KOVITZ INVESTMENT GROUP
Intrinsic Values®

Core Equity Commentary
Winter 2019

Market and Performance Summary

For the fourth quarter of 2018, the Kovitz Investment Group (KIG) Equity Composite[1] (the "Composite") fell by 13.7% and finished the year with a loss of 11.1%. For purposes of comparison, the S&P 500 decreased 13.5% during the quarter and ended 2018 down 4.4%.[2] Since inception on January 1, 1997, our equity strategy has returned 674.0% (9.7% annualized) vs. a return of 411.8% for the S&P 500 (7.7% annualized).

One year ago, in our end of year 2017 commentary, we wrote:

> "Global equity markets continued their advance unabated, shrugging off a host of worries… Historically, one or two of these concerns would have sent markets reeling, if only for a short period of time. Have investors finally given up the ghost of sins past and resolved to tune out the noise that litters the financial news networks and publications? We highly doubt this time is different. For the time being, however, there seems to be a focus only on the good news..."

Outside of a brief respite in February and March of this past year, this sentiment continued into 2018 until it changed abruptly in this past quarter. Instead of focusing only on the good, market participants panicked over everything, resulting in the worst quarterly return since the depths of the financial crisis in 2008. However, what we are experiencing now is not a financial crisis – it's more just a crisis in confidence. Recent concerns have centered largely on the hawkish stance of the Federal Reserve, D.C. dysfunction, the impact that trade tariffs are having on the global economy and U.S. corporate profits, and how a global economic slowdown would impact our own relatively strong economy. The narrative up until recently had been that very little could derail the underlying strength of the U.S. economy.

Historically, the U.S. stock market has averaged a roughly 15% correction per year. In that context, recent movements are nothing out of the ordinary; we just forgot what they feel like after a decade pretty much devoid of such corrections. Perhaps it's our primal survival instincts that cause negative markets to feel worse than the good feels in rising markets. Or maybe it's the breathless coverage by the financial media who never met an unsettling story it didn't like. Intrepid news reporter Eric Sevaried once stated that "The biggest business in America is not steel, automobiles, or television. It

[1] *The returns for the equity portion of your individual account may differ from the Composite due to variations in account holdings, cash position, and other client-specific circumstances.*
[2] *Please refer to the last page of this newsletter for a complete presentation of KIG's Equity Composite, along with relevant disclosures.*

is the manufacture, refinement, and distribution of anxiety." And this was in 1964, well before the advent of the 24-hour news cycle.

Yet, to a great extent, ours is a strategy that needs a certain amount of anxiety and the occasional market correction in order to re-stock the portfolio with bargain securities and to concentrate our holdings in our highest conviction names. The really great investing opportunities are almost always found in environments of fear and doubt. The last thing we want to do is add regret to the list of emotions, so we are taking advantage of prices that will likely seem cheap in retrospect. In other words, it allows us to get active again after sitting on our hands for much of the last couple of years. This is evident in the number of transactions described in our "Portfolio Activity" summary below.

"Perceived" Risk

Recent action in the markets may be indicating the possibility of a recession on the near-term horizon. While we have invested through many recessions, we don't know of anyone – ourselves included – who has a successful track record of accurately predicting one. We do know this, however: it goes against the grain of conventional market wisdom, but every day the market goes down it becomes less risky. Conversely, a rising market becomes riskier with each new high set. Seth Klarman, legendary investor and CEO at the Baupost Group, sums it up this way:

> "Most investors take comfort from calm, steadily rising markets; roiling markets can drive investor panic. But these conventional reactions are inverted. When all feels calm and prices surge, the markets may feel safe; but, in fact, they are dangerous because few investors are focusing on risk. When one feels in the pit of one's stomach the fear that accompanies plunging market prices, risk-taking becomes considerably less risky, because risk is often priced into an asset's lower market valuation. Investment success requires standing apart from the frenzy – the short-term, relative performance game played by most investors."

To value-minded investors, the time to buy is when perceived risk is high; the time to sell is when perceived risk is low. Risk to us is inherent in price and value, not in price momentum. Stock prices fluctuate as underlying fundamentals change or are perceived to change. Since business operations don't fluctuate nearly as much as perceptions, prices often change not because reality has changed, but because investors' perception of reality has changed. A big gap between perception and reality can create a big opportunity for profit.

Losses of the magnitude experienced during the fourth quarter in such a short period of time can become paralyzing for some. Conversely, it can encourage overreaction and increased instability of emotions. These are the primary reasons we have a structural framework in place to guide our actions. Our big-picture philosophy is that we believe in investing in leading business franchises when they face transitory negative events. If we're right about the transitory part, we can typically buy when we believe there's both much less downside and much more upside than the market as a whole.

Our job, then, is to endure the emotional discomfort of deviating from the crowd and not give in to the temptation to guess what the market will do in the short run. The bedrock of our philosophy is that price matters. Just as our clients would be poorly served if we chose to simply pile into whatever shares had appreciated the most over recent years (ignoring price, valuation, and underlying fundamentals), they would be equally disserved if we gave into market fears and ignored the opportunity set brought on by falling prices. This is a time when paying calm, careful, and deliberate attention to the investment landscape can have a tremendous payoff. Sources of future returns are often sowed in times of turmoil.

