



## Core Equity Commentary

### Spring 2017

#### Market and Performance Summary

For the first quarter of 2017, the Kovitz Investment Group (KIG) Equity Composite<sup>1</sup> (the “Composite”) appreciated by 3.5% while our S&P 500 benchmark rose 6.1% during the quarter. Over the past one year the Composite generated a return of 23.5% vs. a 17.2% return for the S&P 500.

The reasonably strong showing in equities this quarter masked an underlying tension: Will the Trump administration policies that are generally believed to be positive for stock prices come to fruition, or will they be derailed by political clashes in other areas, such as the debate over repealing and replacing the Affordable Care Act, or by some self-inflicted political controversy? The market has clearly priced in the enactment of some (perhaps more than some?) of the administration’s pro-growth, pro-business agenda under the assumption that Republican control of the House, Senate, and the White House would make the process nearly seamless. As we have all recently witnessed, that doesn’t appear to be the way Washington works anymore. To the extent the administration’s plans get pushed out or watered down, current valuation multiples in the stock market would likely be negatively impacted. Whether or not interest rates will continue rising is another unsettled debate. Generally, interest rates act on asset values like gravity: the higher they are, the more they pull downward on asset values.

Our crystal ball is always fuzzy on matters such as these and that is why we remain focused on the careful and patient application of our investment criteria and valuation requirements. Recall that the KIG equity strategy has been devised with the goal of seeking long-term capital appreciation through high risk-adjusted returns (i.e. taking on less risk to earn commensurate or better benchmark returns). Relying on a fundamental, research-driven process, we strive to build diversified portfolios of equity investments through the purchase of competitively advantaged and financially strong companies at prices substantially less than our estimate of their intrinsic values. The crux of the strategy leads us to be more concerned with the risk of suffering a permanent loss of capital from an investment that was bought at too high of a price. We are less concerned about the risk of missing opportunities, especially those that may be short-term in nature.

Cash balances, which averaged roughly 10% during the quarter, somewhat dampened the Composite’s results in a rising market. Our cash balances wax and wane based on opportunities we see in the market to deploy capital at reasonable expected returns. While steering clear of trying to time the market, we employ this disciplined approach in all market environments. In the current environment, this principle prevents us from “stretching” for average or below-average businesses for the sole purpose

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<sup>1</sup> 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.

of appearing active and keeping cash balances low. We're just not going to invest your hard-won capital at any price. We were close to fully invested at the time of the election last November and have been trimming back holdings as they've risen over the last several months. Since we've done more selling than buying over this period, our residual cash balances have grown. As we survey the investment landscape, we mostly see equities that are, at best, fairly valued and very few that offer the significant margin of safety we require to initiate a purchase. In other words, because we are a price-sensitive investor, it has become a tough environment in which to put new money to work. If we can't find qualifying opportunities that meet our criteria, the default option is to hold cash until stock price volatility gives us an opportunity to deploy capital into qualifying businesses (i.e. high quality companies whose valuations are low in comparison).

Many investors put very little value on cash, arguing that cash's current low yield makes it a poor investment. However, we believe cash's value comes not from its current yield, but from its optionality. In a down market, cash helps mitigate losses and affords one the opportunity to buy when others are selling out of fear. Current market conditions may lead to the kind of volatility and divergence in the markets that present opportunities for disciplined, value-conscious investors. With our current healthy cash allocation, we will be prepared to capture entry-point pricing opportunities as they emerge. The pursuit of investment returns involves incurring risk. Our counter-cyclical approach – owning less, not because of a hunch or feeling about the direction of the market, but because there is observably less worth doing (owning) – mitigates risk. We will own more when the valuations are clearly signaling there are more attractive opportunities.

At the end of the quarter, your portfolio was invested in what we believe to be reasonably priced, high quality businesses that we believe will compound their earnings at attractive rates for a long time to come. We remain focused on identifying companies with four key attributes:

1. A commitment to maintain a strong financial position as evidenced by a solid balance sheet;
2. An ability to generate sustainable free cash flow based on one or more defensible competitive advantages;
3. Management that intelligently deploys cash balances and free cash flow from operations to grow intrinsic value per share and increase returns to shareholders; and
4. Is selling at a discount to our calculation of intrinsic value.

We further believe that by prioritizing these factors, our portfolio of companies will be positioned to perform better than the market in most types of economic settings.

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The chart below summarizes annualized performance over various standard time periods ending March 31, 2017 and cumulative performance results from January 1, 1997 through March 31, 2017 for the Composite.

