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).

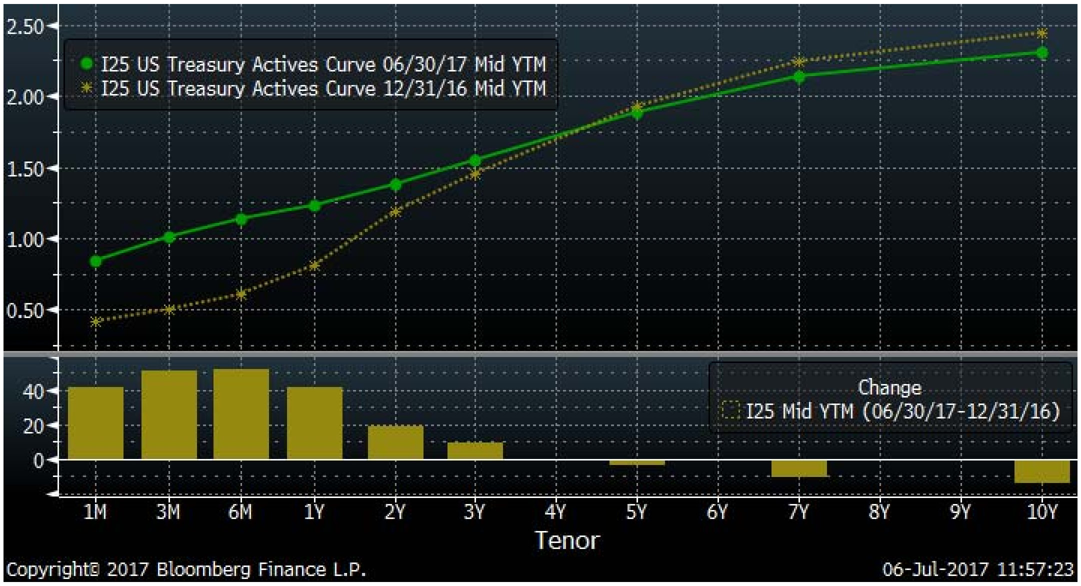
At the same time, stock market volatility, as measured by the VIX (often referred to as the "fear index"), moved lower. After beginning the quarter at 12.38%, the VIX set an all-time low of 9.75% before ending at 11%. The long-run average level of the VIX is about 20%. A declining VIX implies investors 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,

Kovitz Investment Group

Kovitz Investment Group

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 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,

[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.*

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%

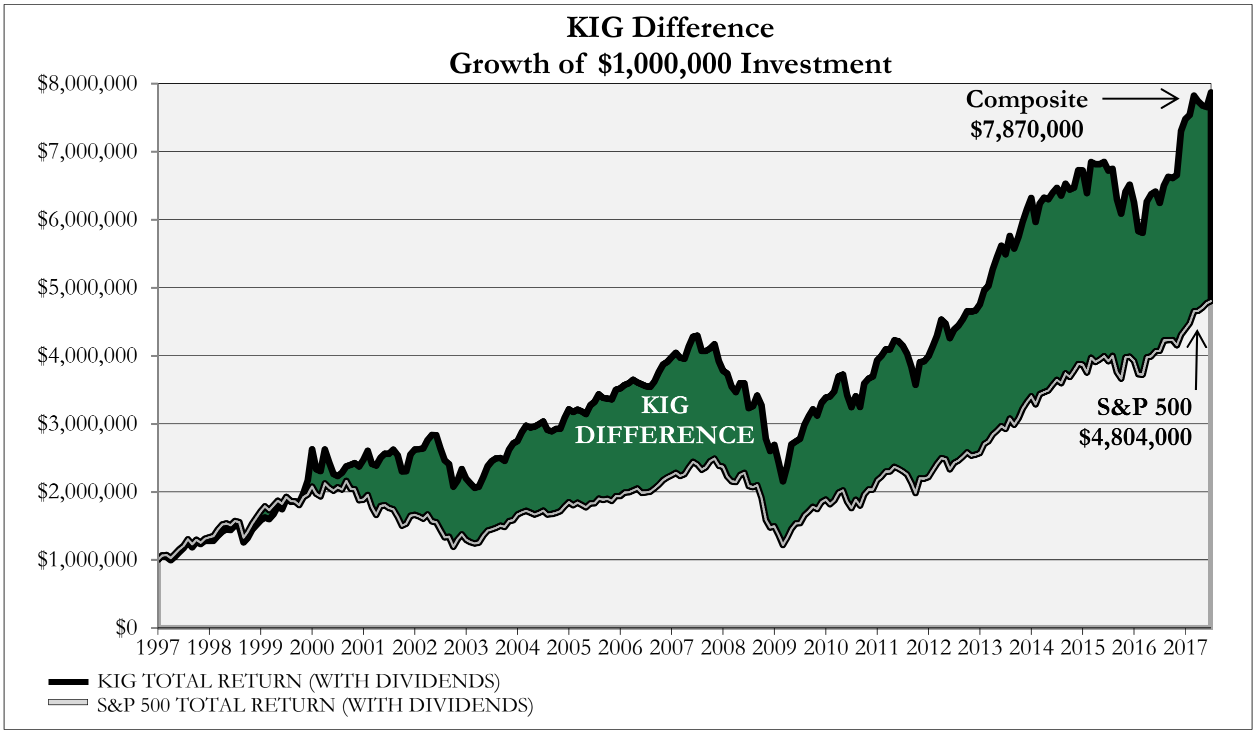
The table below lists the results for the same time periods as above for the S&P 500 and many of the other benchmarks widely held as investments via a “style-box” approach.

