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.*

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,

Kovitz Investment Group

Kovitz Investment Group

Core Equity Commentary
Spring 2018

Market and Performance Summary

The Kovitz Investment Group (KIG) Equity Composite[2] (the "Composite") declined by 3.9% during the first quarter of 2018. For purposes of comparison, the S&P 500 fell 0.8% during the same period.

The equity market, for which 2017 was the least volatile year since 1965, is no longer serene. Of the 61 trading days during the first quarter, the market closed up or down at least 1% on 23 of them. During all of 2017, there were a total of only eight such days. January's gangbuster start which was fueled by the knock-on effects of the corporate tax cut was met with a February sell-off. The month featured several severe single-day declines and the largest ever one-day increase for the index that tracks volatility. In other words, the market was due for a breather and we got one.

The oft-cited reason for the February reversal was the fear of an overheating economy leading to inflationary pressures and the rise in longer-term interest rates that typically accompany such pressures. Remember, interest rates are one of the primary (if not, the primary) determinant of all asset prices, and higher rates act like gravity pulling prices lower. At these rate levels and even higher, we feel our clients' portfolios are well positioned. While we've pared back some of our financial sector exposure on strengthening prices during the quarter, our still healthy weighting should fare well in a rising rate environment as net interest margins, a primary component of earnings, will likely expand. Also, many of our industrial companies could see increasing demand while passing along any increases in input costs. Importantly, many of the high-multiple momentum stocks we don't own may experience valuation headwinds which would aid relative performance.

Regardless of which way the market winds blow next, we will continue to invest on the basis of value and its relationship to price, while we refrain from trying to time the market based on predictions of macroeconomic data or investor psychology. Many people in the news media and asset management industry believe they can assess and predict many things, such as the markets, the economy, politics, and even quarterly earnings. They cannot. Our base assumption is that markets are unpredictable – in good times and bad – and we aim only to navigate and profit from the inevitable upheaval the equity markets so frequently deliver. We are contrarian and confident in our investment processes, which requires us to filter out distractions and opinions of others and focus on the fundamentals and valuation of each individual business rather than the vagaries of the overall market. In other words, we are right at home in this newly volatile environment as we attempt to patiently compound our clients' capital for the long-term.

----

[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.*

The chart below summarizes annualized performance over various standard time periods ending March 31, 2018 and cumulative performance results from January 1, 1997 through March 31, 2018 for the Composite.

KIG Composite[3]
Annualized and Cumulative Equity Performance (Net of Fees)

	Average Annual Total Returns						Cumulative
For Period Ending 3/31/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
KIG Composite	8.1%	7.1%	9.7%	9.2%	9.7%	10.5%	736.5%

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.

