Escaping the 'Math Problem'


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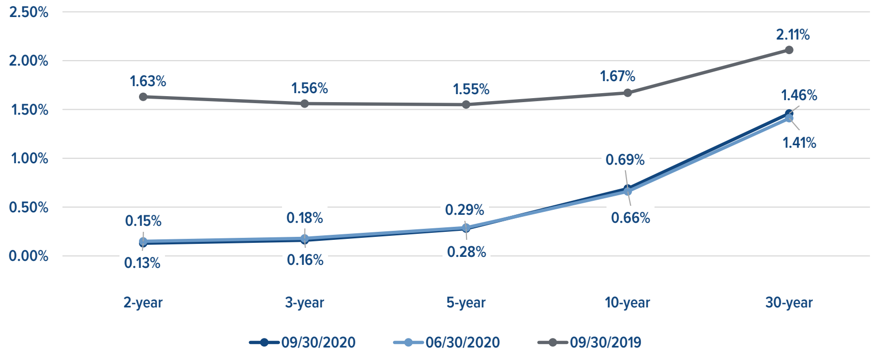
While the fixed income markets continue to be challenging, Weitz fixed income funds delivered positive returns in the third quarter. The Weitz Short Duration and Weitz Core Plus Income Funds in particular exhibited strong performance. This outcome is especially gratifying after the market value declines of portfolio holdings earlier in the year. As noted in our second quarter letter, we were not forced sellers during the March upheaval, and we used our liquidity to take advantage of market volatility during the first quarter. That fact along with the strong rebound in the market values of our portfolio holdings speaks to solid credit work to date.

Weitz equity and conservative allocation funds also posted gains in the third quarter. Please see Co-Chief Investment Officers Wally Weitz and Brad Hinton's **Value Matters** for more details as well as the individual fund quarterly commentaries for full analyses on all of our portfolios.

Fixed-Income Market Update

The graph below shows the changes of select U.S. Treasury rates over the past quarter and year.

U.S. TREASURY YIELDS

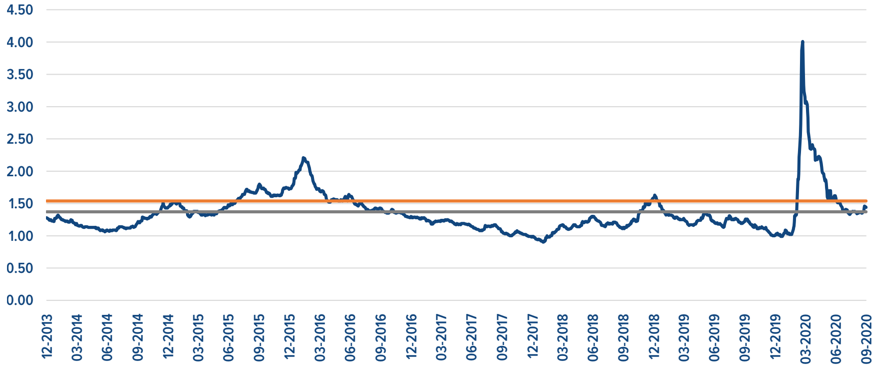


Source: Bloomberg

The Treasury curve hardly budged in the third quarter as shorter rates (2-, 3- and 5-year) remained anchored near zero while longer rates (10- and 30-year) rose ever so slightly.

Spreads on corporate bonds continued to decline in the third quarter, resulting in outperformance compared to U.S. Treasury bonds. A broad measure of investment-grade corporate bond spreads, compiled by ICE BofA, declined modestly in the quarter – from 160 basis points as of June 30 to 144 basis points on September 30. The chart below depicts the path of investment-grade credit spreads for the past five years (blue line) against the one- (orange) and five-year (gray) averages.