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.

Fixed Income Commentary
Summer 2017

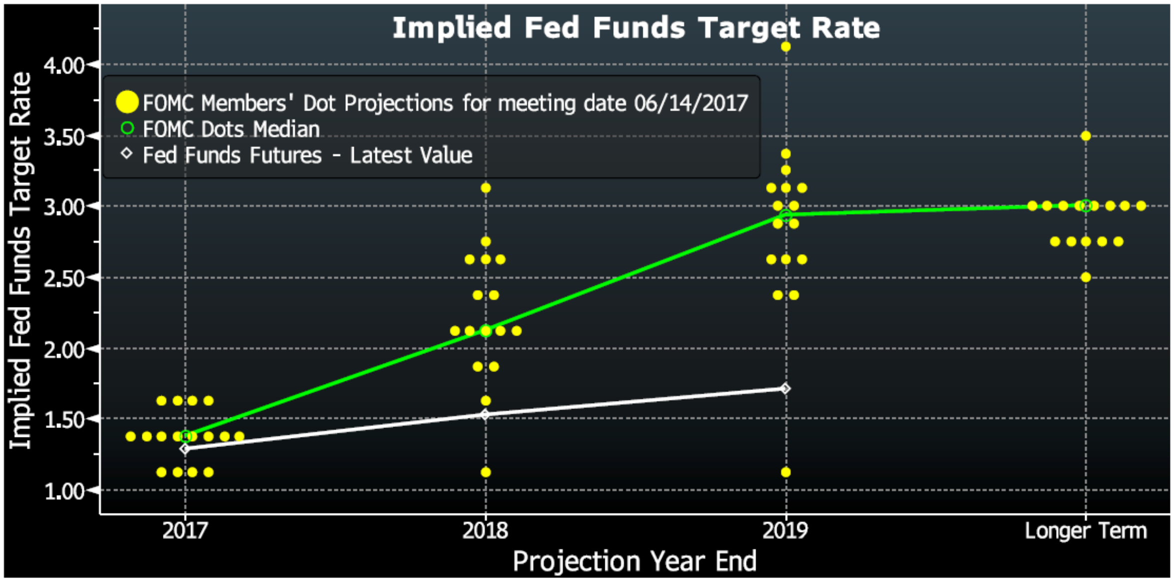
At the June Federal Reserve ("Fed") meeting, the committee once again decided to raise the federal funds target rate by 0.25% to the 1% - 1.25% range. The bump was widely expected and already priced into short-term bond yields. With inflation tapering off this quarter, down to 1.5% from almost 2% earlier this year (the Fed's target rate), the market was more concerned that the Fed would hint toward a change in policy that's more accommodative to economic growth. It did not. The Fed still expects one more federal funds rate hike this year and three more in 2018, which would increase short-term interest rates to over 2%.

The Fed also announced a concrete plan to shrink its massive $4.5 trillion balance sheet. As a monetary tool to stimulate the economy after the Great Recession, the Fed instituted three rounds of "quantitative easing." In practice, this meant that the Fed purchased Treasury bonds and agency mortgage-backed securities with the intent of bringing down longer-term interest rates. Now that the economy is on much more solid footing, the Fed plans to unwind at a slow, predictable pace by not reinvesting a set amount of bond maturities every month. Janet Yellen, the chair of the Board of Governors of the Fed, suggested that their plan would "run quietly in the background" and be as exciting as "watching paint dry." Since price stability is one of the Fed's primary objectives, their desire is to create as little disruption in the financial markets as possible.

Despite these actions, the divide between the Federal Reserve's intent and the bond market's reaction has grown wider over the last quarter. The yield on ten-year Treasury bonds peaked this year at 2.6% in mid-March and has since dropped to 2.3% as of quarter-end. Similarly, the yield on thirty-year Treasuries has fallen to 2.8% from this year's peak of 3.2%. The decrease in long-term yields in the face of rising short-term rates suggests the bond market's perception of long-term growth and inflation rates are much lower than Fed expectations.