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

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

	Average Annual Total Returns						Cumulative
For Period Ending 12/31/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
KIG Composite	-11.1%	7.3%	4.1%	11.1%	7.1%	9.7%	674.0%

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

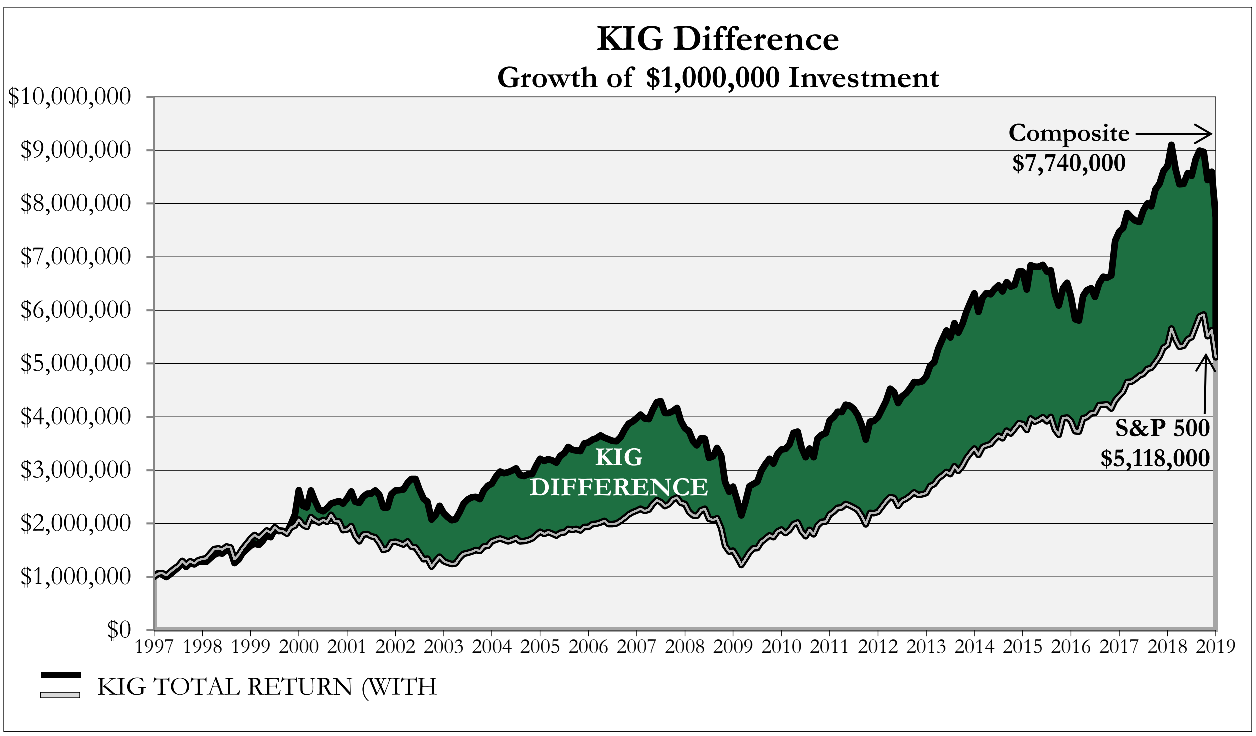
	Average Annual Total Returns						Cumulative
For Period Ending 12/31/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
S&P 500	-4.4%	9.3%	8.5%	13.1%	7.8%	7.7%	411.8%
Large Cap Value (Russell 1000 Value)	-8.3%	7.0%	5.9%	11.2%	7.0%	7.7%	416.4%
Small Cap Equity (Russell 2000)	-11.0%	7.4%	4.4%	12.0%	7.5%	7.6%	397.6%
International- Developed (MSCI- EAFE)	-13.8%	2.9%	0.5%	6.3%	4.7%	4.1%	144.0%

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

International- Emerging (MSCI -EEM)	-14.6%	9.2%	1.6%	8.0%	7.9%	5.5%	222.0%
Gold	-2.8%	5.7%	0.7%	3.1%	7.0%	5.5%	222.3%
Commodities (CRB)	-10.7%	-0.1%	-8.9%	-2.6%	-1.0%	1.5%	38.6%

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.

Since inception on January 1, 1997, the Composite has outperformed the S&P 500 by an average of 2 percentage points annually. That might not sound like much. However, the extraordinary power of compounding is such that this relative outperformance over 22 years has generated considerable rewards for our clients. In dollar terms, $1 million invested in the Composite at inception would now be worth $7.7 million at December 31, 2018. By comparison, a similar investment in the S&P 500 would now be worth $5.1 million. In other words, an investment with KIG would now be worth about 51% more than if one had simply invested in an index fund that tracked the S&P 500.



Portfolio Activity

During the quarter, we initiated one new position, added to numerous currently held positions, and completely exited two others. As discussed above, volatility (also known as sell-offs) is a necessary condition for our strategy's success.

