# An Annual Overview of the Large-Cap Value Strategy (Value Fund)

*by Dave Perkins, CFA, Portfolio Manager*

"Patience, distinctiveness, thrift and trust still count." We borrow these words from the subtitle of an article published in the Economist earlier this spring celebrating the virtues of long-term thinking in an increasingly minute-to-minute world. These ideals ring true not only for those running multi-generational businesses, but to those in the public equities trade who have chosen to focus on the destination as opposed to the elegance or speed with which mile markers are eclipsed along the way. Our destination, from day one, has been healthy growth in principal over time without taking unnecessary risk. These four paragons are integral parts of the Value Fund's historical, and we trust future, success.

## Patience

*"When things are going well and prices are high, investors rush to buy, forgetting all prudence. Then, when there's chaos all around and assets are on the bargain counter, they lose all willingness to bear risk and rush to sell. And it will ever be so."*

– Howard Marks, Oaktree Capital Management

For the better part of the past six and a half years, markets have moved steadily upward. Our Fund and its primary benchmarks – the S&P 500 and Russell 1000 – have increased at compounded annual rates of +19.2%, +18.8% and +19.2% since the recovery began in March 2009. Those skeptical of the health of the underlying global economic recovery as it unfolded, or wary of potential unintended consequences of the Fed's monetary firehose, have been either left at the station or faced with the challenge of boarding a moving train. Insisting on a margin of safety has appeared, at best, old-fashioned. The old adage "don't fight the Fed" has perhaps been seared as deeply into equity investors' psyches as was the now more distant pain inflicted by the financial crisis seven years ago. The fork in the road for the Federal Reserve – and for investors – however, may soon be arriving. With the prospect of the beginning of the end of unprecedented monetary stimulus on the horizon, what does an equity investor do at fair-to-expensive valuations as the Fed is poised to move the other direction?

In recent years, many investors have been unwilling to settle for "what they can get" in a lower-growth, lower-return world. Instead, they have chosen to pay increasing amounts for similar streams of future cash flow or reached further to maintain the yield necessary to support existing or projected spending patterns. These actions seemingly expose a subtle but important shift in underlying risk appetite – that the fear of falling behind has perhaps overtaken the fear of losing money. We have noted with interest how equity markets have taken a series of otherwise troubling world events largely in stride as central banks around the globe have injected heavy doses of liquidity. Broadly speaking, investors have been willing to play along, venturing further out on the risk spectrum convinced "the water is safe" and stronger growth lies ahead. Higher stock prices driven more by sentiment than underlying earnings growth present added risk.

One of the strengths of our investment discipline is the ability to hold residual cash reserves when qualifying investment opportunities are in short supply. This willingness is firmly rooted in the belief that the present opportunity set isn't the only relevant period of consideration for a long-term investor. Human nature has a way of overextending itself, creating opportunities for both purchase and sale at prices detached from fundamental business reality. Over the past three years,

*Weitz Value Fund—Investor Class (WVALX) average annual total returns for the one, five, and ten-year periods ended June 30, 2015 were 5.89%, 16.10% and 5.71%. Returns for the S&P 500® for such periods were 7.42%, 17.34% and 7.89%. Returns for the Russell 1000® for such periods were 7.37%, 17.58% and 8.13%. Past performance does not guarantee future results. Current performance may be higher or lower than the performance data quoted. Performance data current to the most recent month end may be obtained at www.weitzinvestments.com/funds_and_performance/fund_performance.fs. The returns above assume reinvestment of dividends and redemption at the end of each period, and reflect the deduction of annual operating expenses, which as stated in the most recent Prospectus are 1.15% of WVALX's net assets. The returns above also include fee waivers and/or expense reimbursements, if any; total returns would have been lower had there been no waivers or reimbursements. Index performance is hypothetical and is shown for illustrative purposes only.*

the Value Fund's residual cash position has risen as successful multi-year investments have been harvested against the backdrop of a consistently rising market. Texas Instruments, Walt Disney, CVS Caremark and Hewlett-Packard are examples. Finding a similar volume of suitable replacements at 30% or greater discounts to our assessment of intrinsic value has, on the other hand, been a struggle. Valuation-driven selling has thus resulted in an average cash balance approximating 25% of Fund net assets over the past 3 years, well above what we consider to be normal (10-15%).