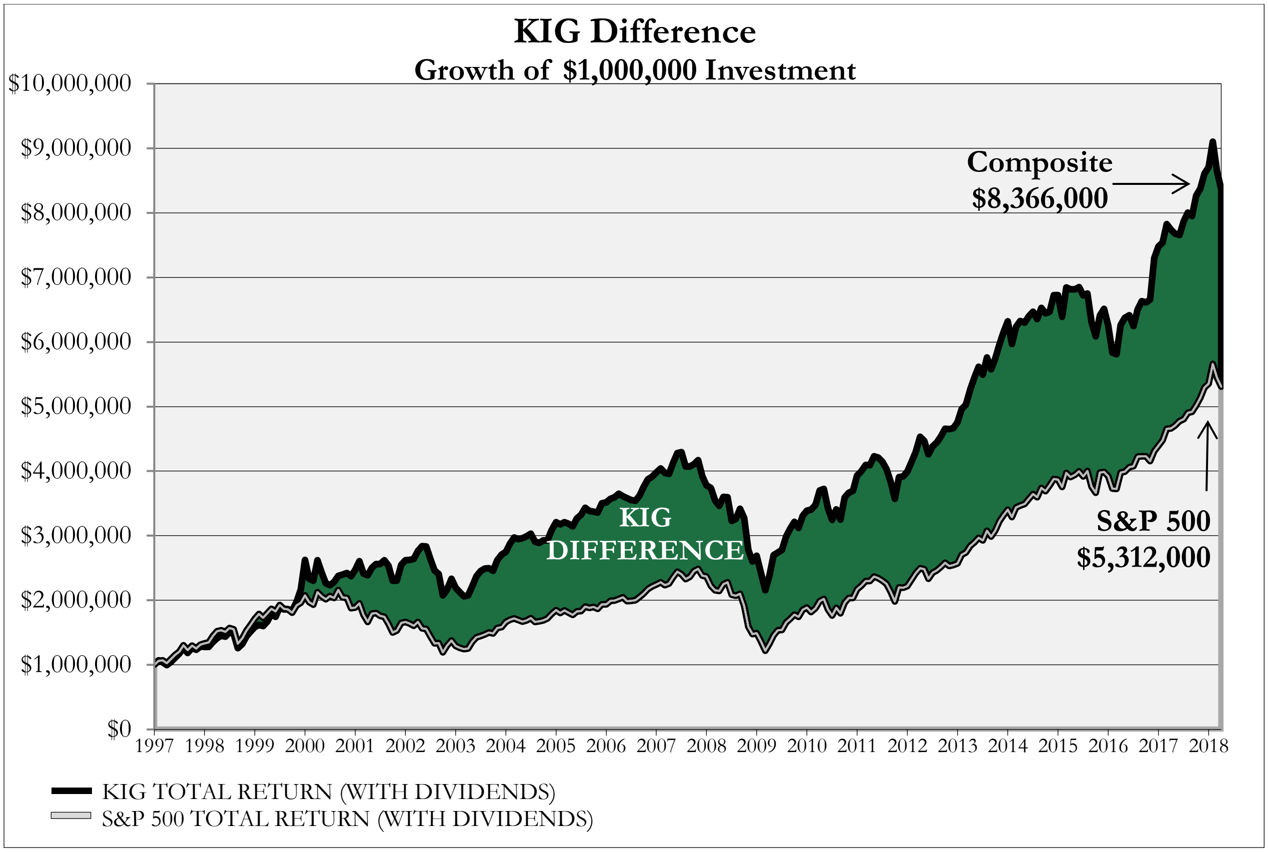
Other Market Indices
Annualized and Cumulative Equity Performance

	Average Annual Total Returns						Cumulative
For Period Ending 3/31/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
S&P 500	14.0%	10.8%	13.3%	9.5%	10.1%	8.2%	431.2%
Small Cap Equity (Russell 2000)	11.8%	8.4%	11.5%	9.8%	11.5%	8.4%	458.7%
International- Developed (MSCI- EAFE)	14.8%	5.6%	6.5%	2.7%	8.6%	4.9%	178.7%
International- Emerging (MSCI -EEM)	24.9%	8.8%	5.0%	3.0%	12.9%	6.5%	282.3%
Gold	5.2%	3.1%	-4.2%	3.0%	8.7%	5.9%	234.7%
Commodities (CRB)	6.4%	-2.1%	-7.7%	-6.3%	0.9%	2.1%	57.0%

Below is a graph of the KIG 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.

[3] *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.*

Since inception on January 1, 1997, the Composite has outperformed the S&P 500 by an average of 2.3 percentage points annually. That might not sound like much. However, the extraordinary power of compounding is such that this relative outperformance over 20+ years has generated considerable rewards for our clients. In dollar terms, $1 million invested in the Composite at inception would now be worth $8.4 million at March 31, 2018. By comparison, a similar investment in the S&P 500 would now be worth $5.3 million. In other words, an investment with KIG would now be worth 57% more than if one had simply invested in an index fund that tracked the S&P 500.



Portfolio Activity

Today's combination of a stable economy, low interest rates, and growing cash flows leaves us excited about the fundamentals of many companies, yet we remain wary of asset prices. Said differently, we can find many companies that meet our qualitative criteria, but the prices of their stocks are not sufficiently cheap to warrant inclusion in client portfolios. However, we were able to find three new investments during the quarter that checked both boxes.

Analog Devices (ADI)

Analog Devices is a leader in the design and production of high-end analog semiconductors. These chips bridge the gap between the physical world and digital devices by sensing and measuring physical inputs and converting that information to a digital signal. They create solutions to solve design challenges in the industrial, consumer, communications, and automotive industries. For example, for an automobile tire pressure warning light to turn on, a chip is needed to convert the analog (physical) signal into a digital (0's and 1's a computer can use) signal. The company has close to majority market share in the key segments of data converters and amplifiers, which together account for nearly three-quarters of revenue. High returns on capital, high and stable gross margins, a strong balance sheet, and high free cash flow conversion all point to a very high quality company. We believe the valuation at entry is sufficiently low to provide ample upside with significant downside protection.

