Value Matters

April 9, 2018

Dear Fellow Investor,

In the first quarter of 2018, we saw the first serious market volatility in two years. There were days on which the Dow dropped over 1,000 points, and there were more triple-digit moves (in both directions) than in any other quarter since the depths of the financial crisis in 2008. One day in early February, an ETN (exchange traded note) built specifically to profit from an ***absence*** of volatility, imploded. It fell over 80% and was liquidated by its sponsor.

The stock market, as measured by the Dow, S&P 500 and Russell indices, suffered its first quarterly loss in about three years. The conservative positioning of our portfolios served us well. The performance **table** on our website (weitzinvestments.com) shows returns over various periods during our 35-year history. As usual, we suggest investors focus on the longer-term results, as they are better reflections of our clients' long-term returns.

Our investment approach is built on taking advantage of mispriced stocks and bonds. We buy the cheap and sell the expensive, so we are happy to see a rise in volatility and some divergence of performance among market sectors and individual stocks. The long, steady rise in stock prices from "expensive" to "more expensive" has made it difficult for us to ply our trade.

We think something is changing. Investors had been lulled into a bullish complacency by the Fed's apparent determination to pump up stock and bond prices and to do whatever necessary to avoid investment "unpleasantness." Now, various threats to the bull market (none of which are brand new) are attracting investor attention. We believe that in the long run, the most important determinant of stock price is the value of the underlying business, but some other factors deserve a mention.

What's Causing the Volatility?

Tech Stocks. Some of the largest tech companies (members of the FAANG fraternity—Facebook, Amazon, Apple, Netflix and Google) have come under particularly strong pressure. The Cambridge Analytics misuse of Facebook data brought Facebook's basic business model under scrutiny. Presidential tweets accusing Amazon of hurting small retailers, not paying enough taxes and taking advantage of the U.S. Postal Service caused some wild fluctuations in its stock. Google also dropped almost 15% in the first week in February as questions arose about threats to its advertising business. Facebook, Amazon and Google are great businesses. We own, or have owned, all three in some of our portfolios, but they are not automatic winners regardless of price level—valuation matters, even with FAANGs.

Index Funds and ETFs. Most important index funds and ETFs are capitalization weighted. That is, the assets within the fund are allocated among the component stocks in proportion to the companies' overall stock market values. Subsequent flows of capital into and out of the fund maintain these proportions. Thus, the stock price movements of the very largest companies (which includes four of the FAANGs) have a disproportionate impact on the volatility of the fund or ETF. And, as money flows into these passive instruments, new units are created by buying each of the component stocks. Large inflows mean large, non-price-sensitive buy orders which can exacerbate volatility of the underlying stocks. The reverse is true when investors sell the funds and the component stocks must be sold on short notice. The short-term fluctuations caused by these trades do not affect the underlying business value of the component companies. This is merely noise in the markets, but the noise can get loud at times and investors can find it unsettling.

Interest Rates and Inflation. Interest rates have been unusually low both because of Fed policy and because inflation has been low by historical standards for several years. Now the Fed is raising short-term rates and letting its bond portfolio self-liquidate as bonds mature. The withdrawal of the Fed's capital from the bond market puts upward pressure on interest rates. Inflation is beginning to tick up because of economic growth and very low unemployment, and this also pushes interest rates higher.

Rising interest rates act as a headwind for stock and bond prices. The impact is direct for bonds. A 10-year, 2% bond issued at a price of $100.00 falls to $83.65 if comparable bonds soon become available with 4% coupons. With stocks, aside from higher borrowing costs, the impact is less direct. Higher bond yields present stiffer competition for investors' capital. In a higher-yield environment, stock investors require a higher prospective return from future cash flows, thus a lower starting stock price. As a result, higher interest rates generally lead to lower P/E ratios.

