Weitz | INVESTMENT MANAGEMENT

Core Plus Income

2Q 2017 Quarterly Commentary

Portfolio Managers: Tom Carney, CFA & Nolan Anderson

Core Plus Income Strategy returned +1.26% (gross of fees), +1.15% (net of fees) for the second calendar quarter compared to a +1.45% return for the Bloomberg Barclays U.S. Aggregate Bond Index (Bloomberg Barclays U.S. Agg), our primary benchmark.

Overview

The first half of 2017 is in the books, as they say. If the second quarter had a name, it might be dubbed Lake Placid, as most measures of volatility (the market's fear index) were low/calm. The U.S. economy continues to appear healthy, despite several forward-looking economic activity indicators failing to build on the highs they achieved in the first three months of the year. This led to smooth sailing and positive returns in the quarter for both bond and equity investors. One measure of economic progress is reflected in the unemployment rate, 4.3% as of the May report. Unemployment is now lower than it has been 96% of the time since 1970. Broader measures of unemployment have also been falling sharply. Given the tight labor market, the Federal Reserve (Fed) raised rates again in June and announced it is likely to start reducing the size of its balance sheet "relatively soon." Despite lower inflation readings in the quarter, the Fed believes the factors weighing on inflation are most likely temporary. Among other variables, the Fed has cited cellular phone competition and lower prescription drug prices as transitory reasons for the inflation drop. Consequently, while the Fed will continue its usual role of carefully monitoring incoming economic data, they appear committed to continuing to gradually tighten monetary policy over the coming quarters.

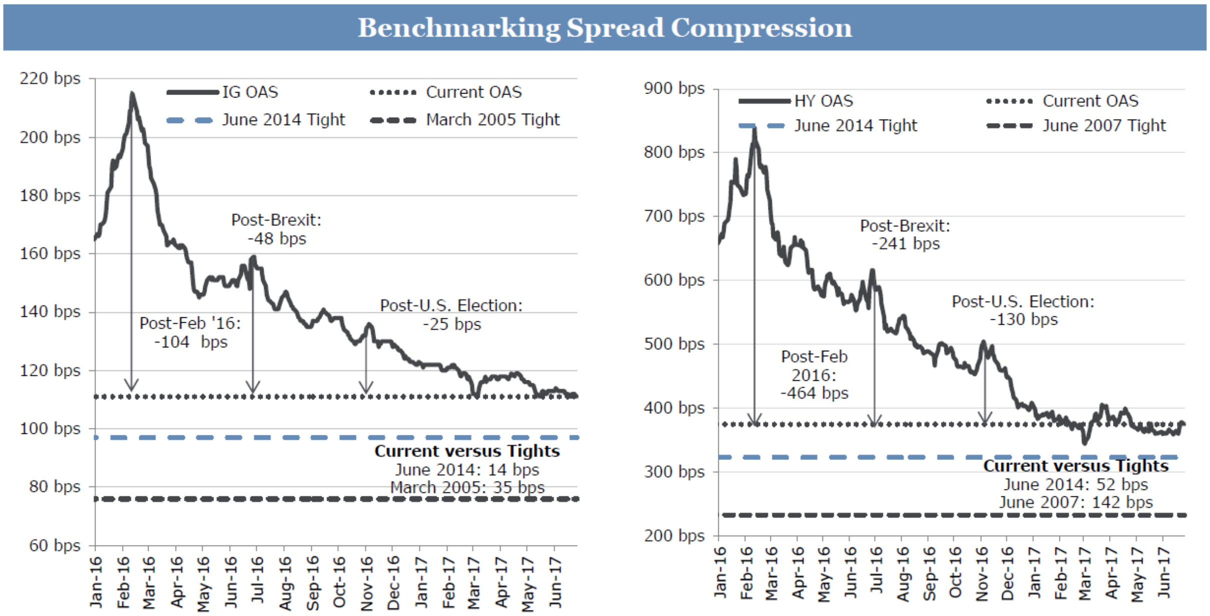
Bond yields were generally lower (prices higher) in the quarter despite modest increases in shorter-term interest rates, as short-term rates generally follow the Fed's monetary policy action. As a result, the difference between short- and longer-term bond yields narrowed in the quarter as the yield curve continued to "flatten." A flattening of the yield curve occurs when the Fed embarks on a monetary tightening campaign. Either the market anticipates the Fed being successful in slowing the economy or worries that the Fed is making a policy mistake by slowing the economy too fast, which may precipitate a recession. The table below provides an overview of select U.S. Treasury bond yields for the quarter.