**KIG Composite<sup>2</sup>**  
**Annualized and Cumulative Equity Performance (Net of Fees)**

For Period Ending 3/31/17	Average Annual Total Returns						Cumulative
	1 Year	3 Year	5 Year	10 Year	15 Year	Since Inception 1/1/97	Since Inception 1/1/97
KIG Composite	23.5%	7.0%	11.3%	6.9%	7.1%	10.6%	673.9%

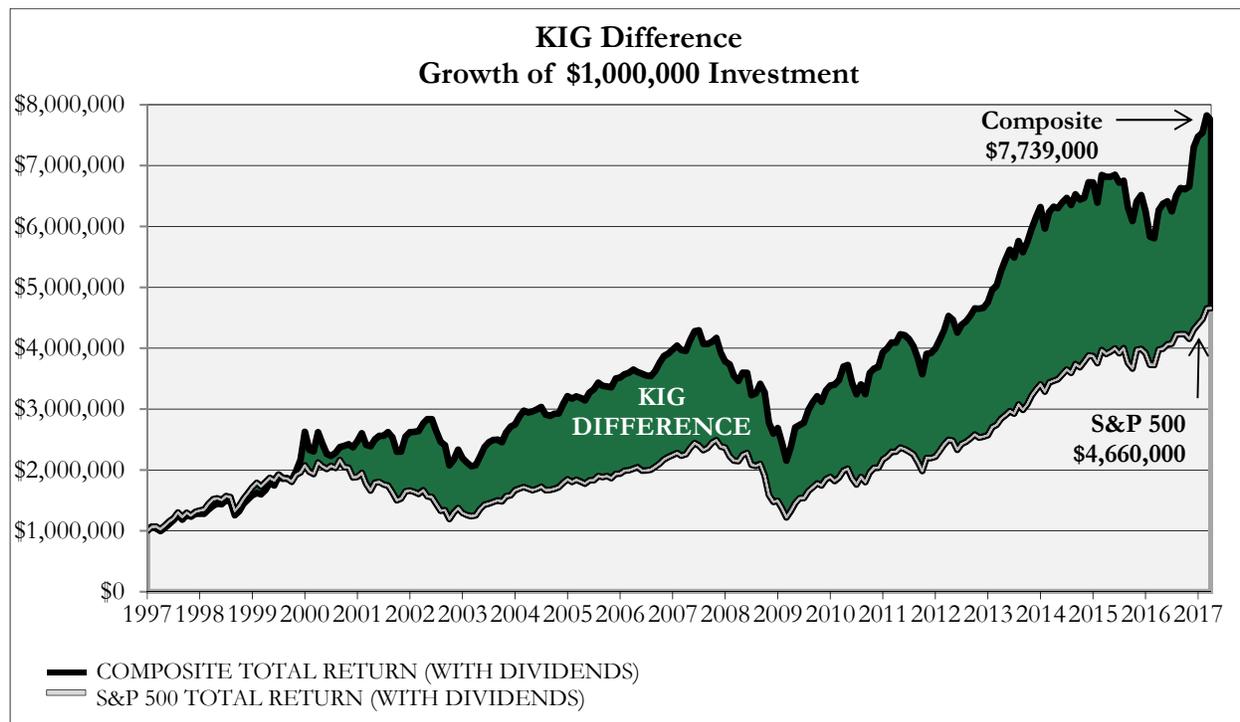
The table below lists the results for the same time periods as above for the S&P 500 and many of the other benchmarks widely held as investments via a “style-box” approach.

**Other Market Indices**  
**Annualized and Cumulative Equity Performance**

For Period Ending 3/31/17	Average Annual Total Returns						Cumulative
	1 Year	3 Year	5 Year	10 Year	15 Year	Since Inception 1/1/97	Since Inception 1/1/97
S&P 500	17.2%	10.4%	13.3%	7.5%	7.1%	7.9%	366.0%
Small Cap Equity (Russell 2000)	26.2%	7.2%	12.4%	7.1%	8.4%	8.3%	399.8%
International- Developed	11.7%	0.5%	5.8%	1.1%	5.7%	4.5%	142.8%
International- Emerging (MSCI -	17.2%	1.2%	0.8%	2.7%	9.5%	5.7%	206.0%
Gold	0.1%	-1.5%	-6.2%	5.7%	9.1%	5.9%	218.2%
Commodities (TR/CC CRB)	9.4%	-15.0%	-9.5%	-4.6%	2.0%	1.9%	47.6%

<sup>2</sup> 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 mentioned above, our pursuit of investments that combine quality with a margin of safety has been 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 market recently ended a record run of 109 trading sessions without a daily decline of 1% in either the S&P 500 or the Dow Jones Industrial Average. Disciplined investors' best friend, volatility, has been practically non-existent.

