Weitz | INVESTMENT MANAGEMENT

Value Matters

October 2, 2017

Dear Fellow Investor,

Our stock funds registered another positive quarter and at September 30 show good nine-month absolute returns. Our bond funds are showing solid returns in a decidedly poor environment for fixed income investors. The full story of fund results is told in the performance table on our website (weitzinvestments.com).

In this extended period of artificially suppressed interest rates and richly valued stocks and bonds, relative returns have been harder to come by. Year-to-date, our returns have trailed the S&P 500 and the Russell 2500. This is frustrating for both clients and our investment team. Our interpretation of this recent "relative performance problem" is that our focus on business valuation and price-sensitive investment discipline has led us to be underinvested in both stocks in general and the most index-moving "momentum" stocks in particular.

After 34 years of managing our funds this way, we have a fair amount of historical evidence that good, long-term compounding has survived several periods of being "out of step" with the market (see the year by year comparisons of each fund's results with its benchmark on our website located on the performance tab for each fund). Warren Buffett has said that he prefers a lumpy 15% to a smooth 12%, and we agree. While we have not sought out the "lumps," they come inevitably as we tend to buy early when we see bargains and sell before tops when prices seem high relative to business value.

It is human nature to focus on relatively short-term investment results. Investors and their advisors are reinforced by near-term "wins" and unsettled by losses, even relative ones. Enthusiasm for stocks that are "working" tends to grow even as those stocks become less cheap. The growing popularity of indexing reinforces the momentum of the market leaders as new money is concentrated in those same stocks. (By the way, indexing does not protect investors from losses when the market goes down.)

There is a staggering amount of energy expended trying to predict short-term market moves and identify likely beneficiaries of changes in Fed policy, government tax and spending policies, and geopolitical events. We believe this short-termism is counterproductive. At times like this, when we find ourselves underweight the favorite stocks of the day, we continue to focus on studying new companies and adding stocks to our "on-deck" list for future investment when the prices are right.

Our Game Plan

As the stock market drifts higher, driven by a narrowing group of popular companies, and we patiently search for reasonably priced new investment ideas, two major questions dominate our deliberations over individual companies' business values.

(1) If low inflation and interest rates are not permanent, when and how fast will they rise?

(2) As companies employing disruptive technologies and business models create havoc with traditional businesses, how should we value both the insurgents and the victims?

We have no definitive answers, but we think shareholders may be curious as to how we are approaching these questions.

Current and prospective ***interest rates*** have a huge impact on asset values. If an investor sees a reasonable probability of earning an 8-10% return from stocks, she will not be tempted by a "sure" 2% return from a bond. But if interest rates rise, and safe bonds yield 6-8%, bonds become much tougher competition for stocks. All things being equal, as interest rates rise, people require higher expected returns from stocks. In other words, when rates rise, investors will pay a lower price (P) for a dollar of a company's earnings (E)—a lower price/earnings ratio (P/E)—than when rates are lower. Over time, even if earnings per share grow: if the P/E shrinks, the return on one's stock investment may be disappointing (or even negative).

Over the past several years, inflation, which is a major driver of interest rate levels, has been surprisingly subdued. Economists differ on the causes of inflation. (Please forgive the following monetary theory jargon.) The Fed's quantitative easing program expanded the money supply (inflationary), but the "velocity" of money has slowed dramatically in recent years (disinflationary). The Internet has probably had a significant disinflationary impact as available information for comparison shopping for all types of goods and services has decreased the pricing power of companies in most industries. Changing consumer tastes and attitudes, especially among Millennials and Gen X consumers, contribute to the uncertainty surrounding future rates of inflation. The Fed has been concerned that inflation is too low, hence the extension of its low interest rate policy for years after the end of the recession. The older of us is a product of the inflationary 1970s, and finds it odd to see a Fed promoting ***higher*** inflation.

While higher inflation and interest rates generally have a negative impact on stock valuations (P/Es), they may be either positive or negative (or both!) for a company's profits. One company's higher cost of debt may represent a boost to its lender's net interest margin. A company with control of its costs and with pricing power for its products can take advantage of rising prices, while a company with a different cost structure may see its profits squeezed (or eliminated) by inflation. While we cannot predict the timing or pace of a rise in the inflation rate, we all want to be confident that the companies we own can not only survive, but perhaps take advantage of higher rates of inflation and interest costs in the future.

On the second question, to what extent can we expect reversion to the mean (of growth rates, market shares, profit margins), and in what ways is this time different? The "Amazon effect" has been devastating to the traditional retailing industry. Google and Facebook have completely changed the advertising business. Streaming video services like Netflix are shaking up the pay-TV landscape, and even Disney's ESPN is facing pricing pressure. Some are inclined to extrapolate these changes as if each is a winner-take-all competitive battle. Others assume that "these threats, too, shall pass."

There is an old joke in the investment business that in the life cycle of a great new business, as growth slows and overly optimistic projections fail to materialize, growth investors sell to GARP (growth at a reasonable price) buyers, who sell to value investors, with the shares ultimately ending up in the hands of the deep value crowd. At each stage, the new buyers are making the assessment that the disappointment is temporary or that the stock price has declined enough to create a bargain. The trick is to be able to distinguish between the seriously troubled "falling knife" and the temporarily misunderstood undervalued security.

