Core Equity Commentary
Fall 2017

Market and Performance Summary

During the third quarter of 2017, the Kovitz Investment Group (KIG) Equity Composite[1] (the "Composite") appreciated by 5.0% while its benchmark, the S&P 500, increased 4.5%. Year-to-date through September 30th, the Composite has risen 10.6% vs. a gain for the S&P 500 of 14.2%. Over the past one year, the Composite generated a return of 25.0% vs. an 18.6% return for the S&P 500.

It seems almost surreal that the bull market in stocks, which began in the still dark days of the financial crisis in early 2009, has now lasted for over 8 ½ years. Even more surreal is the fact that in 2017, the market (using the S&P 500 as proxy) has only had one correction of more than 2%. Historically, stocks have averaged at least one 15% correction per year and corrections of 5%-10% have been commonplace. Volatility is non-existent, which is puzzling given geo-political uncertainty and disarray in Washington D.C. Furthermore, with interest rates low, the economy on firm, if unspectacular, footing, and corporate profits strong, this bull market shows no signs of slowing any time soon.

However, one of the hallmarks of bull markets is that they dull investors' senses. Bull markets breed a certain complacency that leads many to assume more risk in their portfolios. Maximizing returns becomes the priority while risk management takes a backseat. Fear of missing out replaces investment discipline. It can be tempting to forget that nasty downturns happen with some regularity, and there is never a bell rung to announce their arrival before they occur.

With the market trading at elevated levels, many investors tend to justify continued investments on a relative basis. We constantly hear that stocks are cheap when compared to low yielding bonds, or that buying stocks with some kind of dividend yield is better than keeping cash reserves with little or no yield. The acronym "TINA," which stands for "there is no alternative," is sometimes used to describe the rationale for the capital flows into equities.

So what are we doing in the midst of the second longest bull market in history? Since we're a firm where caution is at the heart of each investment decision, we are exhibiting even more caution than usual. Our bottom-up research emphasizes business quality, industry structures, growth opportunities, management skill, and corporate culture. It is further augmented by our assessment of the company's ability to sustain earnings power over economic cycles through an understanding of its competitive advantages, business model, and management's proficiency in the allocation of capital. If a company passes these qualitative screens, our risk management principles will only allow purchase if the shares are trading at a sufficient discount to our estimate of their worth.

We therefore use absolute, rather than relative, methods to estimate companies' intrinsic values. We then use the movement of market prices around these intrinsic value estimates to construct and manage a portfolio of high-quality businesses that have the potential to create sustained shareholder value over many years. When we can't find investments that meet these criteria, our default option is

[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.*

to hold cash, which we continue to maintain at levels higher than normal. We don't view cash sitting around earning negligible returns as an abdication of responsibility. Our primary responsibility is to protect the capital entrusted to us. Growth of that capital is an important, but secondary, consideration. Cash also affords maximum flexibility as it can quickly be channeled into investment opportunities with minimal friction and transaction costs. When – not if – this long-running bull market comes to an end and bargain-hunting comes back into vogue, we'll be happy we have it.

With the ongoing trend towards passive (index) investing and the increasing level of quantitative/algorithmic trading, only a small fraction of trades today are being implemented by humans that make fundamental value judgments regarding companies and their stocks. What should we think about the willingness of investors to subject their capital to a process in which neither individual holdings nor portfolio construction is the result of thoughtful analysis and decision-making, and in which buying takes place regardless of price? We'll stick to our time-tested principles of fundamental value investing that have served us well for more than two decades. To us, it feels like it's a better time to emphasize avoiding losses rather than seeking gains.

The chart below summarizes annualized performance over various standard time periods ending September 30, 2017 and cumulative performance results from January 1, 1997 through September 30, 2017 for the Composite.

KIG Composite[2]
Annualized and Cumulative Equity Performance (Net of Fees)

	Average Annual Total Returns						Cumulative (20.75 years)
For Period Ending 9/30/17	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
KIG Composite	25.0%	8.7%	12.2%	7.2%	9.6%	10.7%	726.6%