When we have acted on attractively priced opportunities, the Weitz team's nose for value has been good. Annualized stock-only returns dating back to June 30, 2008 (the date the Value Fund began focusing exclusively on larger companies with market capitalizations at or above $10 billion) have been approximately +12.3% vs. +8.6% and +8.7% for the Fund's relative benchmarks. Including cash, annualized returns are an acceptable +9.6% over the same period. Our expectation in managing the Fund is perhaps best captured by Berkshire Hathaway CEO Warren Buffett in his 1960 partnership letter:

*"I have pointed out that any superior record which we might accomplish should not be expected to be evidenced by a relatively constant advantage in performance compared to the Average. Rather it is likely that if such an advantage is achieved, it will be through better than average performance in stable or declining markets and average, or perhaps even poorer-than-average performance in rising markets."*

We are pleased to have been able to stay modestly ahead of pace over the past 7 years, particularly given that the last several have not played to our investment strengths. If the stock market continues to grind higher in uniform fashion over the next several years, our aim will be to continue to take advantage of pockets of price dislocation among businesses that meet our quality standards. In the event few are available, we will continue to wait until we see pitches we are confident we can hit. Encouragingly, as we enter the fall, investors appear to be giving fresh thought to risk. Volatility is returning. We welcome these developments as we have been at work constructing the portfolio with a mind toward this seeming eventuality. While our price discipline has been a headwind to returns over the past several years, our residual cash positions the Fund for opportunity should investors' risk appetites or the global economy wane.

## Distinctiveness

At Weitz, we often refer to business and management quality as key pillars of our investment philosophy. We understand this focus isn't terribly unique. After all, who presented with the choice prefers a poor business or manager? Likewise, the desire to find and purchase bargains is the aim of every investor, whether "growth" or "value." Investing with a minimum 3-5 year investment horizon, eschewing benchmarks and choosing to concentrate in our best ideas begins to separate Weitz from the equity crowd. The ability to pursue value beyond traditional high-level financial metrics gives our able research team the latitude to identify mispriced securities wherever they can be found. We think our shareholders are best served by out-of-the-(style)-box thinking. A keen eye on current and prospective company reinvestment opportunities and the skill with which excess capital is likely to be deployed often lead us to conclusions that differ with Wall Street consensus. Finally, and perhaps most importantly, our culture and compensation reward teamwork, intellectual honesty and curiosity, intangibles that are difficult to quantify. As William Bruce Cameron reminds, "Not everything that counts can be counted, and not everything that can be counted counts."

As business analysts, we often seek to distill a company's competitive advantage down to one or two primary characteristics. Consultants, advisors and individuals understandably do the same with investment managers. One of the wrinkles of investing we have come to better appreciate is the strength and durability that come from operating under the right premises and doing lots of little things well. Few of the individual traits or pursuits listed above is necessarily differentiated in and of itself. It is the intersection of each that we believe is distinctly Weitz. A combination that gives the Fund an opportunity to continue generating better than average performance in a relatively efficient and highly competitive marketplace over time.

The Value Fund bears the fingerprints of this DNA. Buffett has written about his gradual evolution as an investor toward higher quality businesses. How "time is the friend of the wonderful company, the enemy of the mediocre" and of his preference for buying a "wonderful company at a fair price" vs. "a fair company at a wonderful price." Over time, our appetite for truly outstanding businesses (and managers) has also increased. Identifying the select group of companies and management teams worthy of investing alongside over long periods of time is a task we approach with effort and humility. TransDigm, MasterCard, Precision Castparts (see chart below) and Monsanto are examples of "compounders" we have uncovered and added to the Fund in recent years. They join an existing stable that includes Liberty Global, Valeant Pharmaceuticals, Google, Express Scripts, Liberty Interactive, Praxair and Martin Marietta Materials, among others.