INVESTMENT GRADE CREDIT SPREADS



Source: Federal Reserve Economic Data (FRED) – St. Louis Fed

Overall, corporate bond credit spreads have meaningfully retraced the large spike upward that peaked in March of this year. Credit spreads remain above where they have been over the last five years, but coupled with very low 'base' rates (U.S. Treasury) on which nominal returns are set, forward returns on offer for corporate bonds are reaching (or have reached) all-time lows.

Index challenges – "Houston, we have a problem"

While attending an Asset TV panel a year ago, Nolan said that we believe bonds generally have a 'math problem,' given that forward returns across a broad swath of the fixed-income marketplace would be meaningfully reduced. If that was true a year ago, it has become even more so today – *especially* for broad index categories. Illustrative of that return dilemma is seen in the primary indexes for two of the Weitz taxable bond funds, namely the Bloomberg Barclays US Aggregate Bond Index (AGG) and the 1-3 year subsegment of the AGG. The table below highlights certain characteristics for the AGG and the 1-3 year subset of the AGG alongside corresponding characteristics for the Weitz Core Plus Income and Weitz Short Duration Income Funds.

	Core Plus Income Fund	Bloomberg Barclays US Agg	Short Duration Income Fund	Bloomberg Barclays 1-3 Year US Agg
Average Maturity	5.81 years	8.18 years	1.59 years	2.05 years
Average Effective Maturity	5.51 years	8.04 years	1.54 years	1.96 years
Average Duration	4.41 years	6.36 years	1.59 years	1.95 years
Average Effective Duration	4.42 years	6.03 years	1.29 years	1.53 years
Yield to Worst	3.79%	1.18%	2.05%	0.35%
Yield to Maturity	3.88%	1.19%	2.08%	0.37%

Key takeaways – events of the past few years have reduced the yield to worst and yield to maturity for the indexes referenced above and for investments that follow those indexes. We believe that our Funds, with carefully selected securities outside of what the indexes hold, and currently with materially higher yield to worst and yield to maturity, offer a better opportunity to escape the aforementioned 'math problem.' We further note that our Funds have lower duration profiles than the indexes (duration is commonly used as a measure of an investment's future interest rate risk).

Federal Reserve – lower for much longer

The Federal Reserve (Fed) made no changes in short-term monetary policy during the quarter (leaving rates at or near zero), but in August the Fed unanimously adopted a new monetary policy framework that, while incremental to the agency's long-term policy goals of promoting maximum employment and stable prices, may result in a *lower* for a *lot longer* short-term interest rate environment.

The Fed's new policy framework establishes an average inflation targeting regime as well as a rather remarkable combination of factors to wait for before moving short-term interest rates off zero. Namely, the Fed expects to maintain the current Federal Funds rate (between zero and 25 basis points) until the labor market reaches full employment and inflation has consistently averaged 2% over a one-, three-, or five-year time period. In other words, the Fed appears willing to allow inflation to overshoot 2% for some amount of time to allow the labor market to reach the Fed's view of full employment. Using the Fed's long-standing measure of 4.1% unemployment as the measure of full employment and the Fed's favored inflation gauge of PCE (personal consumption expenditures), these conditions have been an extreme historical anomaly, rarely occurring together at the same time. The Fed's new inflation targeting regime has something in common with Samuel Beckett's tragic comedy "Waiting for Godot" – they're both waiting for something that may never happen. As one macro strategist suggests by analogy, the Fed is attempting to cast itself as a sort of monetary Peter Pan who wants the economy to come visit Never-Never Land.

While this new policy framework by the Fed may be more evolutionary than revolutionary, it does appear to have important implications for fixed-income investors. The acronym ZIRP (Zero Interest Rate Policy) that came into being after the Great Recession of 2008, and that resulted in short-term interest rates remaining at zero for six years could easily be eclipsed by the Fed's new average inflation targeting and full employment directive.

