years – if the stock price stays low, the company could buy back at least $1 billion worth of shares – we believe earnings power over that time is in the $5-per-share range. We think a 16-18x multiple on that earnings power would be justified, resulting in an $80-90 share price.

MK: Charlie Munger says to always invert, meaning in this case to ask what has to happen for the current price to be the "correct" price. We think if you're not buying Harley shares at this level you believe something permanent has changed in the industry, in the value of the dollar, or with the company's strategy or competitive position. When we look at it from that standpoint, given that we don't believe any of those things are true, it's hard for us not to see the opportunity here.

We're a bit surprised recent-buy American Airlines was even in your universe of quality companies.

JS: It was certainly a recent addition. Like many value investors, we just didn't consider the airline industry investable. Remember one of Warren Buffett's more memorable quotes from his 2008 letter to shareholders: "If a far-sighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down."

The market has changed dramatically over the last few years. Four airlines – American, Delta, Southwest and United Continental – control over 80% of the domestic U.S. market, which has led to a more rational approach to pricing and capacity than has possibly ever been present in the industry. Current management teams are committed to generating returns on capital employed in excess of their cost of capital and on maximizing shareholder returns. Combined with the drop in fuel costs, airlines are flush with cash and appear, at least, set to deploy it in a manner that creates value rather than destroys it.

Is the current regulatory inquiry over possible collusion a concern?

JS: So far there's no formal investigation, just a request for information. You can never know in the regulatory realm, and somebody could have done something stupid, but we don't view the risk of this becoming a problem as high. It's not illegal to manage your business to avoid oversupply. The uncertainty may be keep-

INVESTMENT SNAPSHOT

American Airlines
(Nasdaq: AAL)

Business: World's largest airline formed from the December 2013 merger of American Airlines and US Airways; serves nearly 350 destinations in more than 50 countries.

Share Information
(@7/30/15):

Price	**40.27**
52-Week Range	28.10 – 56.20
Dividend Yield	1.0%
Market Cap	$27.90 billion

Financials (TTM):

Revenue	$41.95 billion
Operating Profit Margin	15.4%
Net Profit Margin	9.9%

Valuation Metrics
(@7/30/15):

	AAL	S&P 500
P/E (TTM)	6.9	21.2
Forward P/E (Est.)	4.6	17.8

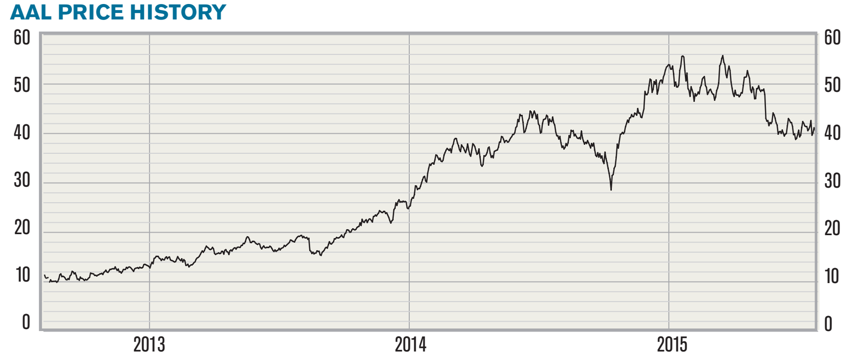
Largest Institutional Owners
(@3/31/15):

Company	% Owned
T. Rowe Price	12.7%
Capital Research & Mgmt	6.1%
Vanguard Group	5.4%
Fidelity Mgmt & Research	5.0%
BlackRock	3.6%

Short Interest (as of 7/15/15):

Shares Short/Float	3.4%

AAL PRICE HISTORY



THE BOTTOM LINE

While there's risk that U.S. airlines' relative embrace of competitive rationality will prove short-lived, Jon Shapiro believes that risk is more than priced into the company's shares. At only 10x his earnings-power estimate that assumes ticket pricing and passenger demand hold while fuel costs increase moderately, the shares would trade at closer to $60.

Sources: Company reports, other publicly available information

ing a lid on stock prices for now, which is fine by us.

JH: We probably shouldn't say it's a good sign that airlines might be investigated for colluding when they stop looking to expand irrationally, but it really speaks to how different the industry behavior has become. When Wall Street got worried about capacity expansion, the airlines went out of their way to say otherwise. That is not at all the way things have traditionally been done.

