KOVITZ INVESTMENT GROUP
Intrinsic Values®

Core Equity Commentary
Fall 2018

Market and Performance Summary

Despite reverberations over trade deals, emerging market weakness, and D.C. folly throughout the latest quarter, U.S. equity markets[1] posted the highest quarterly return since the fourth quarter of 2013. The Kovitz Investment Group (KIG) Equity Composite[2] (the "Composite") returned 5.3% in the 3-month period ended September 30, 2018 vs. 7.7% for the S&P 500 (the "S&P"). Year-to-date, the Composite has increased 3.0% vs. a 10.6% increase for the S&P. Since inception (January 1, 1997), the annualized compound rate of return of the Composite is 10.6%. The corresponding annualized return of the S&P is 8.5%.

In terms of stock prices, it has been a somewhat choppy year for our clients' holdings. When it comes to growth in intrinsic value, however, it is a much different story. We have invested client assets in exceptionally strong businesses with sturdy moats – many of them widening. Most generate cash flow well above their capital needs allowing for generous cash returns to shareholders in the form of dividends and stock repurchases. Eventually, the prices of the businesses in which our clients own a partial interest will catch up with the growth in their value and the improvement in long-term prospects we have observed across the Composite portfolio as we continually monitor and update our company-level assumptions.

As the share of investment assets held in passive investment vehicles (index funds/ETFs) increases, we believe engaging in forward-looking, qualitative, and quantitative analysis of business models, balance sheets, earnings, company investment cycles, and management capital allocation policies—in essence, the margin of safety assessment of upside potential and downside risks in individual stocks—becomes more valuable. Passive investors, on the other hand, primarily look to index-level movements to drive market returns, while fundamentals and valuation are merely an afterthought. Low interest rates have set the cost of capital so low that it has made it difficult for active investors to beat the indices and for value investors to outperform growth. Increased interest rates and credit spreads will likely change this dynamic. In that context, populating portfolios with highly vetted, individual stocks selected on the basis of forward-looking fundamental analysis drives the potential for strong, risk-adjusted returns across changing markets and unpredictable economic cycles.

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[1] *As represented by the S&P 500*
[2] *The returns for the equity portion of your individual account may differ from the Composite due to variations in account holdings, cash position, and other client-specific circumstances.*

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

KIG Composite[3]
Annualized and Cumulative Equity Performance (Net of Fees)

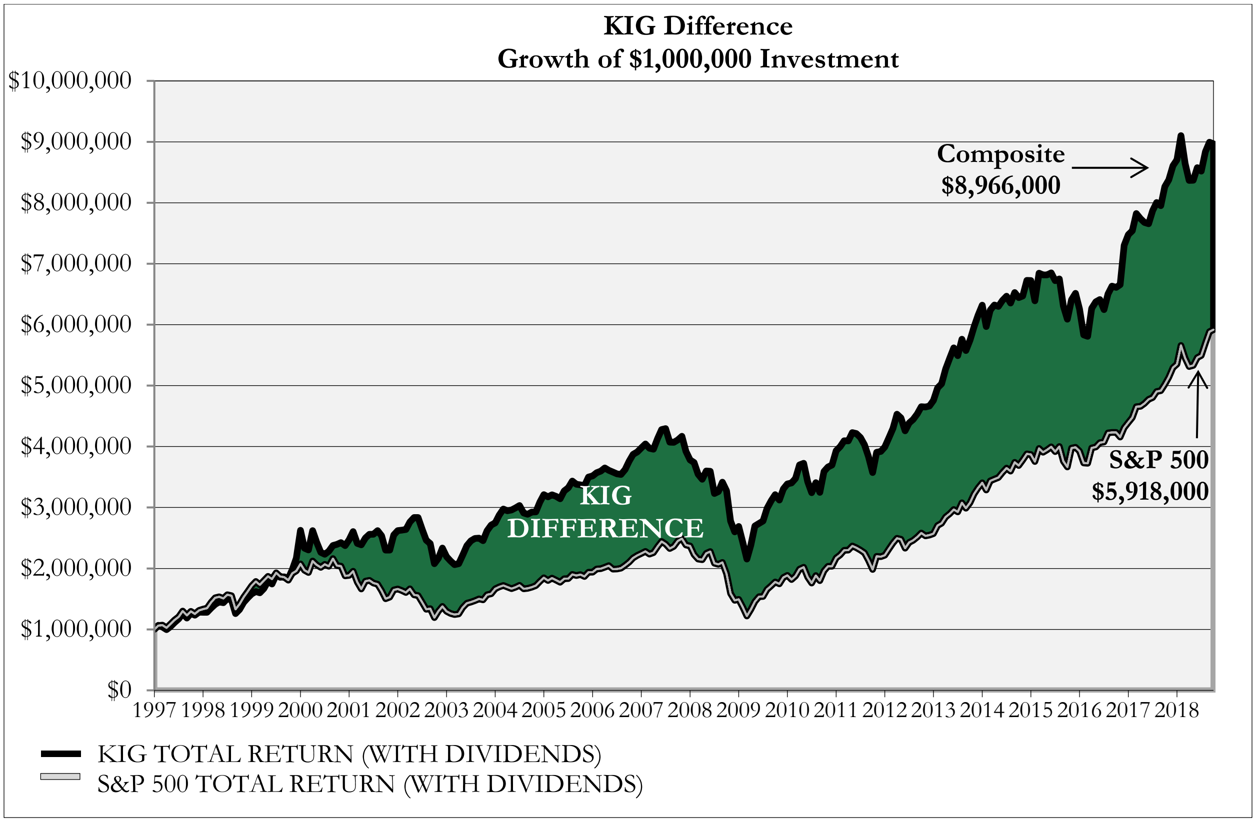
	Average Annual Total Returns						Cumulative
For Period Ending 9/30/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
KIG Composite	8.5%	13.8%	9.3%	10.6%	9.0%	10.6%	796.6%