A chart of the Fed's rate projections versus Fed Funds Futures contracts illustrates the severity by which the market is essentially calling the Fed's plan a bluff (Exhibit 1). The dots show where each voting member of the Fed thinks the federal funds rate should be at the end of each year, while the Fed Funds Futures contracts express the market's opinion. The median federal funds rates expected by the Fed at the end of 2018 and 2019 are 2.1% and 2.9%, respectively. By contrast, the market believes the fed funds rate will only be 1.5% and 1.7% on those same dates. The disconnect is so large that, if the Fed's rate path comes to fruition, one-year government bond yields in 2019 will be higher than thirty-year Treasury yields today at 2.8%.

Exhibit 1



The biggest certainty derived from the division between the Fed and market is that this bond market is filled with uncertainties. Since our overriding concern as fixed income investors is safety of principal, we feel very comfortable limiting risk in this environment. When short-term rates increase and long-term rates fall, the yield curve is said to be flattening, and bond investors are receiving incrementally less yield for investing in longer-dated maturities. By generally limiting our clients' bond portfolios to eight year maturities, we minimize the impact of these shifts in the yield curve and avoid stretching for yield when the market isn't compensating us favorably.

Financial Planning Corner

Summer 2017

There are many uncertainties to contend with when you are planning for the future. For many, one of the most worrisome is managing healthcare costs, which is why understanding Medicare is a crucial piece of financial planning for anyone nearing age 65. Unless an eligible individual is still working and obtaining health insurance through an employer-provided plan, the enrollment period for Medicare encompasses the three months preceding and the three months following the month of an individual's 65^{th} birthday. Late enrollment could result in paying higher premiums for as long as an individual is enrolled in Medicare, so it's important to have a plan in place ahead of time.

Medicare is a federal health insurance program available to qualified individuals, regardless of their employment status, which has four basic components: Part A, B, C, and D; often referred to as "alphabet soup." Medicare Part A covers inpatient care, some nursing facility care, hospice care, and limited home health care. Part A is free for most people, provided they or their spouse have sufficient employment history. Part B covers doctor's visits, outpatient services, clinical and lab testing, durable medical equipment, and preventative health services. There is a monthly premium for Part B based on your income which in 2017 ranges from $134 per month to $428.60. Parts A and B are considered "Original Medicare" and are government plans. Part D is prescription drug coverage designed by the government, but offered through private prescription or insurance companies. Part C is more commonly known as Medicare Advantage, and these are plans run by private insurance companies which replace Parts A, B, and often D. These plans are required to cover all of the services covered by Original Medicare, and may include additional coverage such as dental or vision. A Medicare Advantage plan can choose not to cover services that are not deemed "medically necessary" under Medicare. One important note for both Part D and Medicare Advantage plans is that they generally require you to stay in their "network," which can vary widely depending on the plan. It's crucial if you are a resident of more than one state that you check to make sure the plan you select provides the coverage you need.

In addition to the monthly premiums associated with Medicare, there are deductibles, co-payments, and/or co-insurance costs, which can be significant. One of the options for covering these additional costs is to purchase Medicare Supplement Insurance, more commonly known as "Medigap." These policies are offered through private insurance companies, but the plan offerings and coverage are exactly the same regardless of the company offering the plan. The plans do vary by state, so, similar to Parts C & D, it's important to make sure the plan has the coverage you need if you are selecting a Medigap policy and are a resident of more than one state. We can help you understand the differences among the coverage options so that you can determine which policy might best fit your individual needs.

At Kovitz Investment Group, our Financial Advisors and Planners help clients think through complicated topics, such as navigating Medicare, on a daily basis. Our primary goal is to provide our clients with the resources they will need to make the best decisions for their individualized situation. If you have any questions on this topic or on any other topic related to your personal finances, please don't hesitate to ask your Kovitz Financial Advisor.

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.

KOVITZ INVESTMENT GROUP

Intrinsic Values®

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

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

Joel Hirsh, CFA
312.334.7307
jhirsh@kovitz.com

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

Kate Jonynas, CFP®
312.334.7309
kjonynas@kovitz.com

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

Sanford Kovitz, JD, MBA
312.334.7352
skovitz@kovitz.com

William Lee
312.334.7335
wlee@kovitz.com

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

Bradford Madison, 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

Mark Rosland
312.334.7322
mrosland@kovitz.com

Peter Rudman
312.334.7327
prudman@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
312.334.7348
evernsten@kovitz.com

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

Patrick Wiese
312.334.7305
pwiese@kovitz.com