Analog Devices completed the acquisition of Linear Technology in 2017. Linear possessed a product line that was extremely complementary to Analog Devices'. While normally skeptical of larger acquisitions, we believe the merger of these two companies has created an analog industry leader across an even wider range of products and with increased customer breadth and scale in all of their business lines.

Management is focused on improving gross and operating margins of the newly combined business. Restructuring activities have helped lower the cost structure, which has enabled the company to generate relatively steady gross margins. We believe increased demand will raise utilization rates and further boost gross margins. Additionally, management has also increased focus on higher-margin products, which continues to improve the margin profile of the overall business.

Goldman Sachs (GS)

Founded in 1869, The Goldman Sachs Group, Inc. is a leading global financial company providing investment banking, securities trading, and investment management services to a diversified client base. The company's primary reporting segments are: 1) Investment Banking (contributed 23% of the 2017 revenues), which is comprised of the Financial Advisory and the equity and bond underwriting business; 2) Institutional Client Services (37%), which consists of fixed income, currency, and commodities (FICC) trading, which includes client execution activities related to making markets in credit products, interest rate products, mortgages, currencies, and commodities, and equity trading, which includes client execution activities related to making markets in equities, commissions and fees, and the company's securities services business; 3) Investing and Lending segment (21%), which includes the company's investing-related activities across various asset classes, primarily consisting of debt securities and loans, as well as equity securities that include private equity and real estate; and 4) Investment Management division (19%), which is comprised of management and other fees related to the company's asset and wealth management businesses.

While investment banking has continued to perform well, low volatility in 2017 led to unfavorable market conditions in the FICC segment, which led, in turn, to lower client activity levels and depressed revenues. This weighed on the stock price and enabled us to take our position at a valuation we considered to be too low. We viewed this setback as temporary and the recent increase in volatility, which should aid this segment going forward, is a demonstration of that.

A past Composite holding, we believe Goldman remains well positioned for growth, given its well-diversified operations and solid client franchise. The company's focus on capitalizing on growth opportunities through various strategic and cost control measures will continue to strengthen the overall business and will help leverage the improving environment. Goldman has consistently enhanced shareholder value with steady capital deployment activities that have included increasing share buy-back activity and dividend levels.

Facebook (FB)

We utilized the recent controversy surrounding improper access and handling of user data to initiate a position in Facebook. While the underlying issue is serious, we don't believe it's likely to have a long-term impact on Facebook's earnings power. As Warren Buffett has said, "There is nothing that we own that doesn't have something in the future that might affect it." The vast majority of businesses will face challenges over time, which is why it's important for us to understand the sustainability of a business' cash flows. There will likely be ramifications for Facebook, including the potential for lower user engagement, loss of future advertising revenue, and increased compliance costs to run the business. However, after taking conservative assumptions into account for revenue growth and margins, the valuation post-sell-off still spelled opportunity. Like all the companies in our investable universe, we have followed this company closely and were prepared to act as the predictable wave of selling ensued following the negative headlines.

This is not the first time Facebook has come under fire and it likely won't be the last. Facebook's management must act quickly and will need to take significant action, so they don't risk losing user trust. However, the network effect of this powerful platform has persisted throughout the company's past scrutiny and there has been no measurable impact on its growth as a result. Our feeling regarding this latest incident is that this too shall pass and this dominant digital advertiser will regain its footing.

Increases/Decreases in Position Sizes

In order to optimize the value of our portfolio, we are always questioning our key assumptions, our overall thesis, and the relationship of price to our assessment of fair value for each position. We maintain a conservative and fact-based orientation, adjusting the portfolio as we go along, security by security, to optimize profit potential and reduce risk. This ongoing process results in concentrating the Composite portfolio in our highest-conviction ideas. To that end, we used weakness in the price of many of our current portfolio holdings during the quarter to increase position sizes.

