Kovitz Investment Group
Intrinsic Values®

Market Insights
Summer 2018

"Certainly . . . whoop, whoop, whoop, whoop, whoop, whoop . . . nyuk nyuk nyuk."
– Jerome Horwitz, aka Curly

The only certain thing in this world is the persistence of uncertainty. No matter how much you read, how many CEOs, investors, or industry experts you talk to, or how smart you are, you just can't get around the fact that nothing is certain. Only a Stooge like Curly would believe otherwise.

A real-world example of this uncertainty is playing out right now. Who among us would have predicted that the President of the United States would usher through Congress a massive corporate tax cut that would serve as a huge benefit to owners of stock, and then the same President, not six months later, would embark on a path resulting in escalating tariffs between the U.S. and its major trading partners?

As to how the burgeoning global trade war plays out over the coming months or years, we can't be sure. The range of outcomes is wide, but we believe the most likely scenario is that any negative effects will be broad-based, transitory, and will ultimately reverse when the tit-for-tat maneuvering among countries runs its course and winds down. Ultimately, trading partners will recognize that from this starting point, we are heavily intertwined and will ultimately find a way to work together. Yet the future may continue to surprise.

With this in mind, we note the value of an equity security, which is comprised of the present value of the future cash flows of a business into perpetuity, is only minimally affected by even a multi-year negative event (example: the recession of 2008-2009). Additionally, the ability of corporations, in general, to make the scheduled principal and interest payments on their debt will not be materially impaired. Nor, for example, will a protectionist trade policy by itself meaningfully damage the prospects for buying, leasing, improving, and selling industrial real estate in the greater Chicago area.

We spill a lot of ink in these quarterly missives emphasizing our process and the four primary elements we look for before committing client capital to an investment: companies that have sustainable competitive advantages; a sensible amount of financial leverage; management with a history of prudently allocating capital; and shares that trade at a meaningful discount to our estimate of their intrinsic value. What these four elements have in common is not that they are a means for us to express our certainty regarding the future prospects of a business, but that they allow us to account for the inherent uncertainty regarding the future prospects of a business.

The first element listed above serves to increase the probability that a company will continue to grow and maintain its operating margins in a future where unexpected threats will occur regularly. The second and third elements serve to both mitigate the downside in the inevitable occasions where our assessment of the first element proves incorrect, and as evidence that management will refrain from piling on excessive amounts of debt or pursuing value-destroying acquisitions – both acts of hubris that only a management team that thought the future was certain would undertake.

The fourth and most important element – price and its relation to value – is often the most misunderstood. Value is not a specific point. That would imply a level of certainty in our predictions of the future that does not and cannot exist. Value is a range, a distribution of points, each with probabilities assigned to it that acknowledge the many, varied paths the future could take. Price, on the other hand, is a specific point and the only constant in all of investing. Thus, the importance of buying only at a price that allows for the highest possible probability of gain, and the lowest probability of a future path that results in a permanent loss of capital.

We have written a number of times recently about how the overall market's[1] return is being driven by so-called "growth" stocks trading at high valuations. That trend has continued into this quarter as "growth[2]" has now outperformed "value[3]" by nearly 9% in 2018 and by 32% over the last three and a half years. In contrast to previous periods, US-based "growth" has really been the only major market segment working across the globe this year. In addition to the divergence with the rest of the domestic market, both international developed markets and emerging markets have experienced dismal returns of -3% and -7%, respectively, this year.

The misnomer about "growth" versus "value" though is that plenty of so-called "value" stocks, including most of the companies held in our clients' portfolios, have been growing their earnings at roughly the same rate as the overall market throughout this period. The only difference is that market participants have deigned to reward already richly valued companies (primarily in the technology sector) with even higher valuations. These levels require a high degree of certainty that the future path of earnings will closely resemble the recent past just to be called fair, and they provide very little room for error in that assessment. Meanwhile, many of the companies owned by our clients have been cast aside under the guise of a different kind of certainty: that earnings for these companies will not grow, or grow only modestly for the foreseeable future, despite these same companies disproving that theory many times over the past several years.

