KOVITZ INVESTMENT GROUP
Intrinsic Values®

Investment Commentary

Fall 2015

Market and Performance Summary

For the quarter ended September 30, 2015, the Kovitz Investment Group® (KIG) Equity Composite (the "Composite") decreased 9.4%*, net of fees, compared to a 6.4% decrease for the S&P 500 Index. Year to date, the Composite is down 9.5% versus a 5.3% loss for the S&P.

During this past quarter, we witnessed the first 10%+ correction in the major U.S. stock market averages since late summer 2011. This roughly four year stretch was the third longest such run without at least a 10% drawdown in the last half century. While unpleasant, it should not be unexpected. Corrections of this magnitude have always been part of the investing landscape, and regular readers of these letters know that we have commented repeatedly that corrections are normal course for the equity markets and that we have been surprised at their absence. Even if we haven't seen it in a while, volatility will always be present whenever human emotions are involved in setting temporary prices.

The question that seems to be garnering the most attention from the catastrophist financial press is whether or not the recent correction is a harbinger of worse things to come. To be honest, we don't know, but our working assumption is that we are just in a period of what used to be considered normal volatility. Remember, withstanding volatility in the short-term is just the price an investor pays to achieve longer term rewards. In order to capture the potentially higher returns that stocks can offer over long time horizons, you have to reconcile yourself to the certainty of sometimes horrific unrealized losses over short time periods. Instead of being met with dread, corrections should be welcomed for the potential opportunities they can provide. Everyone wants prices to move up in a smooth continuous line. The reality is that they don't. But that's alright, because, even though there are downturns and wiggles, these occur within an ever-rising trend line that moves up and to the right.

As a result of our investment principles and the resulting composition of the portfolio, we do not believe that stock market declines, currency fluctuations, the Federal Reserve raising or not raising rates, and/or the current economic weakness in China will have a material impact on the intrinsic value of the portfolio. While stocks can trade at any price in the short term, we do not let other investors' actions (manifesting itself in under-performance to the benchmark that "captures" those actions) dictate our valuation discipline.

The more important development related to the fierce price swings may end up being the return to an appreciation for risk. Over the past year or two, the market has put a premium on growth, momentum,

**The returns for your individual account will differ somewhat from the Composite due to slight variations in account holdings, cash position, and other client-specific circumstances.*

and faux-passive investing where hot money chases whatever narrowly defined index has performed well recently. This is not the pond in which we fish. In short, this type of environment is antithetical to our fundamental approach and not an environment in which we would expect to outperform.

We believe, however, that the long term will be kind to our strategy. One measure of the disparity between growth and value investing can be seen in the difference between the returns of the Russell 1000 Value and Growth indices. Year-to-date, the growth index has outperformed the value index by more than nine percentage points. Especially when you take the sky-high valuations of private companies such as Uber into account, this period is reminiscent of the last great "growth market" of the late-90s, which came to a peak in 1999 when growth outperformed value by over 25%. Yet, we all know how that period culminated in the deflation of the dot-com bubble and value subsequently outperformed growth by over 40% from 2000 to 2002. The market goes through these periods from time to time where valuations and fundamentals don't seem to matter, but we have seen repeatedly that stock prices eventually reflect the underlying value of corporations.

We select investments in companies that meet our extremely high standards for business quality. We typically favor companies that are simple, predictable, capable of generating high returns on capital, and trading at an attractive price relative to the company's cash flows. As a general rule we focus on companies in industries with high barriers to entry and that possess solid and increasing pricing power due to brands, unique assets, long-term contracts, and/or dominant market position. Furthermore, they're typically able to fund themselves through operating cash flows and have solid balance sheets that are conservatively financed. If we can buy such companies when they're out of favor and we have accurately assessed their competitive strengths, we should benefit from both incremental earnings growth and multiple expansion.

Though we do not know when these conditions might change, as always, we plan to continue with our disciplined process of valuing businesses and managing portfolio risks. If our strategy worked every day, every month, every year, and in every market environment, everyone would follow it. But it doesn't, so they don't.

As we often say, stocks are not just quotes on a screen that bounce around a lot. Stocks are ownership stakes in businesses that we value and then buy at an attractive discount to that value. This process often takes time to work, but this is the only way we know how to invest. This is not because we are Luddites or slow to adapt to change, but it is because we believe it is the best way to compound wealth over the long term. If we continue to do a good job of analyzing and valuing companies, we believe our effort will be rewarded—even if it takes some time.

