Weitz | INVESTMENT MANAGEMENT

Value Matters

January 2, 2018

Dear Fellow Investor,

2017 was another year of positive returns, and the miracle of compounding continues. We are proud of the long-term performance that we've achieved over the nearly 35 years since we started our Firm. Returns for all of our Funds over various intervals can be found on the performance **table** on our website.

On the other hand, investment returns do not arrive smoothly or on a predictable schedule. We are very accustomed to being "out of step" with the stock market for stretches of time. We are often early both in buying cheap stocks and selling expensive ones. However, we underestimated the persistency of artificially low interest rates as well as investor complacency in the face of high valuations and both economic and geopolitical risks. As a result, our overly cautious portfolio positioning has had a negative impact on our relative returns.

The reason we invest the way we do is that we think it gives us the highest probability of success over long investment periods. We are investing client capital with an eye to funding long-term goals such as college education and improving the quality of life in retirement. We are not focused on short-term performance contests (though we are ***not*** opposed to outsized annual gains from time to time).

Looking ahead to 2018, we would not presume to predict what the stock market will do, but we feel very good about the stocks we own. Several of our favorites, especially a handful of cable TV and broadband providers, reported earnings and business value growth that was not fully reflected in their stock prices. These may well be able to provide above-average returns regardless of general market action. Others that performed well in 2017 and are arguably less cheap, such as Visa, MasterCard, Berkshire Hathaway, Google and Texas Instruments, are expected to continue to grow business value at a rate that should auger well for future returns.

We feel good about our investment process and our ability to implement it because we think it is based on timeless principles. We believe that assets with logically measurable values become mispriced—both on the high and low sides—because investors' emotions lead them to, on occasion, buy high and sell low. Our job, as Warren Buffett has said, is to "buy when others are fearful and to sell when they are being greedy." A portion of our recent interview published by *The Motley Fool* is reproduced on the following pages. Hopefully, it will provide a good reminder of how we approach our version of value investing.

Detailed information on each of our Funds is available on our website and we encourage shareholders to read our Quarterly Commentary. If you have any questions about our Funds or investment process, our (live human) client service colleagues are available to answer or forward them along to our analysts and portfolio managers.

Thank you again for trusting us to manage your investments.

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 December 31, 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: 4.9%, 4.0%, 4.3%, 0%, and 1.5%. Berkshire Hathaway Inc.-Class B: 8.8%, 9.1%, 12.0%, 0%, and 3.2%. Mastercard Inc.-Class A: 4.0%, 2.9%, 6.9%, 0%, and 1.6%. Texas Instruments, Inc.: 0%, 3.0%, 4.3%, 0%, and 1.4%. Visa Inc.-Class A: 3.1%, 4.9%, 3.9%, 0%, and 2.8%. 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.

Collaboration and Profit at Weitz Investment Management

Founder Wally Weitz talks about how he finds and evaluates potential investments.

By John Rotonti · The Motley Fool · November 2017

John Rotonti: How do you define a high-quality business?

Wally Weitz: One well-known investor used to define a great business as one whose product cost a penny, sold for a dollar, and was addicting. That joke lost its appeal when people began to add, "but it kills its customers." We would probably all like to own businesses that (1) have significant competitive advantages (Buffett's "moat,") (2) generate excess cash, (3) have high return reinvestment opportunities in the business, and (4) management with integrity and strong capital allocation skills who treat shareholders like partners in the business and who focus on long-term growth in the ***per share*** value of the business.

JR: Do you use an investing checklist? If so, would you mind sharing a few of those checks?

WW: We don't have a formal list. If we did, the attributes of a "high-quality business" listed in No. 1 would be on it. There would also be some "viability" and "staying power" items. We are fine with the "prudent" use of leverage, but we insist that a company's balance sheet be strong enough to withstand almost any conceivable type of adversity. "The parachute almost always opens" is ***not*** good enough—we don't go sky-diving.

JR: Please explain how you narrow down your investable universe and how large that universe is.