To achieve successful long-term compounding, it is important to be patient and focused on the long-term prospects for businesses. Since most market participants are focused on short-term results, including such things as the impact of changes in near-term quarterly earnings estimates or next quarter's GDP run-rate, opportunities often abound for those who can afford to maintain a longer-term view. When other investors are undemanding, they'll buy anything. Valuation parameters take a back seat, and it becomes difficult for demanding investors to find opportunities offering the required balance of return and risk. In such a situation, demanding investors must be willing to be inactive at times, and this is one of those times.

The KIG Investment Team was not completely dormant, however. We initiated one new position and exited one other. We also trimmed one position that we believe has become more fully valued and increased one position to reflect our conviction in the business.

After being uninterested in the airline sector for a decade or more, we initiated a position in **American Airlines (AAL)** in 2015, and added to it last summer during the brief market freak-out over the Brexit vote in the United Kingdom. Airline stocks have rebounded around 50% since that low point, but, this quarter, we added a second airline, **Delta Air Lines (DAL)**, to the portfolio. At their current valuations, we believe both offer meaningfully more upside than downside on an absolute basis and certainly a better price-to-value ratio than most equities at the current time.

After years of cut-throat pricing competition, undisciplined capacity growth, and labor strife, the airline industry has emerged, in our opinion, as a legitimate business worthy of investment. The basis behind this transformation has come primarily from an industry that has consolidated from more than 10 major airlines to just four today – American, Delta Air Lines, **Southwest Airlines (LUV)**, and **United Continental Holdings (UAL)** – that collectively control over 80% of the domestic U.S. market. This oligopolistic structure has led to a more rational approach to pricing and capacity than has possibly ever existed before. Further enforcing this disciplined competitive approach is that current management teams are committed to generating returns on capital employed in excess of their cost of capital and maximizing shareholder returns. Combined with the dramatic drop in fuel costs that has occurred over the last couple of years, airlines are now generating healthy cash flows. Also, their capital allocation policies have evolved in a manner that they are now creating value for shareholders rather than destroying it.

For instance, over the past two years, Delta has generated approximately \$15 billion in cash flow from operations, repurchased about \$5 billion of its stock, paid out \$900 million in dividends, and reduced its debt by \$3 billion. The remaining \$6 billion was spent on expanding and maintaining their fleet and upgrading IT systems, which are extremely important components in maintaining cost efficiencies and satisfying customer demands.

We also increased our position in the global commercial real estate services firm **CBRE (CBG)**. Our conviction in CBRE's business model and earnings power has grown stronger over our past year of ownership. The company pairs a cyclical, transaction-based brokerage and leasing business with a more stable revenue stream from its property management business to create a formidable company capable of both weathering industry downturns and prospering when markets are active. In addition, this complementary combination offers ample opportunities for cross-selling and consolidation in the highly fragmented commercial real estate services industry.

We eliminated our position in **CVS Health (CVS)**, which is admittedly quite a departure from our more recent communications where we had been positive on its shares. Our thesis changed due to concerns related to the pharmacy benefit management (PBM) portion of their business, and the potential reduction in what we believed to be normalized earnings power. We had believed the stock to be inexpensive on a valuation basis because we thought the shares had more than priced in pressure from recent market share losses to Walgreens on the retail side of the business and some PBM contract losses. We don't believe this is necessarily the case anymore and earnings power could be materially lower than current levels. PBMs have long been a controversial business as their finances have always been relatively opaque. Our working theory had been that regardless of the opacity, the end result is that they were an important part of reducing the overall cost of prescription drugs for their end clients, which are typically large employers and health insurance companies. We have done much work over

the years trying to figure out exactly how PBMs make their money and trying to isolate the competitive forces that affect their profitability. While we could never get complete clarity, our over-arching theory that they were an important part of the drug industry in saving costs seemed credible, and it was reinforced by the fact they experience low client turnover. However, as politicians and the media apply more and more scrutiny to each and every facet of the prescription drug supply chain, including manufacturers, distributors, PBMs, insurance companies, and pharmacies, we can no longer dismiss the possibility that PBMs may be reaping more profits from the supply chain than some would consider their fair share, relative to the value they add for the end consumer. The layers of the onion are being pulled back slowly and we just aren't sure whether CVS' earnings, whether rightly or wrongly, will hold up under this increased examination.

Finally, we used strength in shares of **Harley-Davidson (HOG)** to pare back exposure as its price moved closer to our fair value estimate.

We appreciate the faith 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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