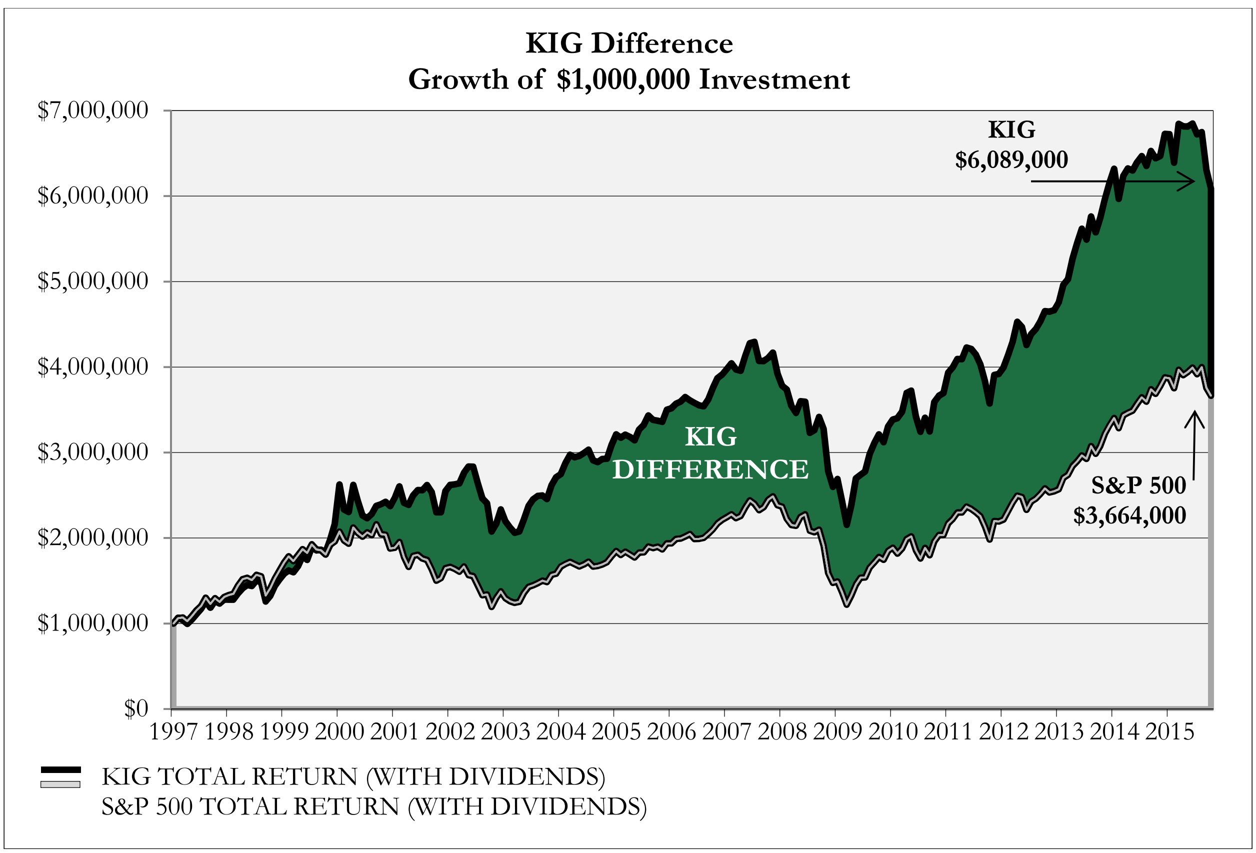
The following is our standard performance report for the Composite, which now encompasses 18 and three-quarter years. The chart summarizes both annualized and cumulative performance results from January 1, 1997 through September 30, 2015 for the Composite and the S&P 500. We remind you that your portfolio's composition is significantly different from the broad market indices, so your performance will inevitably deviate from these indices, especially over shorter time periods. We manage your portfolio for long-term results, and we encourage you to evaluate its performance over a multi-year time frame.

Composite vs. S&P 500
Annualized Equity Performance (Net of Fees)

	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (18.75 Years)
Composite*	-5.5%	9.4%	11.1%	6.1%	6.4%	10.1%
S&P 500	-0.6%	12.4%	13.3%	6.8%	4.0%	7.2%
Rolling Period Outperformance	58%	73%	77%	88%	100%	NA

Composite vs. S&P 500
Cumulative Equity Performance (Net of Fees)

	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (18.75 Years)
Composite*	-5.5%	30.8%	69.5%	80.6%	154.1%	508.9%
S&P 500	-0.6%	42.0%	86.9%	93.0%	79.1%	266.4%



Please refer to the disclosure on the last page of this newsletter for additional discussion regarding the performance of the Composite.