WW: We do not do much formal screening, but each of our ten analysts and portfolio managers collects potential ideas from reading, interacting with other companies, talking to others in the investment business (both buy side and sell side), etc. Potential ideas are researched and discussed. Those that survive scrutiny may be bought or placed on the "on-deck" list for future investment when the price is right.

JR: Are there any industries you tend to prefer? Or avoid?

WW: We have great ***theoretical*** flexibility in what we may invest in. However, we need to be able to understand how the business works, to be able to make a reasonable estimate of what it will look like in 5-10 years and how much cash it will generate over that period. The need for predictability tends to lessen our interest in commodity related or highly competitive and rapidly changing businesses. We tend to favor "capital-light" and subscription businesses like cable TV. We like net cash generators and companies with modest leverage.

JR: You recently wrote that the pricing power of companies in most industries has decreased because of the shopper's ability to quickly compare prices using the Internet. Which types of companies do you believe still have strong pricing power?

WW: Strong pricing power is hard to come by. Unique products and niches protected by licenses, franchise agreements, patents, etc. still exist. Businesses that require huge, upfront capital investments can have an advantage, but in a period of very cheap and abundant capital, few companies are safe. "Network effects" can lead to "winner take all" market dominance, but again, very few advantages are permanent.

JR: How do you think about valuation? Do you use discounted cash flow analysis? Do you set sell targets? Do you have a preferred valuation ratio such as price-to-earnings (P/E), price-to-book (P/B), free cash flow (FCF) yield?

WW: We believe in the ***theory*** that (1) the value of a business is the present value of its future cash flows and that (2) business value is likely to ***eventually*** be reflected in its stock price. However, as Yogi said, "In theory there is no difference between theory and practice. In practice, there is."

Popular valuation ratios mean very little without lots of context. Discounted cash flow analysis is also a very blunt instrument which can create the illusion of scientific precision. There's an old joke that DCF discount rates are like the Hubble Telescope...move it a couple of degrees and you're in a different solar system."

We ***do*** make DCF models on all the companies we get serious about, though. While the single point "value" that comes out of the model doesn't dictate our buying decision, building the model forces the analyst to understand how the business works and the model itself facilitates discussion/debate among our investment team about the attractiveness and value of the business.

One note on "FCF": Practitioners differ on the definition of "free cash flow." We talk about "discretionary" cash flow. That is, cash earnings after ***maintenance*** capex but before ***growth*** investments. For example, regular refurbishment of hotel rooms is required—maintenance capex. Adding a new wing of rooms is discretionary—growth capex. (The difference may not always be clear from financial statements but the distinction is important.)

As for "sell targets," we sell if our estimate or calculations change, if a stock becomes fully/over-valued, or if we have a more attractive alternative use of the capital.

JR: Do you use the same discount rate for every business you are researching or do you adjust your required rate of return based on risk and/or other factors?

WW: We use the same discount rate, currently 9%, for each of our models. However, we use varying "business quality" scores for different companies and this impacts the warranted "terminal multiple" in the model. Also, our confidence in the accuracy of the estimates of future cash flows will vary from company to company, and the portfolio manager will vary their required (price) discount from "value" accordingly. We believe that others who use varying discount rates are adjusting for these same factors, but at a different stage of the analysis.

JR: Will you pay a fair price for a great business? If not, what is the minimum margin of safety you require?

WW: Warren Buffett credits Charlie Munger with convincing him of the wisdom of "paying a fair price for a great business." The differences between a "great" business and a more ordinary one ***should*** be incorporated in the valuation process so if value (V) is measured correctly, we shouldn't have to compromise on the discount from full value that we seek (generally at least a 30% discount).

However, when all stocks seem expensive and nothing seems cheap in ***absolute*** terms, the concept of ***relative*** value creeps in. We are willing to hold more in cash reserves than most managers (sometimes as much as 20-25%), but in today's market, we find ourselves holding onto stocks with price-to-value (P/V) ratios well above our 70% threshold for buying. We have even been known to pay over 70% to initiate or add to a position. There is nothing magic about any of these numbers, but we know that the odds of earning high returns are better when we buy at a cheaper price (the margin of safety).

JR: How long does your team typically research a business that you are not familiar with before you have enough information and conviction to decide if you want to put it into the portfolio?