We took a new position in **US Foods (USFD)**. US Foods is a broadline distributor with a national footprint that supplies food and other supplies to restaurants and commercial kitchens in the health care and hospitality industries. The industry is highly fragmented. Sysco, US Foods, and Performance Food Group account for 16%, 9%, and 6% of industry sales, respectively, but the market shares of other competitors start to drop off dramatically after that. The three large players frequently engage in small, bolt-on acquisitions. The scale they have achieved has become a self-reinforcing advantage as they reap the benefits of purchasing inventory on a larger scale, generating cash that is used to upgrade their distribution centers, and building a more efficient distribution network by optimizing truck loads and increasing route density. US Foods further distinguishes itself from its competitors by offering best-in-class analytics and menu management tools that help their customers optimally run their businesses.

Shares of US Foods had fallen nearly 30% from its recent highs after the announcement of the acquisition of a large competitor, SGA, was poorly received by the market. Instead of deleveraging its balance sheet, the company instead paid what was generally considered a high price for an acquisition. Investors were further disappointed with a worse than anticipated earnings report. While we don't dispute that the management team paid a full price, the asset is a good strategic fit that fills out US Foods' presence in the Northwest, which has been one of the stronger geographic areas in the U.S. for food distribution. Over the long run, we expect US Foods to grow their revenue roughly in line with nominal GDP and be further supplemented by smallish acquisitions. Add in some operating leverage, and earnings have the potential to grow at a mid- to high-single digit pace for the foreseeable future. With the shares trading at 13x forward earnings at our purchase, a six-multiple discount to Sysco, we believe this represents an attractive entry price for a company with a stable, predictable business that should grow earnings at least in line with the overall market over long periods of time.

Among the positions we increased were:

Facebook (FB) – Negative headlines over privacy concerns persisted, pushing the valuation to its lowest level since becoming a public company. User metrics remain intact, however, and we don't see advertisers abandoning the site. The stock is now priced as if the opposite were true in both cases.

American Airlines (AAL) – The stock sold off as concerns over the global economy escalated even as oil prices came down over 30% from its recent highs. At its current valuation, it is hard for us to envision a scenario where there is more downside over the next few years.

Blackstone (BX), **CarMax (KMX)**, **CBS (CBS)**, **Jacobs Engineering (JEC) and Quanta Services (PWR)** – All appear to be pricing in a significant recession that may or may not come. To the extent the economy does weaken, we believe downside from current levels is limited.

Mohawk (MHK) – Shares of Mohawk traded down sharply after the company announced disappointing Q3 results and lowered guidance for the next two quarters. The reduction in guidance is being caused by a confluence of factors, including: steep inflation on input costs due to higher commodity costs; the impact of tariffs on materials imported from China; rising transportation costs due to higher fuel cost and strained capacity among trucking companies; increased competition from foreign competitors due to the strong/strengthening dollar; and, lower-than-expected volumes due to production capacity constraints and weakened demand.

We believe many of these factors are temporary and the negative impact is being compounded by the fact that they are hitting just as Mohawk is nearing the end of an investment cycle. Furthermore, we do not believe the company's long-term competitive position within the industry has been degraded. Mohawk remains a low-cost producer with an expansive global manufacturing and distribution network that would be difficult for a competitor to disrupt. As these forces abate and the U.S. housing market adjusts to higher interest rates, we continue to believe Mohawk's normalized earnings power is significantly higher than recent results would indicate.

We sold **Henry Schein (HSIC)** because it had both reached our estimate of fair value and we believed the capital was better invested in the other positions listed above. At purchase in November 2017, we paid what we believed was a slightly below-market multiple for a superior business and industry leader. After increasing our clients' position on additional weakness in February, the shares quickly appreciated to a valuation of nearly 20x forward earnings, which was in line with our estimate of fair value.

We also exited **McKesson (MCK)**. Unlike Mohawk where we believe most issues are temporary and that their competitive position has not changed, McKesson is a little more nuanced. While McKesson provides a necessary service (delivering drugs) and is one of three large players in a consolidated industry, it has become increasingly difficult to estimate normalized earnings. Headwinds for McKesson seem much more secular in nature (as opposed to cyclical in MHK's case) and we chose to shift capital into other opportunities where we have more conviction.

Key Contributors/Detractors to Results

For calendar year 2018, the individual positions that impacted performance the most during the year were:

Top 5 Contributors		Top 5 Detractors	
Company	Percentage Return*	Company	Percentage Return*
Starbucks	33.5%	**Quanta Services**	-22.9%
Henry Schein	17.4%	**Mohawk Industries**	-45.3%
Robert Half Int'l	4.8%	**CBS**	-24.9%
Aon	9.6%	**American Airlines**	-37.7%
Berkshire Hathaway	3.0%	**Bayer**	-42.0%

*Including impact of dividends

Largest Current Positions

As of December 31, 2018, the Composite's ten largest positions were:

Company	Ticker
Berkshire Hathaway	BRK.B
Alphabet	GOOG/GOOGL
Quanta Services	PWR
Apple	AAPL
CBS	CBS
CarMax	KMX
General Motors	GM
Jacobs Engineering	JEC
AMERCO	UHAL
CBRE Group	CBRE

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.