Ever-patient and ever-disciplined, this divergence continues to appear untenable to us over any meaningfully long period of time, so we will bide our time until a combination of reality and math corrects this imbalance. Others may continue to blithely pay seemingly any price for companies that they must be absolutely certain will grow enough to justify their high valuations, but that is not our way. As always, we will continue to position our client portfolios, side-by-side with our own, in a manner that we believe offers the highest probability of gains while minimizing the probability of a permanent loss of capital. Importantly, despite an environment that is hostile to our style of investing, our equity composite has still generated returns of nearly 300% (after all fees and expenses) since the market bottomed in 2009.

[1] *As represented by the S&P 500*
[2] *As represented by the Russell 1000 Growth Index*
[3] *As represented by the Russell 1000 Value Index*

Across asset classes, our client portfolios are currently positioned as follows:

1. Equities: Our typical client portfolio is close to fully invested in a collection of companies that we believe are priced, in aggregate, at levels that offer a high probability of upside relative to the overall market. 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 continues 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: We are very happy with the performance of Kovitz' hedged equity strategies during the first half of the year as the downside and upside hedges we employed captured gains due to the increased volatility. The strategy remains positioned defensively, much as it has been for the past several years.
4. Industrial R/E and PE: The Kovitz co-sponsored industrial real estate offering focuses on investing in single and multitenant 50-200,000 square foot industrial properties, purchased at substantial discounts to replacement cost. Over four funds, we have purchased, financed, rehabbed, leased, and then sold almost 100 properties. We have developed and taken advantage of deep industry experience and networks to opportunistically purchase properties from motivated sellers in mostly off-market transactions. We strive to sell at low cap rates after stabilizing the properties, and often are able to group properties into attractive portfolios. We recently sold virtually all of the properties in our second and third funds in one large transaction (over 50 properties) in just such a manner, and continue to find attractive opportunities for our fourth fund.

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
Summer 2018

Market and Performance Summary

In the second quarter of 2018, the Kovitz Investment Group (KIG) Equity Composite[4] (the "Composite") returned 1.8% vs. 3.4% for the S&P 500. Year to date, the Composite has decreased 2.2% vs. a 2.6% increase for the S&P 500.

We've been tracking our equity performance, via the Composite, for over twenty-one years. How have we done so far? Since inception in January 1997, the Composite has compounded at a rate of 10.5% annually vs. 8.2% for the S&P 500. When it comes to investment performance, human brains have a tendency to think linearly as opposed to exponentially. A linear mind might find these results satisfactory: 10.5% per year for the KIG Composite for 21+ years, or approximately 221% (10.5% x 21) vs. a 172% return (8.2% x 21) for the S&P 500. The ending value is seemingly about 28% higher. But this would be misleading. To analyze investment returns, one has to think *exponentially* because the annual returns compound over time. Seemingly modest differences in the annual rate of return can generate profound differences in the ultimate gain over long periods of time. Exponentially calculated, the actual gains for the period work out to be 752% for the Composite and 449% for the S&P 500. For instance, if you invested $1 million at the Composite's inception, your stake would be worth $8.5 million as of June 30, 2018. By comparison, if you invested $1 million in the S&P 500 at the very same point in time, it would be worth $5.5 million. This represents an ending value roughly 55% higher, nearly double the linearly derived result. Such is the miracle of compound interest. Harnessing this power has been our approach to wealth creation over the last couple of decades, and we plan to continue in the same vein over the next couple of decades.

Value investing requires discipline to have a realistic estimate of a stock's fair value and to not overpay relative to fundamentals. These gratifying figures reflect the power of our fundamental, value-based strategy that works well over time. Many investors with shorter time frames attempt the investing equivalent of long-range three-pointer after long-range three-pointer, but end up missing the basket badly a fair number of times. Compounding doesn't tend to work well with a high-risk approach like that. Alternatively, an approach like ours that focuses on longer bands of time and looks to attempt only lay-ups and mid-range jumpers, tends to minimize missed shots and allows the power of compounding to do its thing. The goal should never be to maximize returns at great risk, but a long, continuous march toward capital accumulation. The greatest single edge that an investor has is a long-term orientation.

While the absolute performance of the Composite over the last 3 to 5 years has been more than sufficient, the relative performance has been less flattering. However, if there is one indispensable lesson we have gleaned from the last 21 years, it's this: to achieve long-term investment success, we need to stick with our process through the difficult periods, through the uncertain periods, through the volatile periods, and, most importantly, through the irrational periods. This is what we have always

[4] *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.*

done and what we intend to always do. So far, our track record seems to suggest that this careful, steady approach works well over time. For those like-minded and far-sighted clients taking the journey with us, we feel your patience and support will be well rewarded and we feel fortunate to have you.