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 typical diversified "style-box" approach.

Other Market Indices
Annualized and Cumulative Equity Performance

	Average Annual Total Returns						Cumulative
For Period Ending 9/30/18	**1 Year**	**3 Year**	**5 Year**	**10 Year**	**15 Year**	**Since Inception 1/1/97**	**Since Inception 1/1/97**
S&P 500	17.9%	17.3%	13.9%	12.0%	9.7%	8.5%	491.8%
Large Cap Value (Russell 1000 Value)	9.5%	13.6%	10.7%	9.8%	8.9%	8.5%	485.0%
Small Cap Equity (Russell 2000)	15.2%	17.1%	11.1%	11.1%	10.1%	8.8%	523.6%
International-Developed (MSCI- EAFE)	2.7%	9.2%	4.4%	5.4%	6.8%	4.8%	179.0%
International- Emerging (MSCI -EEM)	-0.8%	12.4%	3.6%	5.4%	9.7%	5.9%	248.0%
Gold	-7.7%	1.5%	-2.7%	2.4%	7.0%	5.2%	200.5%
Commodities (CRB)	8.4%	1.1%	-6.8%	-5.2%	0.5%	2.1%	58.4%

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 strong U.S. 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 lower valuations. We were, however, able to find two new investments during the quarter that warranted inclusion in your portfolios.

New Positions

After trading at a significant valuation premium to the rest of the market for pretty much its entire existence as a public company, Starbucks' (SBUX) shares fell to a valuation level we feel provides us with a margin of safety against losing capital over the long term. The catalyst for the move lower was driven by a steep drop-off in same-store-sales in China and a decline in afternoon traffic in the U.S. Even though Starbucks may be close to saturation in the U.S. market, forays outside the U.S. have been well-received and provide ample runway for the future. We believe the recent poor same-store-sales report from China will ultimately prove to be a blip over the next decade. Coffee consumption in China has been growing exponentially as it wins converts from the traditionally tea-based culture. We expect Starbucks to take at least their fair share of this burgeoning market as they grow their footprint and execute on upgrading the operations at previously licensed stores that were part of a joint venture covering most of eastern China that Starbucks recently acquired. Trading at roughly a market-like multiple of earnings when we initiated the position, we welcomed the opportunity to take a position in a company with an incredibly strong consumer brand with a loyal customer base that we expect to grow earnings at an above-market rate for the foreseeable future.

Our next new purchase, **Mohawk Industries (MHK)**, manufactures and markets its own lines of flooring products, including hardwood/laminate, carpeting, and ceramic and stone tile, for residential and commercial use. Mohawk and Berkshire Hathaway-owned Shaw are the dominant domestic players in a fragmented flooring market. After declining around 80% peak-to-trough as a result of the housing bust a decade ago, the company survived, restructured its operations, and has thrived on the back of the recovery in housing. However, the shares have been hit this year due to cautious guidance surrounding increasing costs for oil-based inputs and some unexpected softness in existing home sales. At purchase, Mohawk shares were trading towards the low end of its historical earnings multiple range. This valuation implies that earnings will either decline and then level off or will barely grow from here. Neither of those scenarios seem plausible to us over the long run. Mohawk has an expansive distribution network to market its products, and efficient and improving operations that have consistently grown margins over the last decade. Importantly, Mohawk and Shaw have consistently acted rationally in their duopoly. Upgrading outdated flooring also continues to be one of the highest ROI home improvement projects in which a homeowner can engage. With a long runway for steady demand and continued commitment to finding efficiencies in its operations, we believe Mohawk should trade at a valuation at least in line with the market regardless of any short-term, transitory issues that may be facing the company.