Every situation is different, and we are all still learning about the evolution of "disrupted" industries. Cars disrupted buggy whips, and cell phones disrupted the wireline telephone industry, but the pace of change has accelerated. Walmart is responding to the Amazon threat by building its own e-commerce business and enhancing it with the acquisition of small Amazon competitor Jet.com. Best Buy was hurt badly by online competition a few years ago. In response, it has lowered corporate expenses and has begun matching prices of online competitors. As a result, profits have stabilized, but the long-term prognosis is uncertain. Others like Toys-R-Us, have succumbed to Chapter 11 bankruptcy and will restructure and try again. We have very little exposure to retail stores, but the competitive price pressures find their way back upstream to producers of all types of products.

Video programming has been an interest of ours for a long time. Some traditional cable subscribers who have bought a "bundle" of channels along with broadband and telephone services are now beginning to demand "unbundled" offerings. Providers of video content are facing significant competition from video products that can be delivered over broadband connections. We have modest positions in Discovery and Twenty-First Century Fox, which are being impacted by "cord cutting," but our primary media holdings are cable distributors who sell the all-important broadband connection. We own Liberty Global, Charter (via Liberty Broadband and Liberty Ventures) and Comcast in our various funds, and we feel very good about their prospects for coping with their industry's evolution.

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One might think that the obvious solution to disruption would be to own the disrup***ters***. The performance of the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) would indicate that many investors have taken this tact. We have owned Google for several years and have a position in Amazon in the Value Fund, but our basic problem with this solution is the valuations of the current "winners." We are very willing to pay more for predictable growth in profits, as we have with Visa, Mastercard, Thermo-Fisher and others. However, we need to have reasonable confidence in our projections of future cash flows ***and*** a price that gives us a "margin of safety" that will protect us from unexpected events.

One other subject that we monitor, but do not obsess over, is the overall "macro" environment. This includes both economic and geopolitical factors. The good news is that U.S. and global business conditions seem generally positive. Modest growth and few obvious areas of excess mean that our companies should be able to continue growing their business values—the best antidote to high valuations.

On the geopolitical front, though, we have a sense of cognitive dissonance—fires, floods, hurricanes, famines, shooting wars, threatened nuclear war with N. Korea, secession movements, and less than reassuring political leadership—yet we also have record high stock prices and record low market volatility. In the long run, we expect our country to be fine, and good companies will adapt and find ways to prosper. In the shorter run, though, we wouldn't be surprised if some of these headlines created some downticks in the stock market. In that event, we have cash reserves (15-25%, depending on the fund) and a long "on-deck" list of stocks we know well enough to buy on short notice should they become available at an attractive price.

The Quarterly Commentaries, found on our website (weitzinvestments.com), provide more detail on each fund's portfolio winners and losers as well as positioning going forward. Also, after October 31, we will post information about estimated year-end dividend and capital gains distributions on our website. As always, we thank shareholders for their ongoing support and encourage you to call our client service colleagues if you have any questions.

Sincerely,

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Performance data represents past performance, which does not guarantee future results. *The investment return and the principal value of an investment in the Funds will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. 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 weitzinvestments.com.*

As of September 30, 2017, each of the following portfolio companies constituted a portion of the net assets of Value Fund, Partners Value Fund, Partners III Opportunity Fund, Hickory Fund, and Balanced Fund as follows: Alphabet, Inc. (Parent of Google)-Class C: 4.5%, 3.5%, 3.7%, 0%, and 1.8%. Amazon.com, Inc.: 1.4%, 0%, 0%, 0%, and 0%. Comcast Corp.-Class A: 2.6%, 0%, 0%, 0%, and 1.7%. Discovery Communications, Inc-Class A: 0%, 0%, 1.5%, 0%, and 0%. Discovery Communications, Inc-Class C: 0%, 2.0%, 0%, 0%, and 0%. Liberty Broadband Corp.-Series A & C: 0%, 9.6%, 10.6%, 9.0%, and 0%. Liberty Broadband Corp.-Series C only: 7.6%, 0%, 0%, 0%, and 2.0%. Liberty Global Group-Class C: 5.0%, 7.1%, 7.9%, 2.9%, and 1.5%. Liberty Ventures Group-Series A: 0%, 0%, 4.9%, 3.9%, and 0%. Mastercard Inc.-Class A: 4.2%, 2.6%, 6.0%, 0%, and 2.3%. Thermo Fisher Scientific Inc: 2.7%, 0%, 0%, 0%, and 1.9%. Twenty-First Century Fox, Inc: 3.3%, 3.0%, 0%, 0%, and 0%. Visa Inc.-Class A: 2.8%, 4.4%, 3.4%, 0%, and 3.3%. Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

Included is a reference to the term margin of safety. This term refers to purchasing securities at a price that is less than our estimate of intrinsic value. A potential margin of safety may limit downside risk and optimize the potential for growth.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. The Funds' Prospectus contains this and other information about the Funds and should be read carefully before investing. The Prospectus is available from Weitz Investment Management, Inc. Weitz Securities, Inc. is the distributor of the Weitz Funds.