The chart below summarizes annualized performance over various standard time periods ending June 30, 2018 and cumulative performance results from January 1, 1997 through June 30, 2018 for the Composite.

KIG Composite[5]
Annualized and Cumulative Equity Performance (Net of Fees)

	Average Annual Total Returns						Cumulative
For Period Ending 6/30/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
KIG Composite	8.2%	8.2%	9.2%	10.2%	8.7%	10.5%	751.8%

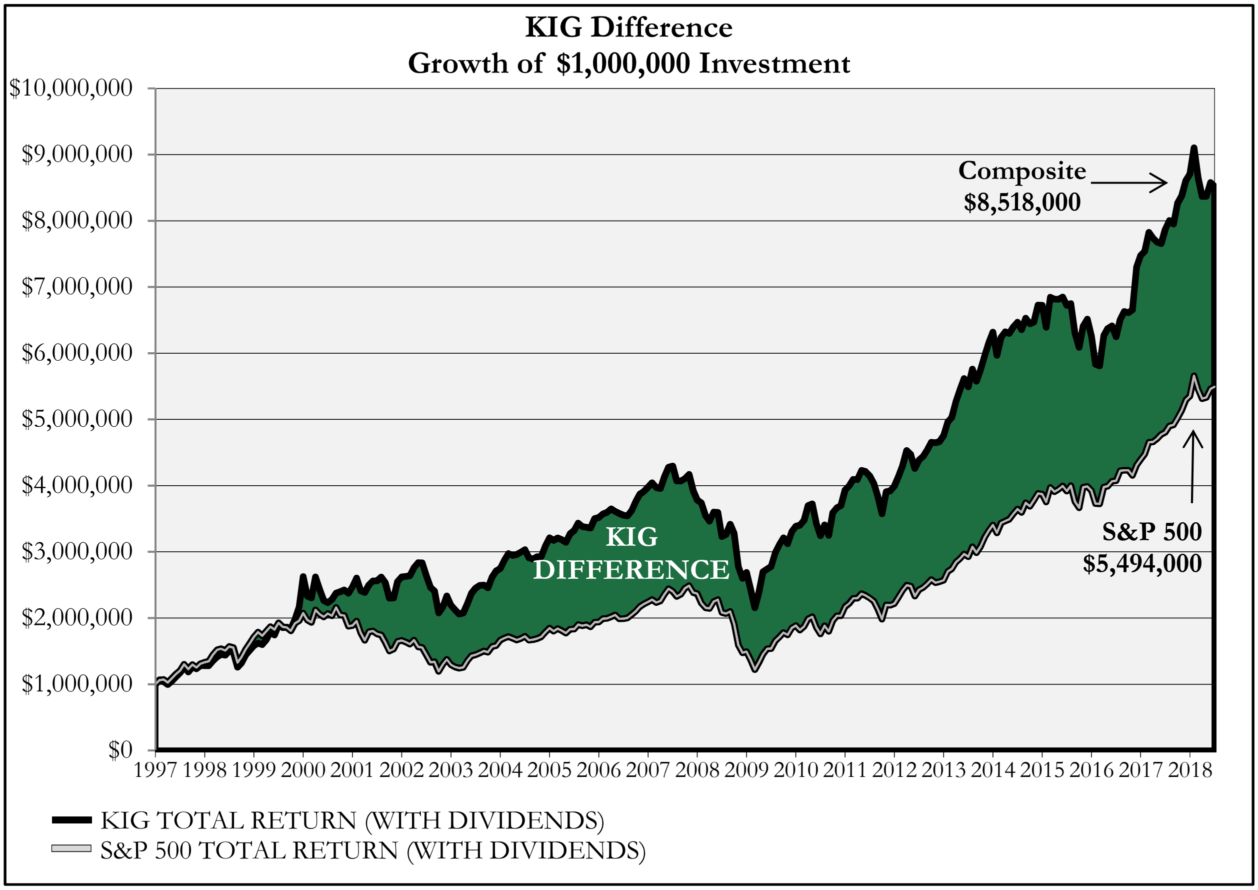
The table below lists the results for the same time periods as above for the S&P 500 and many of the other benchmarks widely held as investments via a "style-box" approach.

