Weitz | FUNDS

Short Duration Income Fund

4Q 2017 Quarterly Commentary

Investment Style: Short-Term Bond
Portfolio Managers: Tom Carney, CFA & Nolan Anderson

The Short Duration Income Fund's Institutional Class returned +1.54% for the 12 months ended December 31 compared to a +0.86% return for the Bloomberg Barclays 1-3 Year U.S. Aggregate Index (Bloomberg Barclays 1-3 US Agg), our Fund's primary benchmark. For the fourth calendar quarter the Short Duration Income Fund's Institutional Class returned -0.1% compared to a -0.2% return for the Fund's primary index. The Fund's performance **table** on our website shows returns for the Fund, its primary index and the CPI + 1% for comparison purposes.

Market Commentary

U.S. financial markets were strong throughout 2017 as equities rose in each month of the year. Volatility was low, as evidenced by the S&P 500's record run during which the broad market benchmark has not experienced a decline of at least 3% in over a year. Neither a parade of hurricanes nor earthquakes in Mexico nor the threat of nuclear war in the Korean Peninsula nor equity valuations seen as too rich nor anxieties about the White House have disrupted this bull market rally that has now entered its ninth year.

The storyline in the bond markets of low volatility and "risk on" was much the same. Despite rising short-term interest rates, the big bond market winners were those who took on the most interest rate and/or credit risk. Thirty-year Treasuries returned over 9 percent on the year while the lowest grade corporate bonds (rated Caa/CCC) returned in excess of 10 percent.

The table below highlights the progression for select U.S. Treasury yields during the last quarter and past 12 months.

U.S. Treasury Yields (%)

	2-year	3-year	5-year	10-year
12/31/2017	1.89	1.97	2.21	2.41
9/30/2017	1.49	1.62	1.94	2.33
12/31/2016	1.19	1.45	1.93	2.45

Source: Bloomberg

Treasury yields rose (prices fell) during the quarter, while a "flattening" yield curve was a key development impacting fixed income returns over the past 12 months. The slope of the Treasury yield curve, the difference between short- and long-term interest rates, flattened meaningfully as the year progressed. For example, the spread difference between the 2-year and 10-year Treasury yield decreased from 126 basis points at the beginning of the year to 52 basis points at year end. The Treasury curve has not been this flat since before the credit crisis of 2007-08. A flattening yield curve can result from investor concerns that the Fed's tightening campaign may lead to a "policy mistake" (leading to slow economic growth, or even to a recession) and/or investor expectations that inflation will stay low or even decline.

In December, the Fed increased short-term interest rates for the third time in 2017 and for the fifth time since the end of the Great Recession in 2009–and suggested that short-term rates may be raised further in 2018.

Corporate bonds and other credit-sensitive securities outperformed their Treasury counterparts of comparable maturity as spreads (the incremental return investors demand above U.S. Treasury bonds for owning corporate debt) narrowed. A broad measure of investment-grade corporate bond spreads compiled by ICE Bank of America Merrill Lynch declined 8 basis points in the fourth quarter and 31 basis points for the full year to 99 basis points at December 31.

Portfolio Positioning

The table on the following page highlights the change in allocation to various sectors for the most recent quarter and compared to a year ago. We believe this summary provides a readable view of how we have allocated capital on your (our shareholders') behalf over time.

Net Assets (%)

Sector	**12/31/2017**	**9/30/2017**	**12/31/2016**
Corporate Bonds	38.3	41.4	42.7
Corporate Convertible Bonds	5.3	5.2	4.0
Asset-Backed	8.6	7.2	6.4
CMBS	0.4	0.5	0.3
Agency Mortgage-Backed	12.3	12.8	15.9
Non-Agency Mortgage-Backed	4.5	4.6	3.4
Municipal	0.4	0.4	0.5
U.S. Treasury	25.7	26.4	22.8
Common Stocks	0.7	0.7	1.0
Cash & Equivalents	3.8	0.8	3.0
Total	**100.0**	**100.0**	**100.0**
High Yield*	**10.9**	**10.1**	**10.1**

