Core Equity Commentary
Summer 2017

During the second quarter of 2017, the Kovitz Investment Group (KIG) Equity Composite[1] (the "Composite") appreciated by 1.7% while our benchmark, the S&P 500, increased 3.1%. Year-to-date through June 30, the Composite has risen 5.3% vs. a gain for the S&P 500 of 9.3%. Over the past one year the Composite generated a return of 26.0% vs. an 17.9% return for the S&P 500.

While the equity market continued its rise, the quarter's most notable development may have been the waning odds of the Trump economic agenda being enacted quickly – or at all. The presumed combination of business-friendly tax cuts, deregulation, and infrastructure spending that would sail through both Republican-controlled houses of Congress seems farther away than ever. The investment implication of this shift in sentiment has been that companies more levered to economic growth have been re-rated lower, while those companies perceived to have secular growth tailwinds regardless of overall economic growth have been celebrated.

Many of the companies we own, such as financials and industrials, are perceived by the investment community as tethered to overall economic growth. While an improved growth outlook would no doubt benefit these companies, our valuation models tell a slightly different story: The stocks trade inexpensively even if growth is less robust. In other words, many of the high quality companies we own are trading inexpensively on fundamental considerations, and remain inexpensive even with modest expectations of how fast their earnings can grow.

As important, each of these categories (cyclical growers/secular growers) has been sold or bought seemingly without regard to valuation considerations. As we pointed out six months ago when the initial reaction to Trump's expected economic agenda favored many of our holdings, we viewed their appreciation simply as moving the valuations of those companies from tremendously undervalued to more moderately undervalued. While the market hasn't completely returned to the irrational bifurcation between loathed value stocks and loved growth and "dividend" stocks that prevailed for much of 2016, the result of the past few months has been to once again make cheap stocks cheaper and pricey stocks pricier. Keep in mind, faster growth may be better than slower growth, but only if you pay a fair price for it. Likewise, slower growth companies can have considerable investment merit if bought at the right price. You, our clients, would be poorly served if we chose to simply pile into whatever shares had appreciated the most recently, ignoring valuation and underlying fundamentals.

As we've made clear over the years, KIG is a value-oriented, research-driven investment management firm. As such, valuation is paramount to each and every decision we make, and we refuse to allow

[1] *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.*

ourselves to get sucked into the Wall Street guessing game of who is going to beat next quarter's earnings or following investment flows into the current "hot" sector. Is it a waste of time to pore through SEC filings when investors seem to be more interested in buying "exposure" than individual stocks? Are we wrong to hold a portfolio of undervalued stocks of fundamentally strong businesses? In this period of time where flows to passive strategies dominate the fantasy of investment advisors, and quantitative trading algorithms dictate the path of short-term price movements, our sense is that we must elongate our already long time horizon. It seems unlikely to us that such a time-tested value-based strategy would suddenly become a liability in generating performance. However, over shorter periods of time, our relative investment performance may lag the market's because we reject the impulse to buy overvalued and extremely risky parts of the market. Our job is to endure the emotional discomfort of deviating from the crowd, which sets the stage for our style of investing to continue to outperform the market over time.

Short-term market price movement does not tell us anything about long-term value. To gauge value, we look at a business through four primary filters. Is it understandable, with sustainable competitive advantages and a favorable long-term outlook? Is it financially durable, with strong cash generation, high returns on capital, and low leverage? Does management have a proven history of high ethical standards, astute capital allocation, and creating shareholder value? And finally, can we buy its stock at a significant discount to a reasonable estimate of intrinsic value?

Our simple goal is to earn good long-term returns by purchasing a part ownership in high-quality businesses, ideally holding them for many years. Businesses are the wealth creation engines of our society. We want to partner with the best of them, but without overpaying for the privilege.

As a mentor once stated, "The most difficult time to invest is now." It seems these words may never be more genuinely felt than in the environment in which we find ourselves today. But is the current investment landscape really more littered with potential mines than usual? Probably not. However, this is a time when paying calm, careful, and deliberate attention and not being shaken out of your core beliefs can have a tremendous payoff.

The chart below summarizes annualized performance over various standard time periods ending June 30, 2017 and cumulative performance results from January 1, 1997 through June 30, 2017 for the Composite.