Other Market Indices
Annualized and Cumulative Equity Performance

	Average Annual Total Returns						Cumulative
For Period Ending 6/30/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
S&P 500	14.4%	11.9%	13.4%	10.2%	9.3%	8.2%	449.4%
Small Cap Equity (Russell 2000)	17.6%	11.0%	12.5%	10.6%	10.5%	8.7%	502.1%
International- Developed (MSCI- EAFE)	6.8%	4.9%	6.4%	2.8%	7.3%	4.8%	175.3%
International- Emerging (MSCI -EEM)	8.2%	5.6%	5.0%	2.3%	10.7%	6.0%	251.8%
Gold	0.2%	1.5%	-0.1%	2.3%	8.1%	5.5%	216.4%
Commodities (CRB)	16.3%	-3.4%	-5.8%	-7.7%	1.0%	2.3%	61.8%

[5] *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

Today's combination of a stable economy, low interest rates, and growing cash flows due to tax reform leaves bargain priced stocks a rarity in the market. We have identified many qualified candidates, but prices would need to be lower for us to react in any significant way. We are content to be patient and wait for the "lay-ups" that we mentioned earlier. We were, however, able to find two new investments during the quarter that warranted inclusion in our clients' portfolios.

New Positions

Expedia (EXPE) is an online travel agency (OTA). In addition to their namesake website, where consumers can purchase airline tickets, book hotels, and make other travel-related arrangements, the company also operates Hotels.com, Homeaway (competes with AirBNB with a focus on whole-home rentals; includes VRBO, which was acquired a couple of years ago), hotel metasearch platform Trivago, and corporate travel management business Egencia. After a period of consolidation, Expedia and Booking Holdings (formerly known as Priceline) have emerged as something of a global duopoly in the OTA space. We believe the OTA industry is poised to continue growing at an above-market rate as more hotels and alternative accommodations are added to their platforms. Ultimately, we believe Expedia and Booking will be very difficult to disrupt as their large scale drives traffic to their sites, which allows them to vastly outspend individual hotel chains on advertising, which drives more traffic to their sites, and so on. It would also be extraordinarily difficult for a company to start from scratch and build the network of properties that Expedia and Booking already possess. A search provider like Google can show options, like Google Flights, but all the data backing those searches and the ability to actually make a purchase comes from the OTAs.

Expedia's shares had fallen about 30% from its recent highs after a couple of earnings announcements failed to meet Wall Street expectations. This was mainly due to larger-than-expected expenses related to an expanded sales force and migration of their IT infrastructure to the cloud. We believe these investments in people and systems will lay the groundwork for outsized growth in the future as OTAs continue to take share from other methods of booking accommodations and Expedia expands into more profitable business in the fragmented European and Asian hotel markets. At a valuation of around 15x forward free cash flow at purchase, we believe the shares should benefit from the compound effect of price to earnings (P/E) that are growing faster than the overall market.

Naspers (NPSNY), our next purchase, is a South Africa-based media company that operates pay TV and traditional print media platforms. One of the company's primary focuses, however, is on discovering and fostering investments in technology and e-commerce companies. In this regard, the bulk of the value of the company is derived from several investments it has made in nascent technology companies. For example, in 2001 Naspers purchased one-third of a small Shenzhen, China-based online game designer named Tencent for $32 million. In what was likely one of the best investment decisions of all time, this purchase is now worth approximately $150 billion (even after a recent partial stake sale). While they make up a much smaller amount of capital, the company's other significant investments include Flipkart, an India-based online retailer (which recently announced its intention to sell its stake to Walmart); Delivery Hero, a Germany-based food delivery company (a la Grubhub); MakeMyTrip, an India-based OTA; and online classifieds such as LetGo. We estimate these investments are worth another $20 billion.

The impetus for our investment is that Naspers currently trades at a value that is 30% below the value of just their stake in Tencent, so we're effectively getting the operating businesses and the rest of their investments for free. While some discount to the sum-of-the-parts may be warranted, the company trades at a 40% discount to what we believe is a conservative estimate of Naspers' fair value when you include non-Tencent assets in the mix. In other words, the sum of the pieces are worth far more than the current market value. This large margin of safety allows us to remain patient while the valuation discount narrows.