**High-yield exposure (as of 12/31/2017) consists of investments in the Corporate, Corporate Convertible, ABS and RMBS sectors.*

Over both periods, Fund holdings of agency mortgage-backed securities (MBS) continued to decline. This decline was driven by prepayments and amortization of principal. While agency MBS has held a prominent position in Fund allocation over the years, we believe the risk/return profile has become unattractive–and have allowed this portion of the portfolio to run off/shrink over the last few years. Incremental capital has been principally directed toward corporate bonds and asset-backed securities (ABS) where we believe the return profiles have been satisfactory relative to the risks of ownership.

As of December 31, our high-yield exposure was approximately 11%, slightly higher than September 30 (our maximum threshold is 15%). Our high-yield exposure continues to be concentrated primarily in higher-quality, shorter-term bonds that we believe have attractive risk/reward profiles. To highlight our preference for higher-quality credits in the current market environment, nearly 80% of our non-convertible high-yield corporate bond exposure is allocated to BB or split-rated companies (those rated investment grade by one agency and non-investment grade by at least one other) that we believe have strong asset and liquidity positions.

Overall portfolio metrics as measured by the average maturity and duration changed slightly compared to the previous quarter. The average effective maturity remained at 2.1 years, while the average effective duration increased to 1.9 from 1.8 years. These measures provide a guide to the Fund's interest rate sensitivity. A shorter average maturity and duration reduces the Fund's price sensitivity to changes in interest rates (either up or down).

Quarterly Contributors

- The corporate bond segment was the largest contributor to results in the quarter, as coupon income was augmented by modest (unrealized) price appreciation as credit spreads continued to move lower. Primary contributors included the real estate investment trust (REIT), banks and diversified manufacturing segments.

- Securitized Products (our ABS, CMBS and RMBS segments of the Fund) continued to perform at or above expectations with respect to credit performance and average life progression[1] while providing steady income and limited price volatility during the quarter.

Quarterly Detractors

- Common stock of Redwood Trust (-7.3%). Despite solid business results for Redwood in the quarter, tax reform and its potential impact on the mortgage market weighed on investor sentiment. We currently do not expect the new tax law to meaningfully impact the company's core business, but will be monitoring the full impact in the months ahead. For added perspective, Redwood's common stock full-year results (+4.5% including dividends) contributed solidly to Fund results.

- U.S. Treasury bonds. Our U.S. Treasury bond investment generated a modest negative total return during the quarter as short-term interest rate increases modestly offset the quarterly coupon income.

Investment Activity

Portfolio investment allocation was weighted toward shorter-term corporate bonds, asset-backed securities and U.S. Treasuries in the quarter. A notable new addition to the corporate bond portfolio was the non-investment-grade bonds issued by The Manitowoc Company. Manitowoc is one of the nation's largest manufacturers of engineered lifting equipment (e.g., cranes) for a variety of construction applications globally, including petrochemical and industrial projects, commercial, power/utilities, infrastructure and residential construction. Manitowoc estimates that it has leading global market shares in each of the major crane categories in which it participates. Under new management and the leadership of CEO, Barry Pennypacker, the company has adopted "lean" manufacturing (a systematic method for waste minimization within a manufacturing system without sacrificing productivity), has successfully restructured and refocused the business, and is on a path of meaningful credit improvement/deleveraging. Based on the company's improving fundamentals, we believe the Fund's investment in the company's 12.75% bonds maturing in 2021 are likely to be called at their earliest call date (February of 2019).

In ABS, we added to our automobile-backed and consumer loan positions. The Fed's three rate hikes in 2017 enabled us to achieve higher yields on one- to two-year investments without taking significant incremental credit risk. Our focus remains on shorter duration (one-to two-year average life) investments backed by seasoned collateral that has experienced steady or better-than-expected credit performance. In addition, given the extended nature of the current economic cycle, we have increasingly focused on sponsorship quality, with an emphasis on increasing our exposure to management teams with proven experience through economic and capital markets cycles.