We increased the Composite's position in **CBS (CBS)** and it is now one of the Composite's top 5 holdings. The television/cable industry is going through secular challenges as it deals with declining subscribers, movement to skinny bundles, and competition from so-called "over-the-top" competitors, such as Netflix and Hulu. However, not all media companies are equally disadvantaged. We would argue that CBS is positioned extremely well for the new era. The CBS broadcast network has many shows that are consistently ranked among the highest rated on television, and its sports rights to the NFL and NCAA basketball still attract large audiences that advertisers covet. Showtime remains a creative powerhouse, and its stand-alone streaming service, along with CBS All-Access, have approximately 4 million subscribers combined. CBS is also still in the middle of the process of increasing the retransmission and reverse-retransmission fees it receives from its cable partners and local station affiliates, respectively. This high-margin revenue has facilitated the reduction of advertising as a percentage of CBS's overall revenue.

In spite of these positives, the investment community remains concerned, perhaps understandably so, as clarity into the future world of media remains murky. However, these concerns have pressured the valuation of CBS's stock to a level where its valuation prompted us to take action. Investor pessimism can overshoot and leave a stock trading at a level that incorporates a wide margin of safety. Another way of saying this is that even if all the negativity was warranted, the downside appears extremely limited from this point forward, in our opinion. If what we described above is more indicative of CBS's future position, earnings will continue to grow and its low multiple will be re-rated higher.

We also increased the Composite's holdings of **Henry Schein (HSIC)** and **United Parcel Service (UPS)**, both of whose shares have dipped on the concern that Amazon.com (AMZN) may encroach further into their business. Based on its operating history, we would never be flippant about a threat from Amazon. However, each of these companies has strong competitive moats that we believe will likely insulate them from any permanent impairment of their earnings power. In Henry Schein's case, the sales force of this distributor of dental, medical, and animal health products acts in a consultative manner with its customers, providing a true differentiator to Amazon's primarily buy-online model. For UPS, the scale and scope of its global package delivery operations create barriers to entry that even Amazon would have trouble replicating without $10s of billions worth of investments. Even Amazon has limits. Again, current valuations lead us to conclude that the potential reward outweighs the risk in these two high quality companies.

Finally, we increased **Carmax (KMX)**, **Jacobs Engineering (JEC)** and **Walt Disney (DIS)**.

To provide ammunition for all our new purchases, we pared back client exposures to some of our best performing stocks over the past year. Among those trimmed were **Bank of America (BAC)**, **Boeing (BA)** and **JP Morgan (JPM)**. We also sold down some of our clients' smaller positions, primarily **Schlumberger (SLB)** and **Cheesecake Factory (CAKE)**.

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 provide 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.

Fixed Income Commentary
Spring 2018

Interest rates moved higher again this quarter with ten-year Treasury yields approaching 3% for the first time since 2013. The ten-year Treasury bond finished last year yielding 2.4%. The increase in yields coincides with a strengthening economy, a rising inflation rate, and an increasing federal funds rate. With respect to the latter, Jerome Powell replaced Janet Yellen at the helm of the Federal Reserve Bank ("Fed") this quarter. The change appears to be more cosmetic than material as Powell's commentary and policy has been largely in line with his predecessor. As such, the Fed hiked the federal funds rate another 0.25% to 1.75% in March and expects two more rate hikes this year. Additionally, Powell does not intend to change the plan laid out last year to reduce the Fed's $4 trillion of bond holdings over time. Both measures indirectly restrict employment and inflation growth to prevent the economy from overheating, and of direct importance to bond investors, they create an upward pressure on interest rates.