Increase in Position Size

We increased the Composite's position in **Amerco (UHAL)**. Revenue growth has been within our expectations but an uptick in expenses has led to somewhat of a disappointing earnings picture over the past several quarters. Our take on the expense issue is that management is continuing to invest in its business as it sees an opportunity to further distance itself from the competition in the rental truck market and to build up its self-storage business. Similar to Expedia, we believe the investments today will ultimately lead to significant future growth.

Fixed Income Commentary
Summer 2018

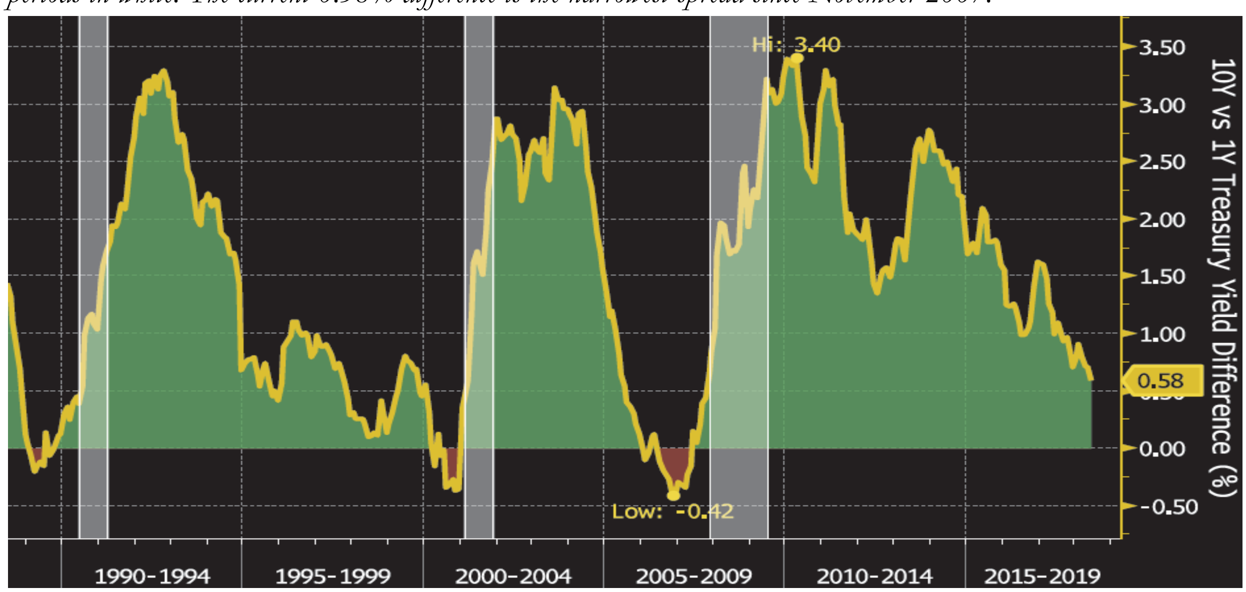
In a widely predicted move, the Fed increased its policy rate by another 0.25% in June to the 1.75% to 2% range. Less expected, the Fed slightly accelerated their forward rate guidance, citing their confidence in the strength of the economy. The Fed's policy has been accommodative since the 2008 Financial Crisis to stimulate employment and economic growth, but their policy may soon become restrictive. With two more rate hikes planned this year and three more in 2019, short-term rates could surpass 3% as early as next year – higher than the ten-year Treasury yield of 2.9% at quarter-end. It appears the Fed is more concerned about the risk of overheating the economy than overtightening policy.

The Fed did not comment on the shape of the yield curve in their most recent statement, but it is likely on the forefront of their minds. A yield curve plots the yields of similar bonds with differing maturities. In a normal interest rate environment, yields on longer-term bonds are greater than those on shorter-term bonds, but, occasionally, short-term yields can be greater, thus inverting the curve. The Fed's policy for short-term rates could be described as full steam ahead, which is leading many market commentators to believe an inverted yield curve may be on the horizon. Inverted curves matter for several reasons, but most notably, they have an amazing track record of forecasting recessions. In the last 30 years, inverted curves have preceded the recessions in 1990 and 2001 and 2008.

Inversions tend to be swift, and reversions to steeper curves can be fierce. The average inversion between one-year and ten-year Treasury yields over the last 30 years has lasted less than a year. In the year following an inversion, the difference in the same yield curve has climbed to an average of 2%. In a word, inversions have historically meant one thing for bond markets, volatility.

