An Annual Overview of the Small/Mid-Cap Strategy (Hickory Fund)

by Drew Weitz, Portfolio Manager

Financial markets entered a renewed period of volatility, beginning in the second half of 2015. Many (if not most) financial journalists and market pundits refer to the large-company-centric S&P 500® Index as their benchmark for "the market." While this index finished the rollercoaster-like final six months of the calendar year relatively unchanged from its halfway point (+0.15%), investors were subjected to abrupt declines in the opening weeks of 2016–falling by as much as 10.27% at the February 11 low.

For investors focused on small -and mid-sized (SMID) companies the experience has been more painful. The Russell 2500™, our strategy's benchmark, fell 7.36% in the back half of 2015 before dropping an additional 14.55% at the same February 11 market low. The combined decline of 20.84% from June 30, 2015, to the market low meets many investors' technical definition of a Bear Market (a decline of 20% or more).

Due to its defensive positioning the Hickory Fund did not fare as badly as its benchmark over this period, returning -18.74%. Although we certainly prefer reporting performance that is relatively better than our benchmark, our top priority is to deliver acceptable absolute returns without assuming undue risk. As shareholders alongside you, we are not celebrating these interim results. That said, an eight-month period is far too short to judge the merits of an investment strategy. It is much more informative to look at long-term results. Since we officially adopted a SMID mandate for the Fund on June 30, 2008, we've maintained an advantage over our benchmark (+8.78% annually versus +7.77% for the Russell 2500™, as of 2/29/2016), though we acknowledge our elevated levels of residual cash have been a sizeable headwind in recent years.

Why SMID?

The hallmark of Weitz Investments has always been to seek out attractive investment opportunities wherever we may find them. Historically, this meant portfolios with flexible mandates investing in companies of any size. Over time, however, we elected to provide our shareholders the ability to concentrate in our best larger or smaller company ideas–hence the decision several years ago to formally adopt for the Hickory Fund a SMID mandate (the Fund invests a majority of its assets in the stocks of smaller and medium-sized companies, which for us means less than $10 billion in market capitalization at the time of our initial purchase).

Smaller company investing carries several potential advantages: the ability to participate in the earlier (and, hopefully, faster) stages of a company's growth; targeted companies may be simpler, with generally fewer business lines (as compared to large, sprawling conglomerates); and we may find opportunities to invest in under-followed or under-appreciated companies before they're well understood by the market (and repriced accordingly). There are always trade-offs, of course, and with these potential benefits come additional potential risks. Smaller companies' stocks often don't enjoy large trading volumes,

The returns set forth above assume redemption at the end of each period and reinvestment of dividends. These performance numbers reflect the deduction of the Fund's annual operating expenses. Annual operating expenses for the Fund, as stated in its most recent Prospectus, and expressed as a percentage of each Fund's net assets, are 1.23%. 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. ***Past performance does not guarantee future results.*** *Weitz Hickory Fund (WEHIX) average annual total returns for the one, five, and ten-year periods ended December 31, 2015, were -7.62%, 7.85% and 5.58%. 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.*

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.

meaning we must be patient as we scale in and out of our positions. However, at the Fund's current size we are able to take meaningful positions in truly small-cap companies that can materially impact our results, and we believe this will continue to be the case even at significantly larger levels of assets under management.

Valuation and the "Margin of Safety*"

Be it a bear or bull market, our Firm's philosophy for investing remains unchanged. These tenets are well known to our shareholders: we think like long-term business owners and believe in building portfolios concentrated in our best ideas, purposefully constructing portfolios that look and behave differently than their benchmarks. At our core is the belief that investment risk is neither price volatility nor underperforming any particular index. Rather, we define risk as the possibility of permanent loss of capital. Or, as Warren Buffett has said more colorfully, "Rule #1: don't lose money. Rule #2: don't forget rule #1." It is for this reason we put company valuations at the heart of all we do. It also explains why, when compelling investment opportunities are scarce, our residual cash balance may rise. This is not market timing, nor are we targeting specific cash levels; it is a natural outcome of our discipline not to place your (and our) investment dollars at risk when valuation levels are not attractive.