There are some important, perhaps obvious, benefits associated with the subtle shift to owning higher quality companies. The ability to own them for longer periods and our willingness to hold them in size to full value lowers both "recycle risk" (the need to find the next great investment upon sale) and taxes. If we've done our homework correctly, the risk of permanent loss should also be lower as compared with more pedestrian businesses with greater competitive, technological and/or regulatory vulnerabilities. Our goal in managing the Value Fund is to create a carefully curated, concentrated collection of great businesses at reasonable (or better) discounts.

## Thrift

Central to any discussion of the Fund's investment philosophy is the subject of price paid. As public equity investors, it is one of the few variables within our control. Businesses, regardless of quality, still play by the same economic rules. Buffett puts it simply– "what is smart at one price is dumb at another." Price is the single largest determinant of an investor's returns. Business value is the lens through which we determine whether or not a given price is cheap, merely fair or expensive.

Valuation is both an art and science. It is the foundation upon which we assess risk, evaluate opportunity, consider purchase, and determine sale. It includes both qualitative and quantitative assessments, as well as numerous assumptions about the future. Naturally, our research efforts are focused only on those companies where a range of potential values can be reasonably assessed. Given that the future is inherently uncertain, we do not believe the value of any business can be known with certainty at a given point in time, so our aim is to be generally right as opposed to precisely wrong.

At a portfolio level, the two primary dashboard instruments we utilize in gauging the broader opportunity set are the price-to-value ratios (P/Vs) of the Fund and our "on-deck" list. They serve as temperature gauges of sorts, alerting us to when the market's engine is closer to overheating and when it is time to consider stepping harder on the gas. If it is true (and we believe it is) that over time a stock's price will ebb and flow around a central, fundamentally-based tether, a correct picture of that tether (intrinsic value) should be a reasonable predictor of long-term investment performance. This has in fact been the case; the Weitz team's collective valuation work on the more than 100 companies that typically comprise these gauges correlates well with longer-term forward returns. When bargains are absent, future returns have been lower, and vice versa.

In recent years, the Fund has had a number of holdings purchased by strategic or financial acquirers. These transactions provide an additional, if unscientific, reality check on how successfully we are measuring business value. We approach valuation from a perspective similar to that of a 100% owner – what are the excess cash flows we will receive in the future and how certain are we about their durability? Below is a table outlining six businesses the Fund owned at the date they reached agreements to be sold and the price the acquirer agreed to pay relative to our

| Company | Ticker | Weitz Value* | Takeout Price* | Date** | Deal Size ($B) | Notes |
|---|---|---|---|---|---|---|
| Burlington Northern Santa Fe | BNI | $95.00 | $100.00 | 11/3/2009 | $26.0 | 60% Cash/40% Stock |
| XTO Energy | XTO | $60.00 | $52.00 | 12/15/2009 | $31.0 | All Stock |
| Dell Inc. | DELL | $18.00 | $13.75 | 2/5/2013 | $24.4 | Management Buyout |
| DirecTV | DTV | $86.00 | $95.00 | 5/18/2014 | $49.0 | 30% Cash/70% Stock |
| Catamaran Corp. | CTRX | $60.00 | $61.50 | 3/30/2015 | $12.8 | All Cash |
| Precision Castparts*** | PCP | $255.00 | $235.00 | 8/10/2015 | $37.2 | All Cash |

*Price per share
**Date transaction announced
***Deal pending

base case valuation estimate at the time.

If we include businesses on our on-deck list and the smaller companies (less than $10 billion market capitalizations) we have owned across the Weitz complex over the past five years, buyers of all stripes, and in many cases with better information than we are able to obtain as public investors, have paid prices that fall largely within 10% (plus or minus) of our base case valuations. Importantly, in only one instance was our valuation meaningfully above the price at which the company was sold (DELL). Judging by the public statements of others, we were not the only minority shareholders unhappy with management's "take-under."

