KOVITZ INVESTMENT GROUP
Intrinsic Values®

Market Insights
Summer 2017

The second quarter of 2017 saw both equity prices and fixed income prices increase. By quarter-end, stocks were trading only about 1% below their all-time high (for a complete summary of the equity market performance, please see the accompanying Core Equity Commentary). Bond prices also increased as yields moved meaningfully lower (recall that bond prices and yields move inversely to one another).

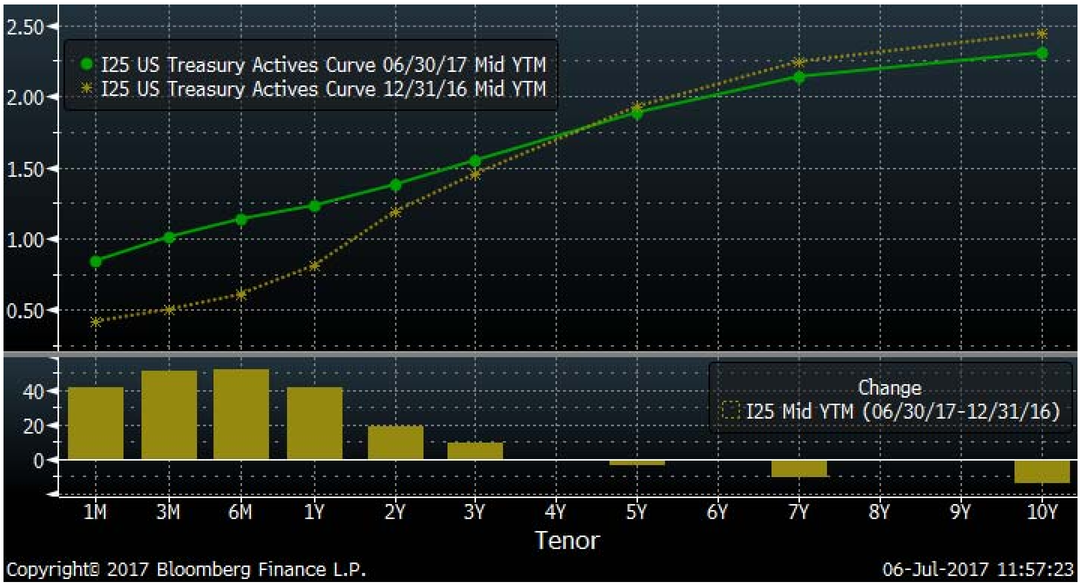
At the same time, stock market volatility, as measured by the VIX (often referred to as the "fear index"), moved lower. After beginning the quarter at 12.38%, the VIX set an all-time low of 9.75% before ending at 11%. The long-run average level of the VIX is about 20%. A declining VIX implies investors perceive very little risk in buying stocks today. However, this level of implied riskiness is at odds with stock valuations that continue to be towards the high end of historical measures. In our opinion, this is at odds with economic reality; a more richly valued market has the potential for greater downside.

S&P 500 (SPX) vs. CBOE S&P 500 Volatility Index (VIX), Year-to-Date

If the stock market is currently pricing in the future cash flows of the underlying companies efficiently, one of three things is happening: 1) economic growth is likely to improve materially, 2) riskiness of the cash flows has declined, or 3) interest rates will remain at current depressed levels for the foreseeable future.

While long-term bond yields fell during the quarter, short-term rates rose as the Federal Reserve continued to increase overnight lending rates. As a result, the yield curve flattened during the quarter (Please see the Fixed Income Commentary for further discussion).

US Treasury Yield Curve, 6/30/17 vs. 12/31/16



In our opinion, the flattening of the yield curve suggests the bond market sees interest rates remaining lower than historical levels for a longer period of time, which implies that economic growth will not be strong enough to justify a normalization of interest rates to pre-2008 levels.

Generally, a rising stock market with full valuations and low volatility are at odds with a flattening yield curve. Ironically, and despite what is generally the case historically, high stock valuations, low volatility and a flattening curve could be pricing in the same opinion. In the event economic growth is positive, but weaker than historical trends, and interest rates are destined to be lower for longer, stocks are mathematically worth more because the discount rate used to value cash flows is lower. In other words, if interest rates remain low, this would translate to stocks trading at a higher multiple than they have historically.

However, the danger lies in the definition of "low" with respect to interest rates. If the yield on the 10-year Treasury were to even partially revert to its mean, it would imply a rate meaningfully higher than today's, and would create a quite challenging environment for current equity valuations. This is one of the main reasons we continue to view right now as a time to be cautious while investing.

Current Portfolio Positioning

In light of the above discussion, we are highly focused on maintaining a disciplined approach to managing our clients' portfolios where valuation is the bedrock of all investment decisions. Over the last twenty years, there have been numerous time periods where we have watched other investors increase their willingness to take on greater risk for diminishing returns. Periods such as the internet bubble of the late-'90s and the commodity and emerging markets bubble of 2007 were prime examples of this behavior. Much as we did in those periods, we have maintained our valuation requirements for both equities and fixed income, and we believe this is the primary reason we have achieved strong returns for our clients *without* taking the extra risk implied by broad asset prices. We are invested side-by-side with our clients and will continue to be more than happy to take a pass on investments with inferior return prospects and elevated odds of losing money. Across our strategies we are positioned as follows:

1. In equities, we remain defensively positioned, with cash levels rising as we have been trimming stocks that have reached our fair value estimates. Our core holdings are performing well fundamentally, but it has been extremely difficult for us to find new ideas to add to the portfolio that meet our qualitative and quantitative criteria. We have discussed this in greater detail in our accompanying Core Equity Commentary.

2. In fixed income, we see little incentive to extend maturities as short-term rates have risen while long-term rates have fallen. As such, we continue to deploy cash in maturities ranging from one to eight years. As always, we are maintaining very high credit quality levels, and do not believe in reaching for yield at the expense of a possible impairment of principal. Please read more about this in our accompanying Fixed Income commentary.

3. Where appropriate, we continue to recommend the inclusion of some alternatives (hedged equity, specific real estate opportunities, etc.), where a more attractive risk/reward profile might exist. An enhanced risk/reward profile often results as a tradeoff for assuming less liquidity than in the public markets. As always, please discuss your particular situation with your KIG financial advisor.

Best Regards,

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