What makes American more interesting than any of the other big airlines?

MK: First of all, it was trading at about 7x fully taxed current-year earnings per share and at the greatest discount to our estimate of intrinsic value in the industry. We also believe there's the potential for extra upside here on both the cost and revenue fronts as the company finally integrates the reservation and other systems of American and US Airways, which was bought in 2013. The company plays it close to the vest in discussing specifics, but the CEO looks a bit like the cat who swallowed the canary when he talks about it publicly.

Now at $40.25, what upside do you see in the shares?

JS: Assuming ticket pricing holds, relatively inelastic demand barring a meaningful recession, and fuel prices reflecting $60-80 oil, we arrive at a fully taxed earnings power of around $6 per share. We wouldn't put a high multiple on that, but think 10x would be reasonable. That would give us 50% upside from today's price.

MK: I would add that while the valuation math is interesting, we're not yet prepared to make an outsized bet here. There is an above-average amount of risk to our upside scenario given the difficulty in projecting ticket pricing and fuel costs, which is why, as Joel described earlier, we used options to trade some of the upside potential for a lower entry price.

From airlines to television, why are you high on CBS [CBS]?

JH: CBS is a household name to many because it operates the highest-rated broadcast network in the U.S., but it also owns cable networks including Showtime and CBS Sports, production and syndication companies that produce content for network and cable TV, the Simon & Schuster publishing business, 30 local-broadcast CBS affiliates and over 100 radio stations. Roughly half of its revenues come from advertising and the other half from fees to license and distribute its content.

After a very strong run, CBS and other similar companies have seen their share prices fall as the tumult in the media industry increases, with content creators, broadcasters and distributors all jockeying over how big of a slice of the media-dollar pie they'll earn. At a basic level we believe the market is overstating its pessimism for CBS, which we think is well positioned for whatever media-industry landscape is ahead.

A lot of that has to do with having high-demand content that is increasingly valuable to both advertisers and distributors. CBS owns rights to a number of

INVESTMENT SNAPSHOT

CBS Corp.
(NYSE: CBS)

Business: Producer and distributor of media content; business lines include the CBS broadcast network, Showtime, Simon & Schuster, and local TV and radio stations.

Share Information
(@7/30/15):

Price	**53.20**
52-Week Range	48.83 – 63.95
Dividend Yield	1.1%
Market Cap	$26.18 billion

Financials (TTM):

Revenue	$13.74 billion
Operating Profit Margin	21.5%
Net Profit Margin	9.8%

Valuation Metrics
(@7/30/15):

	CBS	S&P 500
P/E (TTM)	21.4	21.2
Forward P/E (Est.)	15.4	17.8

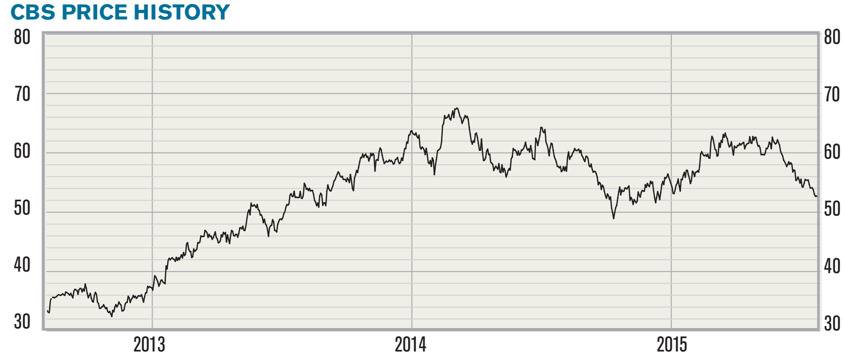
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Capital Research & Mgmt	8.1%
Vanguard Group	5.4%
State Street	4.2%
BlackRock	4.0%
Franklin Templeton	3.1%

Short Interest (as of 7/15/15):

Shares Short/Float	2.9%

CBS PRICE HISTORY



THE BOTTOM LINE

The company's high-demand content should allow it to prosper as media business models evolve, says Joel Hirsh. Assuming ad revenues decline slightly, retransmission fees increase in accord with recent experience and share buybacks continue, he expects EPS – and the share price – to increase at least 12-15% annually over the next three years.

