Weitz Hickory WEHIX

Mixed results, a modified process, and above-average expenses lead to a downgrade.

Morningstar's Take WEHIX

Morningstar Rating	★★
Morningstar Analyst Rating	Neutral

Morningstar Pillars

Process	Neutral
Performance	Neutral
People	Positive
Parent	Positive
Price	Negative

Role In Portfolio
Supporting

Fund Performance WEHIX

Year	Total Return (%)	+/- Category
YTD	5.34	0.71
2016	10.16	-3.98
2015	-7.62	-2.87
2014	2.27	-5.54
2013	27.83	-6.27

Data through 5-31-17

5-26-17 | by Kevin McDevitt, CFA

Weitz Hickory hasn't produced sufficiently in either its current or former incarnations under its current management. Plus, its above-average fees create a further hurdle to future success. For these reasons, we have downgraded the fund's Morningstar Analyst Rating to Neutral.

The firm officially embraced a high-quality strategy in April 2016. But, as comanagers Wally and Drew Weitz said at that time, this was more an iteration than a sea change. The fund has been moving away from its value-oriented, contrarian roots since the 2007-09 credit crisis.

The portfolio has long resided in the mid-blend portion of the Morningstar Style Box, but it now leans more growth than value within that segment. After the fund adopted its current small/mid-cap mandate in June 2008, its average market cap concurrently moved to the small/mid-cap border from the large/mid-cap border.

Since then, its results have been mixed. The fund lags the Russell 2500 Index by 24 basis points annualized through April 2017. However, the fund's hefty cash stakes, which are often 15% or more of assets, have made it less volatile than the index and led to better risk-adjusted results. The fund's Sharpe ratio during that stretch is 0.59 versus the index's 0.52.

But the fund lags the index by hefty margins since Wally and Drew Weitz began their respective manager tenures in 2003 and year-end 2011. During Wally Weitz's tenure, the fund trails the index by 2 percentage points annualized. Since Drew Weitz joined him as comanager, the fund's 10.3% annualized gain lags the index by more than 4 percentage points.

Hindering their efforts is an above-average expense ratio. Although the 2016 annual report showed it increasing to 1.25%, it stayed at 1.24% per the December 2016 prospectus. Its prospectus expense ratio is 20 basis points greater than the mid-cap no-load peer group median. This relatively high expense ratio makes the fund's odds of long-term outperformance that much longer. For now, investors are best served looking for cheaper and better options.

Process Pillar Neutral | Kevin McDevitt, CFA 05/26/2017

In April 2016, this fund moved further in the direction of quality. Because this makes the fund less differentiated, the Process Pillar rating is cut to Neutral. The team dropped the discount rate it uses to value companies to 9% from 12%. This increases a company's estimated fair value and allows more companies, especially high-quality ones, to enter their target range. Deep-value turnaround plays are less common, and high-quality compounders more so. The team typically looks for stocks that are selling at 70% or so of their estimated fair value. But the required margin of safety also depends on company quality. Distressed or commodity-oriented companies must be selling at far deeper discounts to draw the team's interest.

The team looks out as far as 10 years when discounting free cash flows or a company's franchise value, although its investment horizon is usually closer to between three and five years. Quality differences between companies are incorporated into valuation estimates through the terminal multiple and the projected return on capital. Companies now receive a 1-7 quality score across metrics such as competitive position, cash flow consistency, reinvestment runway, return on invested capital, and management quality. Financial leverage is also scored, with the team looking to reduce the amount of leverage it tolerates.

This fund embraced a bigger opportunity set after it adopted its current small/mid-cap mandate in June 2008 and the arrival of comanager Drew Weitz and several other analysts. This group extended the fund's reach into technology, in particular. Previously, manager Wally Weitz largely stuck to sectors with which he was familiar: financials, media companies, and at times telecoms.

The fund has since become a bit more diversified across sectors. Financials don't dominate as much as in the past, although consumer discretionary stocks remain a focus. That weighting has grown from 29.9% of assets 18 months prior to 44.5% as of March 2017. That stake is more than triple the Russell 2500 Index's 12.6%. But this is still below the sector's 47.5% weighting in the fund in early 2010.

The team doesn't embrace leveraged balance sheets as much as it once did. The fund's 43.5% average debt/capital ratio is still above the index's 42.0%, but it's well below the 54.2% level from two years ago. This reflects the change in the team's philosophy surrounding leverage, as strong balance sheets become a bigger priority.

The fund's big cash stake still remains. Cash is usually 10%-30% of assets and was 17.6% as of March 2017. This can be a drag on returns but also leaves the fund well-positioned should a correction create bargains.

Performance Pillar Neutral | Kevin McDevitt, CFA 05/26/2017
At first glance, this fund's record looks uninspiring. Since lead manager Wally Weitz took the helm in January 2003, the fund's 10.1% annualized return trails the Russell 2500 Index by 2 percentage points through April 2017. Plus, since Drew Weitz became comanager in late 2011, the fund's 10.3% annualized gain trails the index by a yawning 4 percentage points.

However, the fund has performed better since it formalized its small/mid-cap mandate in June 2008, but it nevertheless remains mixed. This earns the fund a Neutral Performance rating. Its 9.9% annualized return since June 2008 narrowly trails the Russell 2500 Index's 10.2%. The fund has performed better on a risk-adjusted basis, although not spectacularly so. Its Sharpe ratio, a measure of risk-adjusted results, was 0.59 during this stretch versus 0.52 for the benchmark.

These decent risk-adjusted results owe largely to the fund's often-sizable cash stakes. Cash has been greater than 10% since 2009. This helped the fund survive 2011's third-quarter correction better than its average peer, losing 17.1% versus 20.4% for the mid-blend Morningstar Category. During the 2007-09 credit crisis, cash helped keep the fund's losses on par with the category average, despite a more debt-heavy portfolio. However, holding lots of cash has also hindered the fund's results at times, especially late in bull markets.