So, where is the Fund's P/V today? Earlier we wrote about overall stock price levels having been fair-to-expensive. For the better part of 2014 and the first half of 2015, the estimated P/V ratio of the Fund was somewhere between 0.85 and 0.92. Without question, these ratios are toward the upper end of the Fund's historical range. For context, 0.92 is the highest P/V ratio we have recorded for the Fund since we began formally tracking it roughly 10 years ago. The Fund's trough P/V ratio was 0.44 during the spring of 2009. Not surprisingly, 5-year forward returns from that all-time low were excellent (+22% annualized) for those patient and courageous enough to ride out the storm.

A combination of business value growth, portfolio reshaping and stock price activity has more recently led the Fund's overall P/V ratio back into the low 80s. Theoretically, if each of the stocks we owned today closed the gap with our estimated base valuations over the next 5 years, we would expect to earn attractive rates of return. We caution, however, that the timeline of world events is rarely the servant of spreadsheets. We don't – and can't – know what the stock market will do over the course of the next month, quarter or year, but a greater divergence between stock prices, the return of volatility and lower P/V ratios provide a more attractive backdrop for the Fund.

## Trust

Discipline and process are perhaps most important at market extremes. As Baupost Group's Seth Klarman pointed out early in 2008, however, "One of the ongoing complexities of security analysis is that you can never satisfactorily determine where you are in a cycle." Precisely for this reason, each member of the Weitz research team's average day looks quite similar regardless of what is going on in the market at large. Whether security prices are reaching new highs or new lows (dates knowable only in hindsight, we remind), the process of getting to know industries, companies, competitors, suppliers, customers and managers continues. We believe in the fullness of time our investors are best served by the team's intimate knowledge of and appreciation for differentiated businesses, as opposed to dedicating valuable time and energy attempting to predict whether buyers will outnumber sellers tomorrow or next month. It is this consistency of effort and purposeful focus that form the basis of our investment process.

We are bound to have ups and downs in the years ahead, as we have in the past. Our aim, as ever, is to protect and grow the Fund's capital one company and one security at a time. Thank you for your trust in allowing us to steward your capital.

***Dave Perkins, CFA,*** *joined Weitz in 2004. He graduated from Taylor University in Upland, IN and previously spent three years as an equity analyst with McCarthy Group Asset Management. Dave has been a CFA® charterholder since 2009.*

*The S&P 500® is an unmanaged index consisting of 500 companies generally representative of the market for the stocks of large-size U.S. companies. The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is the trademark of Russell Investment Group.*

*Investors should consider carefully the investment objectives, risks, and charges and expenses of the Fund before investing. The Fund's Prospectus contains this and other information about the Fund and should be read carefully before investing. The Prospectus is available from Weitz Investment Management, Inc., 1125 S 103rd Street, Suite 200, Omaha NE 68124-1071, (800) 304-9745, weitzinvestments.com*

*Weitz Securities, Inc. is the distributor of the Weitz Funds.*

*Effective January 1, 2016, Wally Weitz will no longer be a portfolio manager of the Value Fund. Wally, the Chief Investment Officer of Weitz Investment Management, Inc., will continue to be CIO and a portfolio manager of the Partners Value Fund, the Partners III Opportunity Fund and the Hickory Fund. Brad Hinton and Dave Perkins, who are currently portfolio managers of the Value Fund, will continue to be portfolio managers of the Value Fund.*

*The Fund's top 10 stock holdings (comprising 40.9% of the Fund) as of June 30, 2015 were as follows: Liberty Global plc - Series C (7.2%), Valeant Pharmaceuticals International, Inc. (5.9%), Berkshire Hathaway, Inc. - Class B (4.7%), Liberty Interactive Corp. QVC Group - Series A (3.9%), Range Resources Corp. (3.5%), Express Scripts Holding Co. (3.5%), Discovery Communications, Inc. - Class C (3.3%), Liberty Media Corp. - Series C (3.2%), Twenty-First Century Fox, Inc. - Class A (2.9%), TransDigm Group, Inc. (2.8%). Portfolio composition is subject to change at any time and references to specific securities, industries and sectors in this letter are not recommendations to purchase or sell any particular security. Current and future portfolio holdings are subject to risk.*