The Five Year Litmus Test

We have often said that we would be fully comfortable with an impartial observer evaluating the performance of our strategy over a minimum period of five years. While five years is not necessarily how we define "long-term," we believe it is long enough to see the potential advantages of our focused investment approach. The previous table shows the returns for the latest 5-year period, but we feel it is even more important to take into account each of the 166 distinct consecutive 5-year periods since the inception of our performance track record (using month-end values) in order to get a true reflection of our performance in totality. Over all of these periods, the KIG Composite has experienced 153 positive 5-year return periods and only 13 negative ones, compared with 117 positive 5-year returns and 49 negative ones for the S&P 500. The Composite's average cumulative return for all of these 5-year periods was 53.9% versus 29.9% for the S&P 500. The Composite's worst 5-year period return was -27.6% versus -29.0% for the S&P 500. In its best 5-year period, the Composite's return was 189.5% versus the S&P 500's best return of 181.4%. Most importantly, the Composite has outperformed the S&P 500 in 128 out of the 166 periods – or 77% of the time. While the most recent 5-year period has been subpar, we feel we are continuing to meet our performance goals based on this more holistic performance representation.

Composite vs. S&P 500
Rolling 5-Year Period Returns (Net of Fees)

	Composite	S&P 500
Best	189.5%	181.4%
Worst	-27.6%	-29.0%
Average	53.9%	29.9%
% of Positive Returns	92%	70%

Portfolio Activity

While the market did experience significant downside volatility during the quarter, prices of companies we have had our eye on did not fall far enough for us to get meaningfully more invested in new ideas. However, the number of companies that are on deck, so to speak, has grown significantly (the longest it has been in a while), and we are prepared to act in case of further weakness. This list is full of high quality companies which will provide us an opportunity to upgrade our portfolio even further.

That being said, we did make a number of transactions in the portfolio during the quarter. We added one new position, **Aon (AON)**, took advantage of price weakness to increase our position size in current holdings **Apple (AAPL)**, **Jacobs Engineering Group (JEC)**, and **Quanta Services (PWR)**, trimmed back our exposure to **Walgreens Boots Alliance (WBA)** and completely exited our positions in **Target (TGT)** and **Ocwen Financial (OCN)**.

Aon is the largest property & casualty insurance broker in the world. The company also provides risk and human resources (HR) consulting to a wide range of corporate clients. Since 2005, when current management took over, Aon has divested its capital-intensive underwriting business and strengthened both insurance brokerage and HR solutions through strategic acquisitions. Return on invested capital has increased commensurately and we believe Aon has the ability to return most of its cash earnings to shareholders through share repurchases and dividends. Aon's customer relationships are generally "sticky" and we believe demand for the types of services offered by Aon will continue to grow into the foreseeable future as businesses become increasingly global and complex. When the price of the stock fell along with the general market, we believed this presented an opportunity to buy a dominant player engaged in a good business at a discount to the market as a whole.

As we did last quarter, we increased our position sizes in Apple, Jacobs, and Quanta. Apple's share price declined on worries over whether iPhone shipments will show growth over the robust sales the company posted during the holiday quarter last year when it debuted the larger form factors iPhone 6 and 6 Plus. On this point, we are agnostic as we believe the shares are dramatically undervalued even if they sell slightly less iPhone units during this one quarter. Over time, we believe Apple's integrated hardware/software ecosystem will lead to continued market share gains while its balance sheet, fortified with approximately $150 billion in cash, net of debt, will enable Apple management to return a large amount of capital to shareholders through stock buybacks and dividend payments. We believe both of these will be more important in closing the gap that currently exists between current market value and our intrinsic value estimate than a single quarter of iPhone shipments.