Outlook–Plus a New Fixed Income Teammate

As mentioned at the outset of this commentary, risk taking (either in the form of interest rate or credit) was the key to outsized returns in 2017. We are more than willing and eager to take on credit risk when it is appropriately priced (e.g., energy in 2016). As to interest rate risk, our long-held strategy in the Short Duration Income Fund has been to avoid or minimize those investments whose success depends on getting the interest-rate "call" right. Overall, the Fund's 2017 results were satisfactory considering an environment of rising short-term interest rates. While credit-sensitive investments appear high priced (as measured by overall credit spreads) as we enter 2018, we are encouraged by the improvement in short-term "risk-free" (U.S. Treasury) rates. The prospect for the Fund's forward returns are enhanced by higher short-term base/risk-free rates, as we will be able to reinvest maturing bonds at short-term Treasury returns, for example, that haven't been available in nearly ten years. Should the markets experience any turbulence over the course of the year, we maintain significant capacity to increase our exposure to credit risk. We will continue to focus on short-duration, high-quality investments while selectively investing in credit where the risk reward is appealing.

Finally, we are pleased to announce a new member to our fixed income team, David Kratz. David is a 14-year member of the Weitz Investment Management family, most recently serving as a product specialist in our sales and marketing group. Having been with Weitz as long as he has, David meets one of the most important qualitative factors we look for in a Weitz teammate–cultural fit. We believe David has the attributes to be an excellent fixed income analyst by complementing the credit work we are already doing and aiding in the search for future investment opportunities.

Performance data represents past performance, which does not guarantee future results. *The investment return and the principal value of an investment in the Fund 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****.*

Average annual total returns for the Fund's Institutional and Investor Class for the one-, five- and ten-year periods ended December 31, 2017, were 1.54%, 1.53%, 3.13% and 1.34%, 1.32%, 2.99%, respectively. Returns assume reinvestment of dividends and redemption at the end of each period, and reflect the deduction of annual operating expenses, which as stated in the most recent Prospectus are 0.62% (gross) and 0.93% (gross) of the Fund's Institutional and Investor Class net assets, respectively. Returns also include fee waivers and/or expense reimbursements, if any; total returns would have been lower had there been no waivers or reimbursements. The Investment Adviser has agreed in writing to waive its fees and reimburse certain expenses (excluding taxes, interest, brokerage costs, acquired fund fees and expenses and extraordinary expenses) to limit the total annual fund operating expenses for Institutional Class shares and Investor Class shares to 0.48% and 0.68%, respectively, of each Class's average daily net assets through July 31, 2018.

Investor Class shares became available for sale on August 1, 2011. For performance prior to that date, returns include the actual performance of the Fund's Institutional Class (and use the actual expenses of the Fund's Institutional Class), without adjustment. For any such period of time, the performance of the Fund's Investor Class would have been similar to the performance of the Fund's Institutional Class, because the shares of both classes are invested in the same portfolio of securities, but the classes bear different expenses.

Average annual total returns for the Bloomberg Barclays 1-3 Year U.S. Aggregate Index for the one-, five- and ten-year periods ended December 31, 2017, were 0.86%, 0.86%, and 1.95%, respectively. Index performance is hypothetical and is shown for illustrative purposes only. Comparative returns are the average returns for the applicable period of the reflected index. The Bloomberg Barclays 1-3 Year U.S. Aggregate is generally representative of the market for investment grade, U.S. dollar denominated, fixed-rate taxable bonds with maturities from one to three years.

Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

[1]**Average Life Progression:** A measure of repayment speed for a collateral pool (for example, a collection of mortgages may serve as the collateral pool for an issuance of mortgage-backed securities).

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. Weitz Securities, Inc. is the distributor of the Weitz Funds.