U.S. Treasury Yields (%)

	2-year	3-year	5-year	10-year
6/30/2017	1.39	1.55	1.89	2.31
3/31/2017	1.26	1.49	1.92	2.39

Corporate bonds and other credit sensitive securities outperformed Treasury bonds in the quarter as credit spreads continued to narrow/decline, particularly for non-investment-grade or high-yield bonds. A broad measure of investment-grade corporate bond spreads compiled by Merrill Lynch declined to 115 basis points as of June 30, down 9 basis points in the quarter. The chart on the following page, courtesy of Wells Fargo, highlights the compression in credit spreads that has occurred in the past year and a half. With minor updrafts, the path downward in credit spreads has been quite persistent. Both investment-grade (IG) and high-yield (HY) option-adjusted spreads (OAS) are approaching the tightest levels since the 2008-2009 recession and not much further from all-time lows/tights. This has translated into an environment where investors are being paid less, in the form of incremental spread over safer alternatives like U.S. Treasuries, to assume credit risk. There doesn't appear to be any imminent storm clouds on the investment horizon, as was the case ten years ago when two hedge funds collapsed, an early warning signal (the proverbial "canary in the coal mine") of the impending credit crisis that would engulf the world. However, the seeming tranquility of today's credit and overall bond market *will* inevitably be followed by more turbulence. We intend to remain vigilant for any early warning signals and ready to take advantage of dislocations that any future storm might bring.

Investment Grade | High Yield



Data as of June 27, 2017
Source: Wells Fargo Securities, Yield Book

Portfolio Positioning

The table below shows the change in allocation to various sectors for the most recent quarter and compared to a year ago. We believe this summary provides a view over time of how we have allocated capital.

Since our goal is to invest in sectors that we believe offer the best risk-adjusted returns, our allocations may change significantly over time.

Portfolio (%)

Sector	6/30/2017	3/31/2017	6/30/2016
U.S. Treasury	43.4	42.4	28.1
Corporate	25.8	28.7	42.4
Asset-Backed (ABS)	21.6	14.0	13.3
Commercial Mortgage-Backed (CMBS)	2.5	3.5	4.5
Cash & Equivalents	2.2	5.4	3.3
Corporate Convertible Bonds	1.6	2.1	2.8
Municipal	1.1	1.4	2.0
Non-Agency Residential Mortgage-Backed (RMBS)	0.9	1.3	0.9
Common Stock	0.6	0.8	2.0
Agency Mortgage-Backed (MBS)	0.3	0.4	0.7
Total	**100**	**100**	**100**
High Yield*	**6.2**	**6.9**	**17.0**

**High Yield exposure (as of 6/30/2017) consists of investments in the Corporate, Corporate Convertible and Asset-Backed sectors.*

Our ABS exposure increased to 21.6% of Strategy assets from 14.0% as of March 31. (More on our ABS exposure in the Investment Activity section.) With more capital shifting to ABS, the Strategy experienced moderate declines in corporate bond and CMBS exposure. In addition, the Strategy has minimal exposure to agency MBS, as we believe the risk/return profile continues to be unattractive.

Stepping back from sector allocation, investors may appreciate bigger picture context around how we are positioned and why. In terms of interest rate risk, we increased the duration of our portfolio this year by adding length to our U.S. Treasury position. As of June 30, our average effective duration has increased to 4.5 years from 3.5 years a year ago. The change in positioning reflects the fact that interest rates across the yield curve have shifted materially higher over the past year, albeit at still low levels. Should interest rates continue marching higher from here (with the potential to outstrip inflation), we have the capacity to increase our duration further toward the benchmark (Bloomberg Barclays U.S. Agg) duration of approximately 6 years. Given part of our overall investment philosophy is to avoid taking undue interest rate risk, it is unlikely that we will carry a higher duration than the benchmark over the next few quarters.

With the capital markets enjoying robust investor demand and historically low volatility, we have established a conservative posture with respect to credit risk. We have achieved this by keeping the duration of our credit book relatively short with an up-in-quality bias. For example, the Strategy's corporate credit segment duration is 2.7 years, while the Strategy's securitized products segment duration is 1.2 years. In terms of credit risk, as of June 30, our high-yield exposure was 6.2%, down from 6.9% at March 31, and 17% as of June 30, 2016, (our maximum threshold is 25%). While we acknowledge the yield benefit of allocating capital to high yield, particularly in today's low interest rate environment, we think of our high-yield allocation as more tactical than "plug and play." If we remain fully invested in high yield, regardless of credit spreads, we limit our ability to act quickly should market conditions change. How so? Liquidity.