Sources: Company reports, other publicly available information

live, marquee sporting and entertainment events and has consistently developed popular shows that have become brands in their own right. It was early and aggressive in monetizing its content – the $2 billion goal it set for retransmission fees it earns from pay-TV providers and local TV stations by 2020 is now looking conservative. That all has to do with having programming the pay-TV providers do not want to give up.

Isn't there increased risk the gravy train funded by ever-higher consumer prices for large content bundles gets somewhat derailed by Internet competition?

JH: This is clearly the most discussed topic in the industry today. But you're talking about essentially an oligopoly of large content companies, and for want of a more elegant way of putting it, we don't believe they'll be stupid in how and where they make their content available and at what price. If CBS makes its content available from another distributor – which is all "over the top" is – it will be making a business decision that the benefits outweigh any cannibalization of what it already has. They could make a mistake, of course, but in an environment where demand for good content is growing and it's hard for us to envision bundles that don't include core channels owned by CBS, we believe they're operating from a position of strength.

Is it hard to model future prospects in such an environment?

JH: The shares at today's price [of around $53] trade at a below-market multiple of less than 13x estimated 2016 earnings. If we conservatively assume that advertising revenues decline slightly over time, that growth in retransmission fees comes in basically in line with the experience in recent years as contracts rolled off and were renewed, and that the company continues to buy back shares at a $2 billion annual clip, we expect as a base case 12-15% annual EPS growth over the next three years. Even if the multiple stays at the current depressed level, that would translate into an attractive return on the shares. That's basically assuming the status quo, without any positive developments as the industry evolves.

The biggest risk?

JH: The main risk for CBS is that advertising comes in softer than expected. That's always a higher-risk cash-flow stream, which is why CBS has put so much emphasis in recent years on diversifying its revenue base. Viewership is becoming more fragmented and advertising dollars shifting to online is a threat. We generally believe CBS has the content and distribution to weather that, but we accept that the advertising number going forward could be volatile. At the current share price we're willing to take that chance.

ON CONSENSUS:

It isn't necessary for the three PMs to agree for a position to be bought or sold. We believe consensus breeds mediocrity.

You appear to have become more skeptical about the prospects for Viacom [VIAB], CBS' one-time corporate sibling. Why the distinction?

JS: While the stock's valuation still appears low, ratings have been declining rapidly at Viacom's flagship cable stations, Nickelodeon, MTV and VH1. We've become increasingly concerned that their target demographics are shifting more quickly to use of over-the-top and mobile offerings in which Viacom content may not end up having a prominent place. Valuation so far has kept us from exiting completely, but we've decreased our position size and are watching this evolution closely. We believe the risk to Viacom's cash flows is greater than it is for top-tier content companies like CBS.

In a generally rising market, what have you been selling for happier reasons?

JH: We have a range for what we think a business is worth. When the stock gets to the lower end of the range we want to be trimming, and when it gets to the higher end we want to be outright selling. But we're cognizant of the ability of great companies to create value, so we're continually updating what we believe the business is worth and aren't in a rush to fully exit something that we believe can compound value for many years.

One area in which we have done a lot of selling is healthcare, which made up probably 10-15% of the portfolio a year ago and is now close to zero. We were happy to own stakes in companies like Johnson & Johnson [JNJ], Abbott Laboratories [ABT] and Becton, Dickinson [BDX], but the valuations just got to the point where we were priced out of the market.

You talk about running a non-consensus portfolio. What do you mean by that?

JH: Mitch and Jon deserve a lot of credit for building an organization that discourages groupthink. Multiple people independently work through the research checklist on the same idea and are given time to arrive at what they believe prior to everyone getting together. That allows us when we are all together to more easily zero in on the few key issues at hand, and then to have a spirited and informed discussion to arrive at conclusions.

But even then it isn't necessary for the three of us to agree in order for a position to be bought or sold. Any one of us can veto a move, but that happens very rarely. More common is two agree and one doesn't, but the disagreement is more a function of timing and price than whether this is something we want to do.

MK: We handle it this way so that someone's strong conviction on an idea can still make something happen, even if the other two are more neutral. At the base of it all is that we believe consensus breeds mediocrity over time. VII