We express valuations as the ratio of a company's current stock price compared to our internal estimation of its business value. This price-to-value (P/V) ratio then gives us a means to describe how "cheap" or "expensive" any particular stock price may be (a P/V of 100% equates to a stock trading equally to our business value, and we often consider a P/V of 70% as a potentially attractive "entry point"). We frequently refer to the difference between a company's stock price and our business value estimate as part of our "margin of safety." In addition to the quantitative measure of P/V ratios, other qualitative factors impact our notion of an investment's potential margin of safety, such as business quality, predictability, cyclicality and, perhaps most importantly, the quality of management.

The margin of safety concept was pioneered by Benjamin Graham, but no formal or uniformly agreed upon definition exists. And, of course, no definition can guarantee that an investment is 100% safe. But by insisting on finding investment opportunities where we believe margins of safety exist, we seek to "stack the deck in our favor" and minimize the impact of possible mistakes. ADT Corporation, a top portfolio holding for the Hickory Fund entering 2016 and strong contributor to 2016 results through 2/29/2016 provides a timely example.

ADT: Case Study

Much of our initial ADT thesis, as we outlined in our fourth quarter 2013 Analyst Corner, proved correct, most notably the company's continued success in attracting customers to its more advanced Pulse home automation services and a muted impact from new competitors in an already highly-competitive market. We did, however, underestimate the pace of investments required to grow the business in the near term, and consequently, our business value estimate had declined modestly since our initial investment. Even though the predictable, subscription-based nature of its cash flows had not changed and management was making the right decisions to improve the long-term health of its business, the stock languished for much of 2013 and declined precipitously in January 2014 in response to shareholders fatigue.

At these lower prices, ADT shares still traded at a meaningful discount to what we estimated a long-term business owner would be willing to pay for the whole business. Over the next two years, ADT's shares proved quite volatile as investors alternately cheered and jeered the company's progress, providing opportunities to add to our holdings under $30, and trim above $40. Then on February 15, 2016, we were greeted with the news that private equity firm Apollo Management Group (owner of ADT's much smaller competitor, Protection One) had agreed to acquire ADT for $42 per share (a 56% premium to the previous close), a slight discount to our latest business value estimate in the mid $40s and a gain over our average cost of roughly $37.

Despite initial expectations proving too high, by insisting on investing with a margin of safety, we were still able to achieve a positive outcome. Not every error of estimation has ended, or will end, as favorably, but we believe by sticking to our discipline we can minimize the impact of possible mistakes.

**By "margin of safety," we mean purchasing a stock at a price that is less than what we believe the company is worth, on a per-share basis. However, any investment—even one with a "margin of safety"—can lose money.*

Market Update and Outlook

We have written at length over the years about the various risks to investors' bullish sentiments: unintended consequences of Federal Reserve monetary policy decisions (if or when the Fed will raise interest rates and by how much); persistently low commodity prices pressuring producers and their service providers alike; and a stronger dollar, making US goods and services more expensive, while simultaneously shrinking the value of profits earned overseas. We are often asked, "What's priced into the market at these levels?" The (potentially uncomfortable) truth is that no one knows for sure.

Seeing stocks hit predefined prices to determine whether we are entering a bear (or bull) market is useful for headline writing but tells us very little about the actual valuations of the companies themselves. Obviously, prices have come down, likely more than the related declines in business values (in some cases, very meaningfully). As one would expect, the price-to-value ratios of our current holdings and universe of potential investments have become more attractive. For reference, our estimated portfolio weighted P/V at the time of this letter sits in the low 70% as compared to exceeding 90% barely more than a year ago. In particular, cyclical businesses and/or companies with any exposure whatsoever to the "oil patch" are starting to look cheaper, but they potentially carry with them a higher degree of uncertainty.

We have been selective buyers during this downturn as cash levels declined from 22% at year-end to the high-teens prior to the ADT acquisition announcement. Lower prices are a helpful but not the only criteria for us to put cash reserves to work. We remain disciplined with new investment dollars, seeking the right combination of qualitative and quantitative factors that together create an attractive margin of safety.

As of December 31, 2015, ADT represented 3.7% of the Hickory Fund's net assets.

The Russell 2500™ Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership.
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.

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.

***Drew Weitz,** research analyst and co-portfolio manager, joined Weitz Investment Management in 2008. He has been co-portfolio manager of Research Fund since January 2010 and co-portfolio manager of the Small/Mid-Cap Value Strategy (Hickory Fund) since December 30, 2011. Drew holds a BA in computer science from Carleton College in Northfield, MN. While earning his degree, he spent his summers at Weitz working in various capacities. From 2004-2008 he was a research associate and research analyst with Ariel Investments, a Chicago-based investment firm.*