

Short Duration Income

2Q 2017 Quarterly Commentary



The Short Duration Income Strategy returned +0.71% (gross of fees), +0.58% (net of fees) in the second calendar quarter compared to a +0.31% return for the Bloomberg Barclays 1-3 U.S. Aggregate Index (Bloomberg Barclays U.S. Agg 1-3), 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 (%)

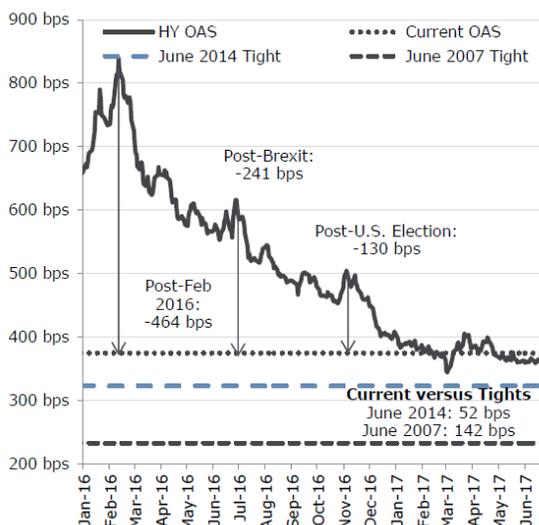
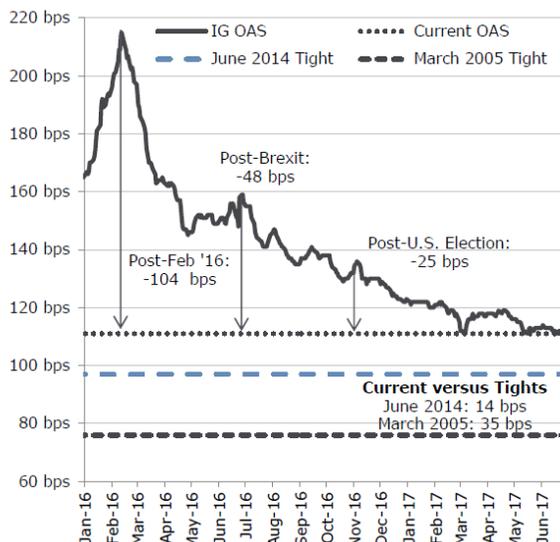
	2-year	3-year	5-year	10-year
6/30/2017	1.39	1.55	1.89	2.31
3/31/2017	1.26	1.49	1.92	2.39

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 below, 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

Benchmarking Spread Compression



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 from 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
Corporate	43.4	43.5	40.5
U.S. Treasury	25.4	24.7	21.5
Agency Mortgage-Backed (MBS)	13.8	14.7	18.1
Asset-Backed (ABS)	7.8	5.7	4.5
Corporate Convertible bonds	4.0	4.0	3.8
Non-Agency Residential Mortgage-Backed (RMBS)	2.6	3.1	4.0
Cash & Equivalents	1.2	2.0	3.6
Common Stock	0.8	1.1	2.3
Commercial Mortgage-Backed (CMBS)	0.6	0.8	1.2
Municipal	0.4	0.4	0.5
Total	100	100	100
High Yield*	9.3	9.8	12.1

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

Agency mortgage-backed (MBS) and non-agency residential mortgage-backed (RMBS) securities holdings continued to decline in the quarter, driven by prepayments and amortization of principal. While agency MBS have held a prominent position in Strategy allocations over the years, we have allowed this portion of the portfolio to run off/shrink over the last few years, as we have not viewed the risk/reward profile as favorable compared to alternatives. Incremental capital has been principally directed toward corporate bonds and ABS where we believe the return profiles have been more satisfactory relative to the risks of ownership.

As of June 30, our high-yield exposure was approximately 9.3% down slightly from 9.8% at March 31 (our maximum threshold is 15%). Our high-yield exposure continues to be primarily concentrated 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, approximately 68% 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 average maturity and average effective duration, changed modestly compared to the previous quarter. The average effective maturity declined to 2.1 years from 2.2 years, and the average effective duration declined to 1.9 years from 2.0 years. These measures provide a guide to the Strategy's interest rate sensitivity. A lower average effective maturity and shorter average effective duration reduce the Strategy's price sensitivity to changes in interest rates (either up or down).

Top Quarterly Contributors

Security and sector selection were key drivers of the Strategy's outperformance in the past quarter. Primary contributors included:

- The corporate bond segment was the largest contributor to results in the quarter as coupon income was augmented by modest (unrealized) price appreciation. Primary contributors included the real estate investment trust (REIT), banks, diversified financial services and insurance segments.
- RMBS, CMBS and Auto ABS. These 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

Top Quarterly Detractors

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

Second Quarter Investment Activity

Portfolio investment remained active during the quarter. As credit spreads have continued to decline (and, hence, less reward for the credit risk assumed), we have been less willing to invest in credit-related bonds with durations much beyond three years. We have not been active sellers of our corporate bond portfolio, but incremental capital to replace maturing bonds has been targeted at shorter duration bonds and what we believe to be even stronger credits. The corporate bond segment's effective duration, for example, has declined in the past year from 2.1 year to 1.6 years at June 30.

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 under one year and are generally the most senior part of a securitization with substantial credit support. Recent investment examples include automobile ABS issued by GM Financial and Mercedes Benz, fleet lease ABS issued by Enterprise Fleet Management and consumer finance lender Marlette Funding.

Our investments may be wide-ranging, but our analysis is the same. We strive to own only those investments we believe compensate us for the incremental credit risk we assume. Our overall goal is to invest in a portfolio of bonds of varying maturities that we believe represents attractive risk-adjusted returns, taking into consideration the general level of interest rates and the credit quality of each investment. We will patiently seek out areas of opportunity and invest one security at a time, relying on a fundamental research-based investment approach. We remain well-positioned to take advantage of any 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 Short Duration 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 indices. The Bloomberg Barclays U.S. Aggregate 1-3 Year Index is generally representative of the market for investment grade, U.S. dollar denominated, fixed-rate taxable bonds with maturities from one to three years.