Quality at a Discount

***Aaron Burr:** You got more than you gave*
***Alexander Hamilton:** And I wanted what I got*
-Hamilton, 2015

At a glance, the concept of quality investing seems pretty clear cut. Quality is synonymous with "good." In practically all aspects of life, everybody wants quality, right? Who would wittingly place their financial goals in the hands of *low-quality* investments?

But of course, the reality is a bit more nuanced.

For example, let's look at another area where quality is a major consideration – car buying. If a car shopper considered **quality** and nothing else, they'd head straight for the Bugatti dealership. Perhaps they would ask to test drive the $3.5 million 1500-hp CHIRON PUR SPORT. After all, combined with world-class handling and agility, the W16 engine can take the PUR SPORT from 0 to 60 in about 2.3 seconds, with a maximum speed of 217 mph. It tops out at 6,900 rpm, it features technology to improve airflow, downforce, and cooling, has magnesium wheels with carbon blades, and features top-of-the-line construction throughout. And as long as you keep up with annual maintenance, you're highly unlikely to end up broken down on the side of the road. Talk about quality!

On the other hand, a car buyer looking at *price* alone might head to the nearest used car lot and ask for the cheapest vehicle in the inventory. They'd likely be taken to see the proverbial 'beater with a heater' with 200k+ miles on the odometer and more than a few underlying issues. It might roll off the lot, but it will have the driver saying a little prayer every time they turn the ignition, and it may very well end up having a major engine malfunction within a year, leaving you stranded on the side of the highway.

The fact is, when it comes to investing, quality is an important consideration, but the price you pay is still a crucial factor in successful investing. And just because something is cheap doesn't mean you should buy it.

At Weitz, we want our investment decisions to get as close as possible to capturing the "best of both worlds" in terms of quality and price. That's why we call our approach **Quality at a Discount (QuaD)**. It's our goal to buy high-quality businesses for a price that we believe is less than what the business is worth – and those that can grow in value over time. In other words, we *might* buy the 'Bugattis' of companies – but only IF we can get a significant enough discount off the 'sticker price.' But in the investment world, there's no AAA to call when you break down, so the 'beaters with a heater' won't find a place in our portfolios.

Quality vs. Value vs. Growth

At Weitz, we've long been known as value investors. And really, that's what we are. But today there are a lot of misconceptions about what value investing means.

Through the 1980s and 1990s, investors were typically grouped into one of two categories – value investors and growth investors. These terms linger on, but their meanings have morphed over the years. It's our view that growth and value are not opposites of one another – they're two sides of the same coin. Growth is always a component of the business value of a company, and to us, there has never been a doubt that a company with fast-growing earnings has more value than one that's not growing at all.

Our Quality at a Discount approach means we're trying to buy above-average to excellent businesses at less than what we've calculated them to be worth. Sometimes that means buying stocks traditionally thought of as value, other times we buy businesses labeled as growth investments. Because of our framework, our investments run the gamut of value and growth. As a result, third-party research providers may, at different times, categorize our funds as value, growth, or blend.

For a specific example, let's look at Google. We first bought shares in the company in the late 2000's. At the time, Google was selling for about 17 times earnings, which was a bit high for our comfort level. But when we factored in the company's historic 20% annual earnings growth and consistent investment in new platforms – we felt the company had a bright future (and it has exceeded our expectations). If we looked only at traditional 'value' metrics (like low P/E ratio), we never would have come within 100 yards of the search engine giant. But when you boil it down, "quality" is just another way to define "value." There's a misconception that value investing means buying only cheap things. But we believe that buying high-quality assets for less-than-premium prices creates a pathway to a better end result.

We're not overly concerned about determining what's a value stock or what's a growth stock. Ultimately, we believe our framework of identifying high-quality companies and buying them at a discount helps differentiate us from the rest of the market and provides us with opportunities to help our shareholders build wealth. That's what we've been doing since 1983, and we think it continues to be an approach that stands the test of time.

What is Quality?

Now, determining the quality of a company is a lot more complicated than figuring out the quality of a car. That's where the Weitz Quality Score Matrix comes into play. Our proprietary quality scoring is an important part of our analysis process, providing us with a roadmap of the type of companies we want to own, if we can see ourselves owning them for a long time, and how we value them. Quality scores range from one to seven, with one being the highest-quality businesses. We measure them based on six factors:

- **Competitive position**
  - Businesses with a strong competitive position are well established with a wide 'moat' within its industry.
- **Return on invested capital (ROIC)/Capital efficiency**
  - This is the driver of business value creation over time. Companies with strong capital efficiency deliver strong returns on capital and invest incremental capital at high rates.
- **Reinvestment runway**
  - How much capital a company can redeploy at high rates of return.
- **Cash flow consistency**
  - Companies with a durable cash flow stream are generally worth more than those with cash flow volatility.
- **Management team**
  - We want to partner with managers that treat us as owners of the business. Strong managers are equal parts investors and operators. They have the ability to generate cash flow, and once that cash flow is created, they reinvest it wisely on our behalf.
- **Financial leverage**
  - While some businesses can support a moderate amount of leverage to help enhance returns, leverage can be taken too far. We realize the risk of "getting out over your skis" in terms of being over-leveraged.

In the table below, you can see what it takes for companies to earn a particular quality score.