People Pillar Positive | Kevin McDevitt, CFA 05/26/2017
Lead manager Wally Weitz has built a team of eight managers and analysts. Continuity has been strong in recent years and should be further enhanced by Weitz's practice, which he began in 2006, of selling 2% of the firm each year to employees. Comanager Drew Weitz, who was promoted at year-end 2011, gives shareholders a likely successor. Note, though, that the fund's results have been subpar since then. While Wally Weitz is in his late 60s, he has no plans to retire. Wally Weitz's experience and a well-resourced team earn the fund a Positive People rating.

Neither is Drew Weitz green at this point. He worked at value shop Ariel for nearly five years as an analyst before joining Weitz in 2008. The team members tend to be generalists, but he has thus far covered media, retail, and technology companies. He holds a degree in computer science, which makes the latter sector a natural fit, and his comfort with technology companies makes him a nice complement to Wally Weitz, who has traditionally stuck largely to media and financials stocks. He was named the director of the firm's equity research efforts in April 2011.

Both managers own positions in the fund worth more than $1 million, aligning their interests with fundholders'.

Parent Pillar Positive | Kevin McDevitt, CFA 08/13/2015
Weitz Funds gets good marks for stewardship, with the main detractor being the family's slightly above-average overall fees. All of the managers invest in the funds that they run, with firm founder Wally Weitz parking more than $1 million in each of his charges. The independent board members also have significant positions in the funds. As a firm, Weitz has resisted the temptation to introduce trendy funds and has not shown any hint of empire-building. It has a clean regulatory record, too.

Weitz has a strong and established investment culture. Wally Weitz founded the firm in 1983 and is still at the helm, running the advisor and comanaging several portfolios. The equity team is composed of eight portfolio managers and analysts who average about nine years of experience at the firm, excluding Weitz himself.

Admirably, Weitz has worked hard during the past nine years to build the organization behind him. He has promoted internally and in 2006 began selling 2% of the firm each year to employees. Both practices should motivate the team and keep retention strong. The firm's five-year manager-retention rate through July 2015 is 100%. These moves also show a proactive approach to succession planning.

The fund boards have done a good job closing funds before they get too big. However, they haven't cut fees as much as they could. Several funds have above-average expenses.

Price Pillar Negative | Kevin McDevitt, CFA 05/26/2017
This fund's 1.24% prospectus expense ratio is well above the 1.08% mid-cap no-load peer median. Its Morningstar Fee Level is Above Average. For this reason, the fund gets a Negative Price rating. What's troubling is that the expense ratio has risen as assets have fallen. The fund has lost more than $200 million in outflows during the past three years. If this trend continues, there could be additional pressure on the expense ratio.

Past performance is no guarantee of future results. Weitz Hickory Fund (WEHIX) average annual total returns for the one, five, and ten-year periods ended March 31, 2017, were 11.60%, 8.39% and 4.95%. The returns above 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 1.24% of the Fund's net assets. 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 www.weitzinvestments.com/funds_and_performance/fund_performance.fs. Included is a reference to the term "margin of safety." This term refers to purchasing common stock at a price that is less than what a company is believed to be worth, on a per-share basis. A potential "margin of safety" may limit downside risk and optimize the potential for growth. 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 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., 1125 South 103rd Street, Suite 200, Omaha NE 68124-1071, weitzinvestments.com, 800-304-9745 or 402-391-1980. Weitz Securities, Inc. is the distributor of the Weitz Funds.

Weitz Funds, Weitz Investment Management, Inc. and Weitz Securities, Inc. disclaim any liability for information contained in this article and are not affiliated with Morningstar.

 Past performance is no guarantee of future results. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its three-, five- and ten-year (if applicable) Morningstar Rating metrics. Weitz Hickory Fund was rated against the following numbers of U.S.-domiciled Mid-Cap Blend funds over the following time periods: 377 funds in the last three years, 340 funds in the last five years, and 219 funds in the last ten years. With respect to these Mid-Cap Blend funds, Weitz Hickory Fund received a Morningstar Rating of 2 stars, 1 star and 2 stars for the three-, five- and ten-year periods, respectively.

The Morningstar Analyst Rating™ is not a credit or risk rating. It is a subjective evaluation performed by Morningstar's manager research group, which consists of various Morningstar, Inc. subsidiaries ("Manager Research Group"). In the United States, that subsidiary is Morningstar Research Services LLC, which is registered with and governed by the U.S. Securities and Exchange Commission. The Manager Research Group evaluates funds based on five key pillars, which are process, performance, people, parent, and price. The Manager Research Group uses this five pillar evaluation to determine how they believe funds are likely to perform relative to a benchmark, or in the case of exchange-traded funds and index mutual funds, a relevant peer group, over the long term on a risk-adjusted basis. They consider quantitative and qualitative factors in their research, and the weight of each pillar may vary. The Analyst Rating scale is Gold, Silver, Bronze, Neutral, and Negative. A Morningstar Analyst Rating of Gold, Silver, or Bronze reflects the Manager Research Group's conviction in a fund's prospects for outperformance. Analyst Ratings ultimately reflect the Manager Research Group's overall assessment, are overseen by an Analyst Rating Committee, and are continuously monitored and reevaluated at least every 14 months.

For more detailed information about Morningstar's Analyst Rating, including its methodology, please go to global.morningstar.com/managerdisclosures/.

The Morningstar Analyst Rating (i) should not be used as the sole basis in evaluating a fund, (ii) involves unknown risks and uncertainties which may cause Analyst expectations not to occur or to differ significantly from what they expected, and (iii) should not be considered an offer or solicitation to buy or sell the fund.