Taking the Market's Temperature

"Chaos and volatility are what 'value' investors live for, and if we can muster the right combination of common sense and courage, we might just thrive." – Wally Weitz August 2020

While we refrain from making bold (if any) market predictions/prognostications, we do fully subscribe to Howard Mark's wise advice of taking stock of the marketplace's proverbial temperature. Speaking of temperature, 2020 has witnessed temperature swings like few, if any, others in history. Thanks to the patient, value-oriented investment approach instilled by our founder, whose recent but timeless quote began this section, our investment approach has always been to take advantage of the opportunities the market provides – by gradually expanding our circle of competence and patiently searching for pockets of favorable risk/reward investments. The 'chaos and volatility' (high temperature) of 2020's first quarter has given way to a much calmer environment (mild temperature). Entering the home stretch of a historically challenging year, this is what we see:

- A 'pedal to the metal' monetary policy that will keep short-term interest rates lower for longer, and a stated intention to allow inflation (when it returns) to run hotter (higher) than the Fed's previous 2% target, in order to aid in the labor market recovery. The result, absent yield curve control by the Fed (a potential topic for another time), may be a steeper yield curve that should have less negative impact on lower duration portfolios.
- An economic recovery that progresses in fits and starts (not V-shaped) where the handoff from a massive fiscal and monetary stimulus will be tricky and likely volatile.
- We may still be in the economic 'eye' of the Category 5 hurricane caused by the response to limit the spread of COVID-19; that is, it may be calm at present, but we continue to expect turbulence as we navigate to the other side of the storm's 'eyewall.'
- The Fed's direct buying of assets (Treasuries, mortgages, corporate bonds, ETFs) has reduced the value and forward return opportunities in many areas of the marketplace, and we believe active managers can add value by seeking out the most promising market sectors.

Our fixed-income funds have broad, flexible mandates that, we believe, allow us to navigate the increasingly lower return environment by identifying investment opportunities away from price-insensitive index investors and less influenced by Fed intervention (such as structured products).

Our goals remain the same. Namely, to (a) preserve capital, (b) maintain a strong liquidity position, (c) understand evolving risks and opportunities, (d) selectively take advantage of favorable risk/reward opportunities, and (e) conduct consistent/thorough credit surveillance. We remain ready to take advantage of valuation disparities that may develop, and we hope to continue to earn your trust.

IMPORTANT DISCLOSURES

The opinions expressed are those of Weitz Investment Management and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through 10/15/2020, are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor's specific objectives, financial needs, risk tolerance and time horizon.

Data quoted is past performance and current performance may be lower or higher. Past performance is no guarantee of future results. Investment return and principal value of an investment will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. All investments involve risks, including possible loss of principal. Please visit weitzinvestments.com for the most recent month-end performance.

As of 9/30/2020, the 30-day subsidized and unsubsidized yields were as follows: Core Plus Income Fund 2.70% and 2.33%, and Short Duration Income Fund 1.72% and 1.56%, respectively.

Effective 12/16/2016, the Ultra Short Government Fund revised its principal investment strategies. Prior to that date, the Fund operated as a "government money market fund" and maintained a stable net asset value of $1.00 per share. Performance prior to 12/16/2016 reflects the Fund's prior principal investment strategies and may not be indicative of future performance results.

Effective 12/16/2016, the Short Duration Income Fund revised its principal investment strategies. Since that time the Fund has generally maintained an average effective duration between one to three and a half years. Prior to that date, the Fund maintained a dollar–weighted average maturity of between two to five years. Performance prior to 12/16/2016 reflects the Fund's prior principal investment strategies and may not be indicative of future performance results.

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

Definitions: Investment Grade Bonds are those securities rated at least BBB- by one or more credit ratings agencies. **Yield to Maturity (YTM):** the total return anticipated on a bond portfolio if the bonds are held to maturity. **Yield to Worst (YTW):** the lowest potential yield (most conservative yield) that can be received on a bond without the issuer actually defaulting. YTW is calculated by using worst-case scenario provisions, including prepayments, calls and sinking funds. Furthermore, YTW is a forward-looking estimate that ignores capital gains.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com.

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