Eliminated Positions

We exited our position in **General Electric (GE)**. Our original thesis was that GE was a leader in all of the industries it participated in, 2017 was a "kitchen sink" year, 2018 earnings per share (EPS)/free cash flow (FCF) would be approximately $1 per share, and extensive restructuring and cost-cutting and a recovery in their power business would allow the company to grow at an above-market rate off that base. As events unfolded in 2018, many of these assumptions proved faulty. We did not expect further costly reserve increases coming out of the remains of GE Capital and that the boom in construction of large gas turbines over the prior five years was more the anomaly than the significant decrease in demand recorded in 2017 and 2018. Further, the company embarked on extensive asset sales. These sales may prove to stabilize the company and ease the burden of debt and pension obligations, but none of the sales were completed at levels that we felt weren't already incorporated in a reasonable sum-of-the-parts valuation of GE as a whole. As a result, we decided to redeploy the capital into new positions we felt offered better probability-adjusted returns going forward.

Gaining an Edge

Many investors in today's market still believe that gaining an edge comes primarily from gathering information. While it is extremely important to accumulate as much information as possible on any potential investment idea, that isn't what is likely going to give you an edge. Each piece of information that you think is proprietary is, with very few exceptions, likely already embedded in market prices. Gone are the days when Warren Buffett, just paging through his trusty Moody's Manual, could find profitable, well-managed companies selling at rock bottom prices. Some of the stocks he found were almost certain winners as he was doing work that others weren't doing. Technology, a significantly larger and more sophisticated financial media, and the growth in the ranks of professional investors and analysts have leveled the playing field when it comes to gaining information. Almost always, this type of low-hanging fruit has been arbitraged away because of the breadth of information now available and the ease with which it can be accessed.

What hasn't become commoditized is the ability to gain an edge by understanding biases and acting in a way that gives you a behavioral advantage. We believe our edge is gained through thinking differently than the crowd, through thinking on a different (longer) time horizon than the crowd and taking advantage of stock price volatility. Not only have these potential advantages not gone away, but they've likely strengthened as attention spans, patience, and the time that investors are willing to wait for positive results have all gotten much shorter. This pervasive short-term thinking creates a gap between price and value as oftentimes short-term investors are selling stock because they think the next few quarters will look bad, even if they believe the next five years will look good.

Investors who focus on trying to gain an information edge are typically focused on short-term information. For instance, we have been approached by numerous "research" organizations looking to sell satellite imagery of farms in order to predict crop yields in the upcoming harvest, or data on the changing number of cars in parking lots at shopping malls and strip malls in order to predict the direction of sales trends for retailers. This type of information might be useful in predicting whether or not a company will "beat expectations" in the next quarter, but it isn't all that much of an advantage in determining the long-term value of the enterprise or its longer-term competitive position. It brings to mind a quote from sociologist William Bruce Cameron who said, "Not everything that can be counted counts, and not everything that counts can be counted." Computers can do an unmatched job dealing with the things that can be counted: things that are quantitative and objective. But many other things – qualitative, subjective things – count for a great deal more, and we doubt computers can do what the very best investors do.

We believe this creates an advantage for investors who choose to focus on longer time horizons and company fundamentals. Results may not come quickly, but, over time, gaps between market prices and our estimates of intrinsic value should close.

Bank of America (BAC) is an example of how significant gaps between price and value can exist. Going back to the end of 2015, Bank of America shares traded around $17. Just over a month later in early February 2016, the stock traded down to around $11 as fears over the bank's energy portfolio and a possible economic slowdown wiped away almost $60 billion in market value. Today, the shares trade around $30, or almost triple the 2016 lows. This roller coaster ride in market capitalization is much more pronounced than the change in its intrinsic value. How does a company as widely followed as Bank of America experience such dramatic changes in valuation? Investors sold it off in the early part of 2016 because of a potential hit to its near-term earnings outlook. In our opinion, however, what was happening at the time was unlikely to impact the long-term earning power of the franchise. Those who were able deal with the possible negative short-term results (and a potentially lower stock price) and were willing to look out three to five years saw a bank with sticky, low-cost deposits, a well-capitalized balance sheet, an improving cost structure, and durable earnings power.

Thinking long term is a commonly talked-about potential advantage in our industry, but it is one that is much less often borne out by the actions of investors. John Maynard Keynes once wrote, "Worldly wisdom teaches that it is better for [one's] reputation to fail conventionally than to succeed unconventionally." Our practices may be somewhat unconventional, but we believe they provide us with one of the last true edges available in the markets.

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