WEITZ QUALITY SCORE MATRIX

Company Characteristics	Quality Scores 1-2	Quality Scores 3-4	Quality Scores 5-7
Competitive Position	Highly entrenched	Healthy	Little clear edge
ROIC/Capital Efficiency	Attractive	Above average	Lower/poor trend
Reinvestment Runway	Excellent	Visible	Limited
Cash Flow Consistency	Top quintile	Above average	Cyclical/unstable
Management Team	Top-tier	Capable	Undistinguished
Financial Leverage	Low	Reasonable	High-to-onerous

As you might expect, we are mostly interested in the companies with a quality score (QS) of 1 or 2. But that's not to say we're **only** interested in buying the most pristine, best-of-breed businesses in each category. We also buy companies with a QS of 3 to 4, especially when we expect improvement in one or more QS categories. These businesses have acceptable quality characteristics, can frequently be purchased at a discount to our estimate of intrinsic value, and are often overlooked by investors.

As for the businesses with a quality score of 5-7, we're usually not interested in those (we don't buy things just because they're cheap).

At a Discount

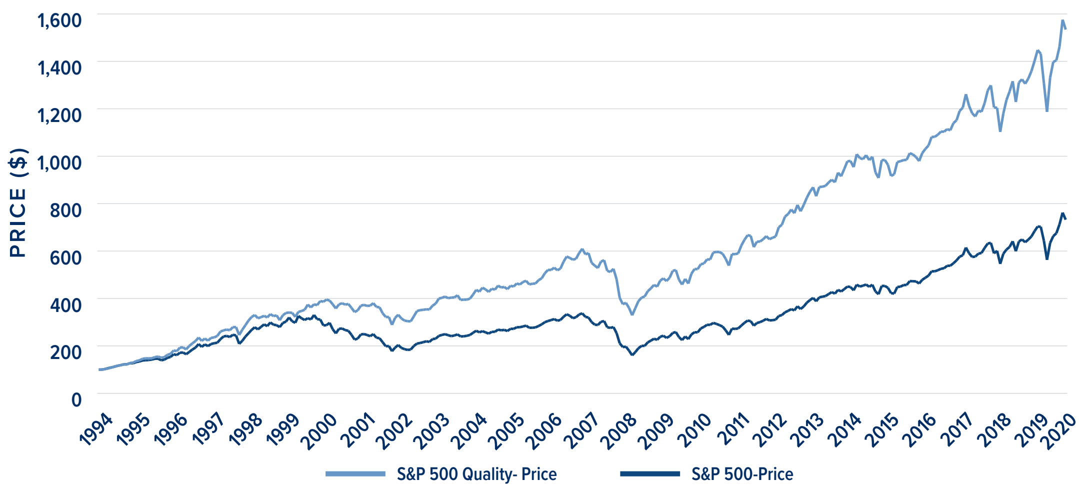
Alright, so now that we've established quality, how do we determine what constitutes a reasonable price? Through every step of our investment process, we're looking at the present reality of the businesses we own, or want to own, and comparing today's stock price to our current estimation of business value. For most businesses, we estimate what they are worth by using a discounted cash flow (DCF) analysis, which is a method of estimating the value of a business based on its present value of future cash flows. This value is calculated by using a discount rate; at Weitz, we currently use an equity discount rate of 9%. This is a pretty stringent rate, especially in the current interest rate environment. But as long-term investors, we think that it is prudent over multiple business cycles.

In addition to DCF analysis, we also perform scenario analysis to capture a range of estimates of what each business is likely to do over the next five years. We start with what we believe is the most likely scenario – or the base case – which we determine by calculating what we think a private buyer would pay to own the whole company. It is from our base case that we require a stock price discount before we'll put cash to work. Next, we run a "down case" scenario. The point here is to be imaginative on the downside – what are the roadblocks that might emerge and what is the probability of them happening? Finally, we run a "high case." Even though we don't base decisions on the high case results, it's important to think about the scenarios that could go better than we expect. High-quality businesses with strong moats and capable managers often find ways to add value; they make strategic moves when opportunity strikes.

Our stringent process and constant vigilance give us the confidence to own portfolios that are concentrated in our best high-quality ideas.

"Sleep Well at Night"

Academic research would suggest that high-quality investments tend to offer a level of outperformance versus the broad market. Historically, having a strong competitive position, high capital efficiency, reinvestment runway, consistent cash flow, and competent management have resulted in higher profitability, stronger balance sheets, and consistent earnings growth. For example, even though our assessment of business quality may not equate to the S&P 500 Quality Index, notice the Quality index has provided a level of long-term outperformance compared to the broad S&P 500.



In addition to strong performance, higher-quality companies may offer more stability. These types of businesses may be better positioned to weather market corrections and benefit from a cushion to corrections. This can result in a somewhat smoother ride for investors. It's difficult to put a price on these kinds of sleep-well-at-night stocks, but going back to our initial analogy, it's the equivalent of feeling confident your car will start in the morning and not leave you stranded on the side of the interstate.

While much of what we do still revolves around the traditional notions of value investing, we believe Quality at a Discount is a more accurate way to describe our approach. We don't want to be hemmed-in by the boundaries or limitations set by the standard definitions of value and growth. In the end – investing is about getting more than you gave, and we believe Quality at a Discount investing is the pathway to achieving that goal.

IMPORTANT DISCLOSURES

As of 09/30/2020, Alphabet, Inc.-Class C (GOOG) constituted a portion of the net assets of the following Weitz Funds: Balanced Fund (1.7%), Partners III Opportunity Fund (4.5%), Partners Value Fund (4.8%), Value Fund (5.4%),

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 12/22/2020, they 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.

All investments are subject to market risk, including the possible loss of principal. Holdings are subject to change and may not be representative of the Fund's current or future investments.

Investors should consider carefully the investment objectives, risks, and charges and expenses of a fund before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com or from a financial advisor. Please read the prospectus carefully before investing.

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