Weitz | INVESTMENT MANAGEMENT

Value Matters

July 4, 2018

Dear Fellow Investor,

The stock market wobbled in the first quarter, and we gave a little cheer. Not because we want stocks to go down—absolute returns are more important than the relative variety—but because we were encouraged that investors were beginning to notice the headwinds that have been threatening to sidetrack the upward trajectory of the U.S. stock market.

We believe that the Fed's quantitative easing program "over-achieved" in its mission to restore confidence after the mortgage crisis of 2008-09. Essentially "free" credit stimulated takeover activity, encouraged massive stock buybacks and generally gave investors the courage to bid prices of both stocks and bonds up to very high valuation levels.

We didn't embrace this new reality to simply buy what is working, and that has had an opportunity cost. By sticking with our philosophy of thinking like a business owner and insisting on a margin of safety in buying stocks, we've generally trailed our benchmarks over the last few years. We have been here before–many times–but never for a period this long.

Now, some of the potential negatives for investors are becoming clearer. A strong economy, a tight labor market and the first round of Trump administration tariffs have begun to raise the cost of doing business for American companies, raising the specter of inflation. The fact that we are threatening our closest allies, as well as China, with tariffs and trade barriers adds an odd political twist. In any event, this is not helpful in a world of global trade and interconnected supply chains.

The Fed has begun to raise short-term interest rates and reverse its quantitative easing policy. This means that money is being removed from, rather than added to, the securities markets. The need to sell over $1 ***trillion*** of new government bonds each year to finance the budget deficits created by the recent tax cuts puts upward pressure on interest rates.

Political and financial turmoil in the EU and elsewhere have pushed up the value of the dollar relative to other currencies. This causes problems for emerging market countries whose dollar denominated debt becomes more expensive to repay. It also depresses the reported earnings of U.S. companies whose foreign profits are earned in local currencies which, in turn, translate into fewer dollars.

These are ***headwinds***, not economy killers. We do not see the ghost of Smoot-Hawley tariffs throwing the world into a repeat of the 1930s. And higher short-term interest rates and a flattening yield curve don't necessarily foreshadow a recession. Companies with strong balance sheets and wide competitive moats should be able to cope. Some may even be able to take advantage. Nevertheless, given relatively high valuation levels, we should expect some stock market choppiness.

We would welcome a new, more balanced view of the risks and opportunities facing equity investors. Our 35-year track record has been built on ***periodically*** investing aggressively in very cheap stocks when investors are fearful and selling, or avoiding, stocks, and then harvesting profits when the outlook is more cheerful. We have not had the opportunity to use this playbook for some time.

Our Game Plan

In the second quarter, technology and other "reliable growth" stories continued to appeal to investors. They led the market higher, and because some are very large, they had a disproportionate impact on the capitalization-weighted indices. According to economic consultants, GaveKal Capital (and under the heading of "fun with statistics"), during the first six months of 2018, Amazon, Microsoft and Apple accounted for 71% of the gain in the S&P 500. Those three, along with Mastercard and four other tech stocks, accounted for 105% of the index's gain. The other 492 stocks were, collectively, down year to date.

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Among the weaker performers in the quarter were industrial, housing-related, financial, airline and auto companies that were subject to real, or perceived, threats to their prosperity. Given this divergence among groups of stocks, we were able to find some attractive new investment ideas. Some of these we have followed for a long time (and may have owned before), such as CarMax and Mohawk Industries. Others, like Fortune Brands and Perspecta (a spinoff from DXC Technologies) are new holdings for us. This quarter's Portfolio Managers' Discussions will elaborate on some of our new buys.

On another note, there are some more "mature" holdings that have been drags on our results recently, but for which we have high expectations. They will be familiar names to longtime clients and we consider them good investments which happen to be (currently) out of favor.

Allergan is the product of multiple healthcare company mergers and still bears the scars of a protracted takeover battle. Its CEO made a very timely sale of its fading generic drug business and has been very active in positioning the company for future growth. In the meantime, investors are skeptical, and the stock sells at about 10 times earnings. Activist investors, who are often too short-term oriented for our taste, are clamoring for change. Whether the company is allowed to grow to its full potential or is pushed into a shorter-term resolution, we expect to profit from Allergan.

Liberty Global is the European cable company created by John Malone. It has been a strong contributor to our results over the past decade, as evidenced by our very low cost basis, but it has been a drag on performance the past couple of years. Liberty has been very adept at portfolio management—buying cable systems at attractive prices, then building and selling them to eager buyers. They have also been aggressive buyers of their own stock when its price is depressed. Growth has slowed recently due to competitive pressures and some construction missteps, but we believe that impatient investors are underestimating its value. The stock was priced at $26.61 at quarter end, and we estimate the business value at over $40 per share.

Finally, ***Charter Communications*** and two companies (***Liberty Broadband*** and ***GCI Liberty***) whose fates are tied directly to Charter represent important holdings in our stock funds. We believe that each is undervalued and that they will be strong contributors to future results. Drew Weitz is the analyst who follows these companies, and he has written a detailed description of each in this quarter's upcoming Analyst Corner.

Outlook–Optimism Tempered by Common Sense

We believe that financial analysis and logic drive ***long-term*** investment results, but in the near term, human nature carries the day. As long as the Fed "promised" low interest rates and plentiful credit, it was natural there would be a stock market wave. Add a new administration in Washington offering tax cuts, trillion dollar infrastructure spending and the elimination of "anti-business" regulation, and the positive investor reaction is understandable.

As we said above, we are optimistic about our companies' business prospects. We also think that the country and the economy will survive the political and economic policy choices of the current administration. But, it does seem likely that a more mixed set of headlines will temper investor enthusiasm over the next year or two. If that leads to further market volatility that produces investment bargains, we will welcome it.

Thanks again to our patient shareholders.

Sincerely,

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