Political climate. The polarization of Congress and the determination of the president to bring change to Washington have injected a large dose of uncertainty into the stock and bond markets. Concerns around the current political climate and 'what might be' is not helpful for business planning. However, America has withstood an amazing variety of leadership, and we are confident this trend will continue.

War with North Korea and other apocalyptic events are not impossible, but they seem so unlikely that we do not dwell on them in picking stocks and planning investment strategy. Plausible threats and scary headlines will probably move markets from time to time, but we need to emotionally pace ourselves.

Promised **regulatory relief** has been welcomed by the business community. Budget hawks have also cheered the "streamlining" of various government departments and agencies. We suspect that the actual rule changes and compliance cost savings will be less than anticipated, but from many individual companies' points of view, there are positives. The potential collateral damage from these changes to citizens, the environment and our image in the world are a different matter, and something we will need to watch closely as investors.

Trade issues are potentially very troublesome. We believe free trade is generally good for business. Tariffs and other impediments to free trade have not worked well in the past and seem particularly unwise given today's complex global supply chains. The outcomes of "Art of the Deal"-style bluster and backtrack negotiating tactics are hard to predict but seem certain to complicate life for many businesses, farmers, workers, consumers and investors.

The changes to the **tax code** are significant. While it arguably benefited a different segment of the tax paying population than advertised, it has had a major positive impact on much of corporate America. Ironically, Berkshire Hathaway, whose chairman disagreed with the structure of the cut, was probably the biggest single beneficiary, with roughly $29 ***billion*** in one-time tax savings in 2017 plus ongoing savings due to the lowered corporate tax rate. Berkshire is the largest single investment holding among our portfolios, and an increase in book value of about $18,000 per A share is appreciated.

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The potential downside of the tax cut is that, in combination with a less-than-conservative spending bill, the impact on the growing budget deficit may well turn out to be inflationary. The president and Congress are apparently already discussing adjustments to both the tax and spending bills, so we must be alert to potential changes.

Finally, fears of impending **recession** arise from time to time. The recovery from the Great Recession of 2007-09 is in its ninth year. This is one of the longest periods that the U.S. economy has gone without a recession, and its longevity worries some. Most economists seem to agree that both the U.S. and global economies are growing nicely, and we have no argument with that point of view. Our companies are generally growing their earnings and business values, but we always watch carefully for signs of deterioration in industry and company results. We believe that our companies have strong enough balance sheets and competitive positions to withstand a recession (and possibly take advantage of it). Nevertheless, when a recession eventually arrives, investors tend to overreact, and we do not want to be caught unaware.

Our Game Plan

The near-term outlook for the "market" is ***not*** the same as the outlook for our next 3-5 years of returns. Historically, after a long bull market, we generally see a period of sideways market "consolidation." Over the past nine years, company earnings (E) have grown, ***and*** the valuation placed on those earnings (P/E) has also grown. It would be perfectly normal to see a period of years in which earnings continued to grow but P/E ratios shrink. The result would be a market that generally moves sideways but with plenty of short-term volatility.

Our investment approach is to take aggressive positions when investors are fearful, and stocks are very cheap; to hold them as markets recover; and to harvest the gains when an overvalued market makes stocks relatively unattractive. We have not enjoyed the protracted period of over-valuation of recent years, but we believe we are entering a period when investors face enough uncertainty that they will present us with lots of opportunities. This is not an environment in which we expect oversized absolute gains, but we are hopeful that it is one in which we can protect capital in the near term and set up the portfolios for ***very*** good returns over the next 3-5 years.

Thanks for your patience while we have "waited for our pitch."

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 March 31, 2018, 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: 5.0%, 4.1%, 4.3%, 0%, and 1.4%. Amazon.com, Inc.: 2.1%, 0%, 0%, 0%, and 0%. Berkshire Hathaway Inc.-Class B: 9.1%, 9.5%, 12.2%, 0%, and 3.0%. Facebook, Inc.-Class A: 2.0%, 0%, 0%, 0%, and 0%. Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

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.