While liquidity in the high-yield market is strong today, driven by strong risk appetite and positive flows, these conditions can quickly reverse. Market dislocations often lead to mispriced securities and wide bid-ask spreads, much like what the energy sector experienced in late 2015/early 2016. When the tide goes out, those capable of being liquidity *providers* benefit at the expense of liquidity *demanders*. Should credit spreads compress further without an accompanying increase in interest rates, resulting in even lower investment yields, we may further decrease the duration of our credit investments and/or increase quality.

Overall portfolio metrics, as measured by average effective maturity and average effective duration, changed modestly compared to the prior quarter. The average effective maturity of our Strategy decreased to 5.2 from 5.4 years, and the effective duration increased to 4.5 years from 4.3 years. The Strategy remains materially underweight duration relative to our benchmark and the majority of our intermediate-term bond peers.

Second Quarter Contributors

Security and sector selection were key drivers of performance in the past quarter. Primary contributors included:

- U.S. Treasury bonds. The Strategy's longer maturity bonds (particularly those 10 years or greater) provided the largest positive contribution. The Strategy's Treasury holdings have an average maturity of approximately 9 years.
- U.S. Corporate Credit. Includes investment-grade corporate bond investments in REITS and diversified financial services companies. Primary contributors included the bonds issued by Berkshire Hathaway, Boston Properties, Equity Commonwealth, Markel Corporation and Vornado Realty.
- Securitized Products. Our ABS, CMBS and RMBS segments continued to perform at or above expectations with respect to credit performance and average life progression, while providing steady income and minimal price volatility during the quarter.
- Redwood Trust's common stock (up 4.3% for the quarter) and corporate convertible bond investments.

Second Quarter Detractors

- No portfolio segment generated a negative contribution to results in the quarter. However, select U.S. Treasury bonds and securitized products experienced modest negative total returns in the quarter, but their small position size kept any (unrealized) price declines from affecting overall portfolio results.

Investment Activity

Portfolio investment remained active during the quarter. New asset allocation was weighted toward ABS and U.S. Treasuries, along with modest new investments in corporate credit. The asset-backed segment (ABS) continued to grow in the quarter as we identified several qualifying investments that fit our risk/reward tolerance. Our ABS investments have an average duration of approximately 1 year and are either (1) the most senior part of a securitization with monthly amortization and substantial credit support or (2) subordinated bonds backed by seasoned collateral. By conducting monthly credit surveillance as a collateral pool seasons, we can identify specific securitization pools where credit performance and/or repayment speeds are performing in-line or better than expected.

As credit support builds while the securitization deleverages (i.e., overcollateralization results in the collateral pool exceeding what is expected to be necessary to make payments on the securities), there is potential for positive credit rating migration and tighter credit spreads. We added to our prime and subprime automobile ABS issued by AmeriCredit, CarMax, Chrysler Capital, Credit Acceptance, DriveTime, Exeter Finance, GM Financial, Mercedes-Benz, Prestige Financial, Santander Consumer and Westlake Financial. We also added to our marketplace consumer loan positions in Marlette Funding and SoFi. In addition, we established new positions in equipment ABS issued by Ascentium and Commercial Credit Group and fleet-lease ABS issued by Enterprise.

Outlook

In the first quarter, we spoke about the state of the credit markets being more advantageous for borrowers than lenders. While the Fed did raise interest rates another 25 basis points in June, a positive for lenders, very strong appetite for risk has caused a further tightening of credit spreads, and in many cases the result is lower overall investment yields for investors. To that end, and despite our flexible mandate, the difficulty in finding qualifying credit investments is increasing. In the meantime, we continue to seek out opportunistic, shorter-term corporate and securitized product investments that provide attractive risk-adjusted returns, both in investment grade and non-investment grade. Markets invariably do change, and with abundant liquidity in the form of cash and U.S. Treasuries, we stand ready to take advantage of any potential market weakness.

It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list. The holdings identified do not represent all of the securities purchased, sold or recommended for Weitz Inc.'s advisory clients. You may reach Weitz Inc. at 1125 S 103rd Street, Suite 200, Omaha NE 68124, at 800-304-9745 or at weitzinvestments.com.

Investors should consider carefully the investment objectives, risks and charges and expenses of the Strategy before investing. ***Performance data represents past performance, which does not guarantee future results.*** *Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.*

Performance information in this letter is the weighted-average performance of accounts managed by Weitz Investment, Inc. ("Weitz Inc.") under its Core Plus Income Strategy (the "Strategy"). All other portfolio holdings information is for a particular "Representative Account" in the Strategy.

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 U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.