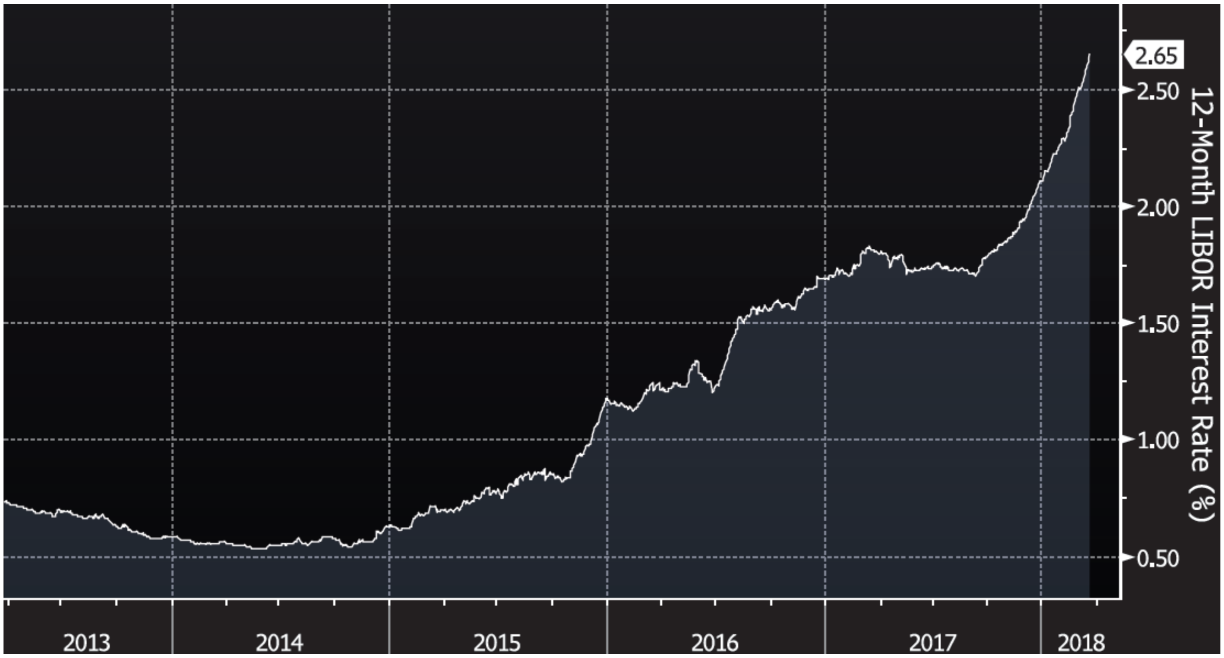
In the short-run, rising interest rates can be painful for bond investors. Rates and bond prices move in opposite directions – as rates increase, bond prices fall. The risk that rate movements will impair a bond's value is known as interest rate risk. There are two primary ways to minimize interest rate risk, both of which we employ in clients' bond portfolios:

1. **Buy bonds with limited time to maturity.** Since bonds are redeemed at a set "par" value and approach that value as time to maturity decreases, price deviations on short-term bonds are minimized.
2. **Buy floating-rate bonds.** Instead of being locked into fixed coupon payments, the coupons on floating-rate bonds reset to prevailing market interest rate levels. Since the coupons adjust for rate changes, the bond's price can remain relatively constant.

We moderate maturities by capping our clients' bond ladders at a maximum eight-years to maturity. While this structure is designed to protect principal better than longer-term maturities in a rising rate environment, it's the floating-rate bonds we have purchased for our clients that are showing the most immediate benefits.

Most of our non-agency mortgage-backed securities ("CMOs") are collateralized with adjustable-rate mortgage loans, and the coupons on these bonds have been ratcheting up along with other short-term rates. We originally started buying CMOs near the depths of the Financial Crisis in 2008. At the time, the bonds were trading at "fire sale" prices, and the success of the investments relied on home prices stabilizing and homeowners staying afloat. Every mortgage payment is delivered to investors at 100 cents on the dollar, so when bonds are purchased at large discounts, each payment realizes sizable gains for investors. Today, homeowners are on solid footing, and the CMO market is no longer plagued with the same risks from a decade ago. With credit no longer a major concern, bond prices are more rational, and total return relies heavily on coupon payments. Fortunately, coupon payments have been soaring over the last three years.

Short-Term Rates Are Soaring



The coupon rates for many floating-rate bonds are pegged to twelve-month LIBOR, including many non-agency mortgage-backed securities ("CMOs").

Adjustable-rate mortgages – much more popular before the Financial Crisis than today – are home loans with interest rates that change periodically based on movements in an underlying index, typically one-year Treasury yields or LIBOR rates[4]. For example, a borrower could be charged 2%, plus the twelve-month LIBOR rate. This borrower benefited from a low 2.5% mortgage interest payment in 2014, but that rate has climbed to over 4.5% today. If the Fed continues with their rate hike plan, the borrower's rate should continue to grow. Unless the borrower can pay off the loan or opts to refinance to a fixed-rate mortgage, those adjusted rates will keep flowing through to CMO holders in the form of higher coupons. Our primary goal as bond investors is to enhance client returns without accepting high levels of interest rate or credit risk, and CMOs play an important role in our clients' bond portfolios of doing just that.