WW: The amount of overall effort would depend on how complicated and unfamiliar the business is, how many of us participate in the background work and visits, what was required to get a good read of the management, etc. The full research process might take weeks or months, but for a potentially compelling, time sensitive idea, we may be able to get to a decision point much quicker.

JR: How important is it to invest in companies that can grow profitably in this low-growth world?

WW: Growth is an important factor in calculating business value. What matters to us, though, is stock price relative to business value, not a growth rate, ***per se***. Predictable growth has been rare in recent years, and we believe that many investors have been over-paying because of its scarcity value. This opinion has impacted our relative performance in recent years, but we believe that over-paying for even a great business is speculating.

JR: How do you evaluate a company's balance sheet? Do you look for a particular coverage or debt ratio?

WW: We want to be confident that our companies have the financial strength to withstand, and take advantage of, any potential economic adversity. Past liquidity crises, especially 2008-09, have reinforced the necessity to be imaginative about what can go wrong. No "rules of thumb" are adequate substitutes for stress testing and having a "belt and suspenders" mind set.

JR: When should a company pay a dividend or repurchase stock?

WW: We want companies' capital allocation decisions to be focused on long-term growth in business value ***per share***. Our first choice is reinvestment in the business if the company has high return opportunities to do so. Stock buybacks are great if the stock sells well below its intrinsic business value and terrible if the stock price is above intrinsic value. Historically, many managements have bought enthusiastically at high prices and failed to buy much at cheap prices. However, despite a history of poor execution, buybacks can be very effective in increasing the value per share for remaining shareholders. Dividends can be an attraction for many shareholders, but in this low interest rate environment, it appears that "chasing yield" has resulted in unwarranted stock price inflation in many cases.

JR: Do you have any performance metrics that you prefer management compensation be based on?

WW: Top management should focus on growing intrinsic business value ***per share*** over a very long period of time. Other managers should have goals that are consistent with this, but tied primarily to results that they personally can affect. Getting the incentives right takes common sense and creativity and "off the shelf" metrics may not be appropriate.

JR: Do you meet with management of the companies you are invested in?

WW: Yes. Ideally, several of us will spend extended periods of time on multiple occasions with key decision makers. This type of access is not always available, but meetings at conferences, investor days and other settings can be acceptable substitutes. We want to have a sense of the personalities and character of management, as well as a reading on their competence, breadth of knowledge, sense of urgency, and their attitude toward shareholders. These are intangibles and it takes experience to distinguish reality from charisma.

JR: What is one question you think investors should ask of each management team when performing due diligence on a business?

WW: One of my favorite questions is, "If this were a private business and you and I were the only owners, how would you change the way you run the business?" The answers can be very good triggers for follow up questions.

JR: What step(s) should investors take to try avoid value traps?

WW: Sometimes it is very difficult to recognize when a business's long-term prospects (and thus business value) have changed permanently. If this is the case, an investor expecting "reversion to the mean" may find herself owning a "value trap." Distinguishing temporary from permanent changes can be very difficult and requires correct interpretation of intangible factors. Statistical "cheapness" is not enough.

JR: When do you sell? Will you hold a high-quality company that is fairly valued?

WW: We do not use an automatic "stop loss" policy. When a stock goes down, we reassess as objectively as possible and may hold or buy more if we believe we are right about valuation or we will sell if we find we have made a mistake or facts have changed. We will generally sell a stock when it approaches full value, but if investment alternatives are poor and we believe the long-term outlook is positive, we may hold it despite it being fairly valued. (In taxable accounts, we will think in terms of investment alternatives for after tax proceeds of a sale.)

JR: How do you think about position sizing and portfolio diversification?

WW: We believe in concentrating a portfolio in our best ideas. For us, that means diversifying among types of businesses and trying to be aware of second order correlations of risks. We generally consider 5% to be a "full" position, but on rare occasions, we may allow a position to grow to twice that size. When assessing risk, we focus on the possibility of ***permanent*** loss of capital, not temporary price volatility.

To read the full interview please visit www.weitzinvestments.com/about/content/MotleyFool_QA_112017.fs.