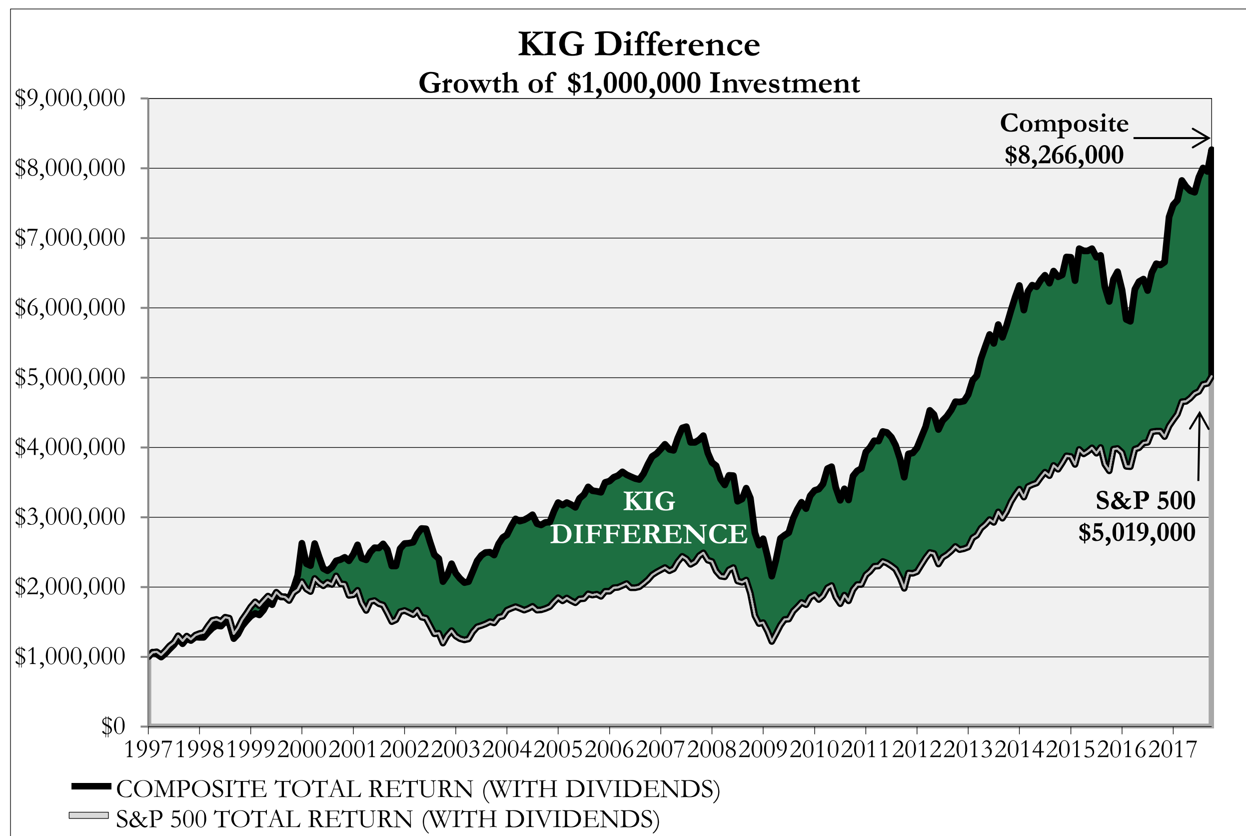
The table below lists the results for the same time periods as above for the S&P 500 and many of the other benchmarks widely held as investments via a style-box approach.

Other Market Indices
Annualized and Cumulative Equity Performance (Gross of Fees)

	Average Annual Total Returns						Cumulative (20.75 years)
For Period Ending 9/30/17	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
S&P 500	18.6%	10.8%	14.2%	7.4%	10.0%	8.1%	401.9%
Small Cap Equity (Russell 2000)	20.7%	12.2%	13.8%	7.8%	11.4%	8.5%	441.1%
International-Developed (MSCI-EAFE)	19.1%	5.0%	8.4%	1.3%	8.3%	4.9%	171.6%
International-Emerging (MSCI - EEM)	22.5%	4.9%	4.0%	1.3%	12.5%	6.2%	250.8%
Gold	-3.4%	1.3%	-6.8%	4.8%	8.8%	5.9%	225.5%
Commodities (CRB)	-1.0%	-12.8%	-9.7%	-5.4%	1.2%	1.8%	46.1%

[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 (January 1, 1997) 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

It continues to be a difficult environment in which to invest new capital. Finding qualifying investments that combine business quality with a margin of safety has been challenging. Fortunately, we believe the stocks we continue to hold have sufficient upside, and that our clients' equity portfolio results will not be held back over the long term. We have spent a great deal of research time boning up on companies and industries as we put together a shopping list to take advantage of when stocks go on sale.

That said, we took initial positions in two companies during the quarter: **PPG Industries (PPG)** and **Cheesecake Factory (CAKE)**. PPG is the largest global supplier of protective coatings. While "coatings" encompasses a broader definition, it would not be unfair to say simply that PPG makes paint for many different uses. Their primary end markets are new and maintenance construction (43% of sales), automotive manufacturers and after-market (33%), aerospace and ships (9%), and general industrial uses, which consists mainly of packaging coatings (15%). The business has undergone a dramatic shift over the past decade, evolving from a mixed chemicals/coatings platform into an almost pure coatings business. As a result, margins and returns on capital have improved in a stair-step pattern. We believe PPG is a high-quality business with durable competitive advantages, such as high switching costs and brand equity. The business also demonstrates pricing power, scale in distribution,

and continual innovation in products and application. PPG generates strong free cash flow (FCF), and management has demonstrated an ability to balance its use between investing for growth through attractive acquisition activity in a still fragmented industry and value-enhancing share repurchases. We do not believe its valuation at our initiation price of 16x FCF reflects these attributes.

The Cheesecake Factory is, in our opinion, an extremely well-run restaurant and bakery with excellent unit economics, strong cost controls, and a brand that makes its restaurants a destination for great food (and cheesecake!) in a fun atmosphere. The stock has fallen out of favor as the casual dining industry, in general, has experienced rising food and labor costs. Cheesecake has also been tainted by the fact that many of its stores are located in or near malls where online shopping has contributed to decreasing foot traffic. An old investment saw states: "There are only two types of companies: those that are having problems and those that are going to have problems." Our historical results are based on, more often than not, correctly identifying when a good company is suffering from temporary, rather than permanent, problems. We firmly believe Cheesecake is in the former camp, and the valuation is such that further downside is limited as we wait for results to improve.

We did not exit any positions during the quarter, but we trimmed our **Leucadia (LUK)** position as it briefly traded near our intrinsic 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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Past performance does not guarantee future returns.