[4] *The London Interbank Offered Rate ("LIBOR") is the rate which most large international banks are charging each other for short-term loans and is a widely-used benchmark for short-term interest rates.*

This newsletter has been prepared by Kovitz Investment Group Partners, LLC® (KIG), an investment adviser registered under the Investment Advisers Act of 1940, and is a quarterly newsletter for our clients and other interested persons. Within this newsletter, we express opinions about direction of the market, investment sectors and other trends. The opinions should not be considered predictions of future results. Discussion in this newsletter relating to a particular company is not intended to represent, and should not be interpreted to imply, a past or current specific recommendation to purchase or sell a security, and the companies discussed do not include all the purchases and sales by KIG for clients during the quarter. A list of specific recommendations made by KIG over the past year can be made available upon request. In addition, please note that any performance discussed in this newsletter should be viewed in conjunction with complete performance presentations that we update on a periodic basis. Such presentations are available at www.kovitz.com, or by calling us at 312-334-7300. Information contained in this newsletter which is based on outside sources is believed to be reliable, but is not guaranteed or not necessarily complete.

Past performance does not guarantee future returns.

Mary Anderson, MBA
312.334.7355
manderson@kovitz.com

Jenny Boyke, MAS, CPA, CFP®
312.334.7316
jboyke@kovitz.com

Marc Brenner, JD, CPA
312.334.7302
mbrenner@kovitz.com

Robert S. Burnstine, JD
312.334.7362
rburnstine@kovitz.com

David Castro, CFP®
312.334.7361
dcastro@kovitz.com

Andrea Cohen, CFP®
312.334.7312
acohen@kovitz.com

John Conway, CRPC®
312.334.7343
jconway@kovitz.com

Ed Edens, MBA, CFP®
312.334.7333
eedens@kovitz.com

Amanda Falkum, CFP®
312.334.7351
afalkum@kovitz.com

Skip Gianopulos, JD, LLM, CFP®
312.334.7303
sgianopulos@kovitz.com

Leonard Gryn, CPA
312.334.7360
lgryn@kovitz.com

Cara Haselrig
312.334.7331
chaselrig@kovitz.com

Joel Hirsh, CFA
312.334.7307
jhirsh@kovitz.com

Debbie Hopkins, MBA, CFP®
312.334.7325
dhopkins@kovitz.com

Joel M. Hunter, CFP®
312.334.7357
jhunter@kovitz.com

Kate Jonynas, CFP®
312.334.7309
kjonynas@kovitz.com

Mitchell Kovitz, CFA, CPA
312.334.7301
mkovitz@kovitz.com

William Lee
312.334.7335
wlee@kovitz.com

Melissa Mabley Martin, CFP®
312.334.7328
mmabley@kovitz.com

Bradford Madison, CFP®, CTFA
312.334.7347
bmadison@kovitz.com

Christopher Nicholson, CFP®
312.334.7319
cnicholson@kovitz.com

Jack Nicholson, MBA, CFP®
312.334.7323
jnicholson@kovitz.com

Jason Petitte, CFA
312.334.7311
jpetitte@kovitz.com

Peter Rudman
312.334.7327
prudman@kovitz.com

John E. Roessler, CPA, CFP®
312.334.7365
jroessler@kovitz.com

Mark Rosland
312.334.7322
mrosland@kovitz.com

Ted Rupp, MBA
312.334.7317
trupp@kovitz.com

Rich Salerno
312.334.7304
rsalerno@kovitz.com

Jonathan Shapiro, CFA, MBA
312.334.7324
jshapiro@kovitz.com

Jesse Stumpf, CFA
312.334.7320
jstumpf@kovitz.com

Eric S. Vernsten, JD, MBA
312.334.7348
evernsten@kovitz.com

Bruce Weininger, CPA, CFP®
312.334.7334
bweininger@kovitz.com

Patrick Wiese
312.334.7305
pwiese@kovitz.com