KIG Composite[2]
Annualized and Cumulative Equity Performance (Net of Fees)

	Average Annual Total Returns						Cumulative (20.5 years)
For Period Ending 6/30/17	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
KIG Composite	26.0%	6.8%	12.4%	6.2%	7.6%	10.6%	687.0%

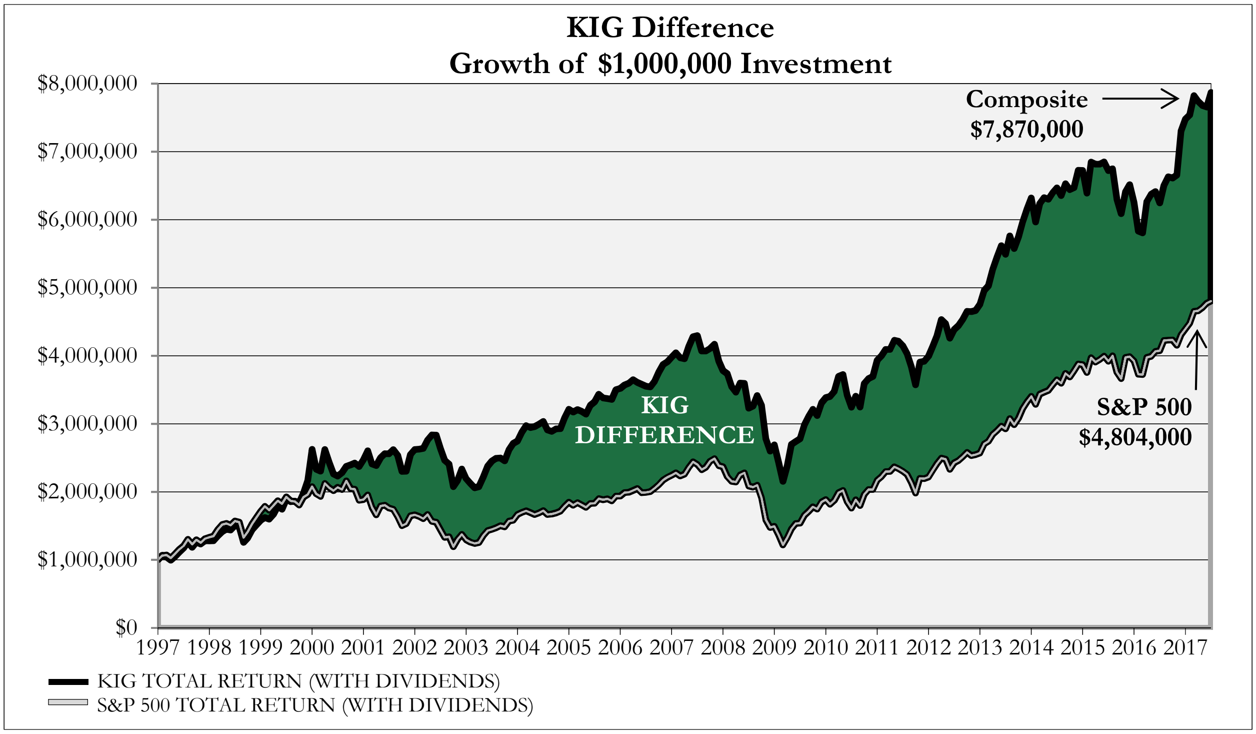
The table below lists the results for the same time periods as above for the S&P 500 and many of the other benchmarks widely held as investments via a "style-box" approach.

Other Market Indices
Annualized and Cumulative Equity Performance

	Average Annual Total Returns						Cumulative (20.5 years)
For Period Ending 6/30/17	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
S&P 500	17.9%	9.6%	14.6%	7.2%	8.3%	8.0%	380.4%
Small Cap Equity (Russell 2000)	24.6%	7.4%	13.7%	6.9%	9.2%	8.3%	412.1%
International Developed (MSCI-EAFE)	20.3%	1.1%	8.7%	1.0%	6.3%	4.7%	157.6%
International Emerging (MSCI-EEM)	23.7%	1.1%	4.0%	1.9%	10.6%	5.9%	225.2%
Gold	-6.9%	-2.7%	-5.5%	5.9%	8.8%	5.8%	215.7%
Commodities (TR/CC CRB)	-8.7%	-17.0%	-9.1%	-5.3%	1.5%	1.6%	39.1%

[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.