Is A Yield Curve Inversion on the Horizon?

The chart plots the difference between ten-year and one-year Treasury yields over the last 30 years, and shades recessionary periods in white. The current 0.58% difference is the narrowest spread since November 2007.



At a time when the economy and interest rates appear relatively healthy, it's important to remind bond investors to never let their guard down – risks are pervasive. At Kovitz, our investors have a dedicated team of experienced fixed income professionals who manage risks on their behalf. We build high-quality bond portfolios with limited interest rate sensitivity to be a ballast for investment accounts – built with the goal of weathering any storm. We tend to welcome volatility as a chance to scour the fragmented, inefficient bond market for opportunities to enhance yields without sacrificing the safety of investor principal.

Illinois Pension Woes Continue

Illinois pension problems were back in the headlines this quarter. Harvey, a city just a stone's throw from Chicago's southern border, was forced to lay off nearly half of its police and fire department in April. Harvey has been plagued with financial mismanagement for decades, but the Illinois Comptroller recently rendered the city nearly insolvent by diverting state-shared revenues to Harvey's underfunded pension liabilities instead of the city's general coffers. The move was the first use of a new statue enacted in Illinois in 2016, coined the pension intercept law.

The new law aims to shore up city pension funds across the state. Cash-strapped cities in Illinois have chronically underfunded pension obligations by redirecting state tax contributions to benefit current city employees and bondholders. It seems Illinois will no longer give these city governments discretion over vital state funds. For obvious reasons, this has sounded alarms around the municipal bond market since bondholders rely on the same sources of revenue for principal and interest payments.

While we don't believe Harvey to be an isolated incident, we've found most concerned bond investors have painted Illinois' municipalities with a very broad brush. Prices and yields of bonds associated with the state of Illinois trade cheaper, sometimes significantly, than other states' municipal bonds of similar credit risk. The general market's disregard for Illinois bonds extends even to the state's most prosperous cities with wealthy citizens, growing populations, and strong municipal balance sheets. For investors willing to do their homework, bargain bin prices – and accompanying higher yields – can be had without added risk in our opinion.

For example, the City of Hinsdale, Illinois issued a series of general obligation bonds in June, backed by the full credit and taxing power of the city. The issuance was assigned the highest possible rating of AAA by both S&P and Fitch. Despite the rating agencies' confidence, the series of bonds priced much closer to out-of-state A-rated municipalities than AAA. The Hinsdale bonds maturing December 2026 were priced to yield 2.75% at issuance. According to the MMD Scale[6] that same day, AAA-rated municipal bonds maturing in 2026 broadly traded at yields of 2.35%, while A-rated municipal bonds (two categories lower) yielded 2.82%.

[6] *Thomson Reuters Municipal Market Data (MMD) Scale is a yield curve that represents the average rates of general obligation municipal bonds (trading in blocks of $2+ million) of a range of credit qualities and maturity dates. The MMD Scale is widely uses as a benchmark rate for municipal securities.*

Hinsdale and Harvey both have underfunded pensions, but stand in stark contrast to each other in every other financial measure. Hinsdale is an affluent suburb located about 20 miles west of Chicago. The city has a median family income of $207,000 and an unemployment rate of 3.7% as of year-end 2017, compared with nationwide stats of $73,000[7] and 4.1%[8], respectively. The city's management has historically practiced conservative financial planning with consistent budget surpluses and available cash comprising a sizable portion of annual expenditures. When analyzing the credit, Hinsdale's pension obligations are the sole detractor. Even so, the required pension contributions comprise a manageable 10% of the city's annual expenditures, and Hinsdale has plenty of financial flexibility to handle any adverse changes.

At Kovitz, we like to utilize our unique familiarity with Illinois municipalities to find value in situations like this recent Hinsdale bond issue. Over an eight-year investment horizon, we are not concerned with Hinsdale's ability to repay debt, and our goal is to obtain excess yield over the Scale as an enhancement to clients' bond portfolios. Most pension funds within Illinois are a cause for concern, but there are many municipalities insulated from the problems, if you know where to look. This is another time we prefer to be greedy when others are fearful.

[7] *The US Median Family Income reported by the US Census Bureau as of 12/31/16 (the most recent data).*
[8] *The US Unemployment Rate reported by the Bureau of Labor Statistics as of 12/31/17.*

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