As we wrote about last quarter, Quanta is well positioned to benefit from multiple drivers of investment in electric power transmission and distribution, including aging infrastructure, growth of renewable energy, coal plant retirement, and regulatory changes. As power generation shifts from coal-fired generators to natural gas-fired and solar and wind gain share in the overall power grid, the need for transmission and distribution infrastructure investments is growing. The company has established a strong presence throughout the US and Canada, where it serves a multitude of regulated utilities and independent power producers. Jacobs, which has a well-diversified revenue stream spread across multiple industries, provides engineering and construction services to industrial, commercial, and government customers. Jacobs is focused on long-term relationships with its preferred clients as a source of recurring business. Both Quanta and Jacobs have what we consider to be asset-light business models, where capital expenditure needs are limited, resulting in high free cash flow generation relative to reported earnings. Strong balance sheets remain a strategic priority and competitive advantage for each company allowing them to more easily meet their working capital requirements on projects, pursue tuck-in acquisitions, and continue to buy back stock at currently depressed valuations.

In each of these decisions, our analysis is based on an objective evaluation of the fundamentals. Other investors can get so caught up in predicting other investors' behavior that they ignore value and fail to buy bargains out of fear that the assets in question will remain unpopular. This creates opportunities for those willing to think independently and endure what may be short-term malaise.

Precision Castparts (PCP), whose stock we bought just last quarter, received a buyout offer from **Berkshire Hathaway (BRKA/BRKB)** in August. While the premium that Berkshire offered to purchase the company was over 20% to where it had been trading, the price was somewhat lower than what we think the shares may have been worth had Precision's management had the opportunity to work through recent weakness as an independent company. Offsetting this is that the payoff came more quickly and our large holding of Berkshire Hathaway should benefit nicely from the acquisition of this high quality company. With upside now limited to the buyout price, we have been selling shares as needed to fund other opportunities.

Our decision to sell Ocwen is based on a combination of factors. First and foremost, we have come to believe that determining whether or not Ocwen's earnings power is permanently impaired is, at best, a 50/50 proposition. In the aftermath of the penalties assessed by the New York State Department of Financial Services that prohibited Ocwen from acquiring Mortgage Servicing Rights, we believed that Ocwen, after experiencing a fair amount of short-term pain, would ultimately be able to right-size its operations to adapt to a period of declining revenue until it was able to cast off the yoke of these regulatory penalties. Unfortunately, its servicing expenses have actually grown over the course of this year despite the fact that they are servicing fewer loans. As unexpected as this was, it was not an insurmountable obstacle if some portion of these expenses proved to be temporary. The piece of information that pushed us to sell the position was when Ocwen's management released a plan to reduce expenses that, under a good scenario, would only barely restore profitability in 2016 and left the future beyond that entirely uncertain.

Secondly, we no longer believe Ocwen's net asset value (adjusted book value) serves as a strong indicator of the company's value. Over the course of our ownership of Ocwen, we have frequently cited our estimate of its adjusted book value as a proxy for a presumed floor for the stock price and that we would not sell if the price was below this level. Our assessment currently places a net asset value of somewhere between $9 and $13 depending on how a number of off-balance sheet assets are valued. (This figure has fallen from previous estimates we've cited as Ocwen's servicing book has gotten smaller due to its inability to replace roll-off of loans from prepayments and due to operating losses.) What has changed is that we no longer have confidence that Ocwen could realize this value, thus it is no longer placing a floor under the stock price.

In order for net asset value to serve as a floor for a company's valuation, one of two things must be currently true: 1) it must be reasonably possible for the company or the company's assets to be purchased by a third party in the ballpark of that net asset value or, 2) the company must be a viable, profitable enterprise. Due to the regulatory scrutiny that would inevitably accompany a purchase of Ocwen's assets in the short run, we always assumed #1 was not specifically applicable to Ocwen in the near future. However, for reasons stated above, we believed Ocwen was (or soon would be) a viable, profitable enterprise and the stock's valuation would eventually converge with or, in an upside scenario, surpass our estimate of net assets as #1 was brought back into play. As also stated above, recent events have caused us to lose confidence in Ocwen's ability to do anything other than limp along in the short run, at which point we no longer felt Ocwen met the second criterion.

As always, the question we have to answer is where is our capital best deployed? In this case, we concluded there were more attractive opportunities elsewhere on a risk-adjusted basis. For positions held in taxable accounts, we also felt that the value of the tax loss available today for selling Ocwen exceeded the probability-adjusted value we could realize in the future by continuing to hold the position.

We appreciate the faith that you, our partners, have placed in us to manage your capital on a long-term basis. The extended time frame you allow us to focus on provides a tremendous advantage as we go about our investment decision making process. Managing other people's money is an enormous responsibility and we hope you take comfort in the fact that we are doing the exact same thing with our own money as we do with yours.

Best Regards,

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