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.



Portfolio Activity

As we have repeated for several quarters now, the pursuit of investments that combine quality with a margin of safety remains difficult. The hunt is typically easier when the market is weak and more difficult when it is strong. We recently passed the eight-year anniversary of the market bottom after the financial crisis. Since then, stocks have basically gone straight up with only a few brief periods which could be considered minor corrections. The disciplined investors' best friend – volatility – has been practically non-existent. The current ultra-low interest rate environment, which we consider temporary rather than permanent, has caused many investors to abandon their long-term views and accept today's lofty valuations as normal. In times like these, investors primarily concerned with preservation of capital – like us – must be willing to be relatively inactive. We are perfectly happy to wait for opportunity, rather than purchase securities that, in our view, do not have an adequate "margin of safety."

Investment activity this quarter consisted of initiating one new position, adding to three existing positions, trimming our exposure to one and eliminating another.

Our new position was taken in **Bayer AG (BAYZF)**, a life science company headquartered in Leverkusen, Germany. Possibly most recognizable as the creator of Aspirin, Bayer is a global firm generating nearly €50 billion of revenue through its operations developing and marketing pharmaceuticals (36% of 2016 revenue), agricultural crop science products, such as seeds and herbicides (22%), over-the-counter consumer healthcare products (13%), and animal health products (3%). The remaining 26% of revenue is derived from a chemicals division that Bayer is in the process of divesting, the proceeds of which along with cash and stock will be used for the announced acquisition (pending anti-trust approval) of Monsanto, the US-based crop science innovator. When everything shakes out, Bayer will be focused exclusively on health care and crop science. Within these areas, the combination of established, highly successful products and a healthy pipeline of future offerings driven by a long history of innovation forms the basis of a defensible competitive advantage relative to its peers.

Our entry was made possible, in part, by the current malaise in Bayer's and Monsanto's crop science businesses. Multiple years of large corn and soybean harvests across the globe have depressed the prices of these commodities, which has depressed the income of Bayer's and Monsanto's customers and put downward pressure on the prices of Bayer's and Monsanto's products. At about 13 times our estimate of post-divestiture, post-merger earnings – earnings that are depressed by the factor mentioned previously – we believe our purchase represents exactly the type of opportunities we look for: a competitively and financially strong company whose share price is depressed due to what we perceive as temporary factors. Situations such as this should provide outsized returns when the temporary factors abate, or, in a worst-case scenario, they provide a large margin of safety against a permanent loss of capital.

We increased our position sizes in **Amerco (UHAL)**, **General Motors (GM)**, and **Harley-Davidson (HOG)**. Amerco's U-Haul division meets all of our qualitative criteria for a business that is using its competitive positioning to continually widen its moat versus the competition. Earnings have been lumpy as management continues to invest in the business without regard to hitting pre-defined quarterly goals. Management's primary concern is to build intrinsic value over time, and they have our proxy to do that even if Wall Street would like them to be more short-term focused.

General Motors also continues to run its business for the long-term. Considering its strides in terms of margin expansion and disciplined capital allocation, we believe the company isworthy of our investment dollars. There is plenty of debate as to the trajectory of new car sales over the next few years, but our analysis demonstrates that GM's stock is priced for severe declines. We therefore don't see much downside even if this dire scenario comes to pass.

After trimming shares of Harley last quarter on strength, we added back to our position on weakness. Sales continue to be lackluster, but much like General Motors we believe this is priced in the stock at current levels. Meanwhile, the company is generating healthy free cash flow which they are using to pay a decent sized dividend and to repurchase stock.

We pared our exposure to **Boeing (BA)** after a roughly 30% gain year-to-date has brought its price closer to our estimate of fair value. Finally, we eliminated our remaining position in **Coca-Cola (KO)** for valuation reasons.

We appreciate the confidence that you, our partners, have placed in us to manage your capital on a long-term basis. In the long-run, we believe your patient capital, alongside of ours, will be amply rewarded for following our investment discipline instead of following the crowd. We would not be comfortable investing your money or our own in any other way.

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