KOVITZ INVESTMENT GROUP
Intrinsic Values®

Market Insights
Spring 2018

Volatility is dead, long live volatility!

The year began with a continuation of the tranquil, steadily rising stock market[1] that so characterized all of 2017. However, despite his unfortunately accurate prediction of six more weeks of winter, famed meteorological prognosticator Punxsutawney Phil failed to warn investors of the jarring return to volatility that would coincide with his traditional annual announcement. Of the 39 trading days between Groundhog Day and the end of the quarter, 21 saw increases or decreases of more than 1%, 6 of which involved changes of greater than 2%. To put this in perspective, throughout all of 2017, there were only 8 days where the market closed more than 1% higher or lower than the previous day and precisely zero days where the daily change was greater than 2%. Scary stuff, right?

Well, not exactly. First of all, the market logged a loss of 0.8% for the quarter, so all the juking and jiving resulted in a market that was essentially unchanged. In fact, the number of days in which the market moved up more than 1% versus down more than 1% were roughly equal. Secondly, this degree of daily variation is much closer to the historical norm than the anemic volatility the market displayed in the previous year.

Even more importantly, we welcomed the volatility and hope this is just the beginning. While it may be unnerving to some investors, our patient approach of waiting for price and value to diverge requires it. Thus far, the increased stock market volatility has provided us with the opportunity to add to several existing positions and initiate two new ones. In these cases, their prices had declined more than the market average, while we could discern virtually no difference in the companies' values.

Although we feel the prices of many of the holdings in our clients' portfolios have fallen or remain substantially below their fair value, it remains puzzling why certain corners of the market persist in widening the gap between price and value in the opposite direction. Contrary to the impression given by the media of a steep sell-off in once-hot areas of the market, the overall quarter was marked by a resurgence of the recent trend where already expensive "growth" stocks became more expensive and outperformed the rest of the market. For example, despite peak-to-trough declines of around 10% to close out the quarter, Amazon and Netflix returned 24% and 54%, respectively, since the beginning of the year. Both companies began the year trading at already expensive valuations of 142x and 85x 2018 estimated GAAP earnings, respectively, and they ended the period trading at an astounding 172x and 108x 2018 estimated GAAP earnings, respectively.

[1] *All references to the "market" or the "stock market" refer to the S&P 500.*

T 312.334.7300 115 South LaSalle Street, 27th Floor, Chicago, IL 60603 www.kovitz.com

Meanwhile, the bond market continued to provide mixed signals. The Federal Reserve raised the overnight fed funds target rate another quarter of a percent in March and offered guidance to expect two more such rate increases in 2018 and three more in 2019. While longer-term rates increased in line with short-term rates for much of the quarter, they began tailing off slightly throughout March and ended at the lowest spread between the two in the last decade. Given this flattening of the yield curve and the Federal Reserve's current expectations for short-term rates, the market in longer-dated maturities is effectively saying, "I'll believe it when I see it."

Current Portfolio Positioning

As usual, there is a lot to worry about in the world and the economy right now. The current buzzwords include tariffs, trade wars, Syria, North Korea, and so on. Also, as usual, the ability of companies in possession of sustainable competitive advantages, high and sustainable returns on capital, sensible financial leverage, and a history of prudent allocation of shareholder capital – all the characteristics of companies we look to invest in – to consistently adapt to the ever-changing circumstances in which they operate gives us peace of mind as we invest your and our capital, side-by-side, across all asset classes. Our client portfolios are currently positioned as follows:

1. Equities: After the activity that took place during the quarter as a result of the increased volatility, our typical client portfolio is close to fully invested in a collection of companies that we believe are priced, in aggregate, substantially below their worth. Please see the accompanying Core Equity Commentary for additional details.
2. Fixed Income: Client portfolios remain focused on capital preservation. Our bond laddering strategy that balances the impact of rising interest rates between stability of principal and opportunity for reinvestment at higher yields has weathered the current environment well. Additionally, the increase in short-term rates has proven to be a great benefit to our clients' substantial holdings in non-agency mortgage-backed securities backed by adjustable-rate loans. Please see the accompanying Fixed Income Commentary for additional discussion of the interest rate environment and how Kovitz is responding to it.
3. Hedged Equity: KIG's hedged equity strategies performed remarkably well during the quarter as both the downside and upside hedges employed captured outsized gains due to the increased volatility.

As always, these are general comments that do not apply to all KIG clients. Please discuss your particular situation with your KIG Financial Advisor for more information on these topics.

Best Regards,

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