Weitz FUNDS

Letter to Shareholders

Print

July 1, 2014

Dear Fellow Shareholder:

In many ways, the second quarter of 2014 was a continuation of the past several quarters. After a weather-induced first quarter dip in GDP, the U.S. economy resumed its modest recovery from the “Great Recession” of 2007-09. The Federal Reserve “tapered” its quantitative easing (QE) program but still purchased $310 ***billion*** of bonds during the first half of the year. U.S. stocks continued to drift up—the conventional wisdom being that while valuations were not compelling, as long as the Fed was providing “liquidity” and near-zero interest rates, it was safe to continue buying. In fact, failure to keep buying exposed investors to the risk of being left out of the continuing bull market.

We have been wary for some time about the level of stock prices relative to underlying business values. We own some excellent companies and they continue to grow in value, but in many cases, their stock prices have risen even faster. Price sensitivity and investment discipline dictate that we sell the expensive and if reasonably priced replacements are not available that we hold cash. So, our cash reserve levels remain elevated in the mid- to upper-20% range. This cash “anchor” held back second quarter and first half returns, but we think the “opportunity cost” of holding out for better values is slight and that we will be rewarded for our patience.

While QE has had an indirect effect on stocks, bond prices have been impacted directly and significantly. The resulting bond market rally has produced positive total returns (interest income plus capital appreciation) for longer-term bonds, but has left prices artificially inflated and yields suppressed. The Fed can maintain this (surreal?) situation for a long time (it already has), but eventually bond buyers will insist on being paid more (higher yields) on their investments. Our Short-Intermediate Income Fund holds a relatively short, high quality portfolio. We think it will provide reasonable protection for bond investors when reality returns to the bond market.

Investment Commentary and Outlook

The domestic stock market has been relatively quiet this year. Volatility has been very low. Investors have seemingly ignored potentially upsetting financial and geopolitical news from various corners of the world. The Fed’s largess is likely one of the reasons, but as usual, short-term moves in stock prices are a mysterious mixture of real and imagined forces that we cannot predict.

What really matters over the years is how our companies grow and evolve and how much we pay for their shares. Generally speaking, day-to-day business has been good for our companies. Sales, profit margins and earnings have been rising over the past several years. Balance sheets have been strengthened as companies take advantage of cheap and plentiful credit to lower interest costs and extend maturities (a very tangible benefit of the Fed’s QE). “Organic” growth has been fairly strong in spite of the sub-standard pace of the recovery.

Equally, and in some cases more importantly, our companies are proactively making things happen that increase the per share values of their businesses. Nearly every one of our companies has been involved in some form of merger, acquisition, restructuring, share repurchase or internal “new business” startup over the last six months.

On the acquisition front, a number of companies have made small, “tuck-in” acquisitions that enhance their existing businesses. Others have made, or are pursuing, more “transformative” deals, the most significant current example of which is Valeant’s hostile bid for Allergan. We believe that Valeant’s odds of success have improved, but if it cannot acquire Allergan, it will undoubtedly move on to other attractive targets. Texas Instruments, Iconix Brands, TransDigm, Oracle, Google, LabCorp Holdings, Liberty Global, Liberty Media and others are all examples of companies which have made good use of acquisitions to build their businesses over the years. Disciplined company builders can usually find ways to buy good businesses that add value in any economic or market environment.

Berkshire Hathaway is also an active acquirer, both at the parent company level and through its various subsidiaries. Warren Buffett is holding cash reserves of $40-50 billion and has expressed strong interest in making more very large acquisitions. Berkshire recently agreed to swap its long-time holdings of the Washington Post Company (now called Graham Holdings) for a TV station and Berkshire shares held by that company. When completed, this tax-efficient transaction will reduce the number of Berkshire shares outstanding and add another cash generating asset to the fold. Berkshire is constantly growing and evolving as a group of operating businesses but also, in extreme stock market dislocations like 2008, Warren has the courage and capacity to make bold investment moves. Berkshire has been a holding in our stock funds continuously since our firm opened in 1983.

DIRECTV is on the receiving end of a takeover offer—it is the target of an acquisition by AT&T. DIRECTV had grown its business steadily over the years and had increased its value ***per share*** significantly by making very large share repurchases. AT&T is offering roughly twice the price we paid for our first shares about three years ago. We have mixed feelings about giving up our holdings but it has been a good investment for us.

If Berkshire Hathaway has been busy ***within*** its holding company structure, John Malone has been ***very*** busy collecting businesses, combining them, trading them, using spinoffs and tracking stocks and generally embracing complexity to enrich his shareholders. The diagrams and "roadmaps" of Liberty's evolution are almost comically complicated, but the results have been terrific over the past 25 years or so that we have been investing with John Malone. Like Warren Buffett, we trust him to find ways to build value in the businesses we own, regardless of what the stock market does.

So, stock prices are high, bargains are rare and volatility is low. We prefer to see prices moving up and down more dramatically, giving us opportunities to buy great stocks at cheap prices. For better or worse, though, the stock market does not move according to our preferences. Stocks go through long stretches of over- or under-valuation. Profits come in batches. We have to be patient when there is little buying and selling to be done, and prepared—with researched investment ideas and cash—to act when opportunity arises.

Sincerely,

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As of June 30, 2014: Valeant represented 5.5%, 4.1%, 6.0%, 3.8% and 1.8% of the Value, Partners Value, Partners III Opportunity, Research and Balanced Funds' net assets, respectively. Texas Instruments represented 2.7%, 3.1%, 2.8% and 1.7% of the Value, Partners Value, Partners III Opportunity and Balanced Funds' net assets, respectively. Iconix Brands represented 3.4%, 3.1% and 4.4% of the Partners Value, Partners III Opportunity and Hickory Funds' net assets, respectively. TransDigm represented 2.1%, 1.1%, 3.2%, 1.6% and 4.1% of the Value, Partners Value, Partners III Opportunity, Research and Hickory Funds' net assets, respectively. Oracle represented 2.2%, 2.2%, 2.1%, 1.9% and 1.9% of the Value, Partners Value, Partners III Opportunity, Research and Balanced Funds' net assets, respectively. Google represented 2.3%, 2.1%, 1.2% and 1.4% of the Value, Partners Value, Partners III Opportunity and Research Funds' net assets, respectively. LabCorp Holdings represented 1.1%, 2.1%, 3.1%, 4.4% and 2.0% of the Value, Partners Value, Partners III Opportunity, Hickory and Balanced Funds' net assets, respectively. Liberty Global represented 5.0%, 4.3%, 4.0%, 2.3% and 3.1% of the Value, Partners Value, Partners III Opportunity, Research and Hickory Funds' net assets, respectively. Liberty Media represented 3.8%, 5.2%, 5.8%, 4.8% and 3.1% of the Value, Partners Value, Partners III Opportunity, Research and Hickory Funds' net assets, respectively. Berkshire Hathaway represented 4.4%, 4.1%, 5.5%, 4.1% and 2.5% of the Value, Partners Value, Partners III Opportunity, Research and Balanced Funds' net assets, respectively. DIRECTV represented 3.0%, 3.7%, 4.7% and 2.9% of the Value, Partners Value, Partners III Opportunity and Research Funds' net assets, respectively.