

Happy New Year! The Fed was the Grinch that stole 2022, and we're happy to turn the page on the calendar.

The positive and negative crosscurrents of the past three years have left investors unsettled. Covid, post-Covid, Russia-Ukraine, China, and the dominating economic headline of the past year – inflation. The Fed began its anti-inflation battle in early 2022. It methodically raised short-term interest rates (the federal funds rate) to a range of 4.25-4.50% at year end, with further increases promised. The absolute level of rates is not high by historical standards, but the abrupt reversal after twelve years of near-zero rates was a shock to the system for many.

The domestic economy is slowing, and though the impact on most industries has been moderate so far, fears that the Fed will overdo it and cause a recession have led investors to “sell first and ask questions later.” Prices of many goods and services have begun to come down, and some believe/hope that the interest rate tightening will end soon. But the Fed got so much criticism for being too accommodative for too long – being “asleep at the switch” – that we would guess Chairman Powell & Co. will err on the side of caution. They will want to be sure that inflation has been tamed.

The 2022 scoreboard is written in red ink. The S&P 500 peaked on the first trading day of 2022, and it ended down 18.11%. Bonds were not a safe haven, as simple arithmetic – “yields up = prices down” – dictated negative returns.

2022 may have been the “adventure” we predicted a year ago, but it was not much fun.

What's Next?

The Fed expects to raise rates a few more notches and to hold them there for most or all of 2023. They may or may not achieve a “soft landing” (bringing down inflation *without* entering a recession) for the economy. All companies are cyclical to some degree, but we believe good businesses with sound balance sheets will survive without permanent damage. The tightening cycle will end, and the economy will eventually be okay.

A longer-term issue relates to the general valuation level of the stock market. Twelve years of extremely low interest rates and extraordinary amounts of printed money injected into capital markets via monetary (quantitative easing – QE) and fiscal (Covid relief) policies left investors with limited alternatives to stocks. Lower interest rates seemed to justify higher valuations, and investors gradually got used to very high price-to-earnings (P/E) ratios.

We assume that interest rates will settle into a more normal range (i.e., well above zero) after the Fed returns to a more “neutral” policy. If so, we expect stock valuations will also settle back to more normal levels – perhaps mid-teens P/Es for the S&P 500 vs. low-twenties at the recent market peak.



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VALUE MATTERS: WHAT TO DO WHEN OTHERS ARE FEARFUL

This scenario would not be tragic for investors. A considerable amount of the valuation “air” has already come out of stock prices over the past year. Companies with strong earnings growth should be able to overcome P/E compression. It just means that the investment tailwind of the past decade-plus will be missing.

Over the years, investor optimism ebbs and flows. Capital moves among investment alternatives. The U.S. and global economies are usually growing, and corporate earnings go up most years. The long-term trend in stock prices is generally *up*. Occasionally, something triggers a correction, leading to a market decline of 10% or so. Sometimes the correction goes further, and at the -20% mark is labeled a bear market. Bears occur more often than one might think, most recently in 2018, 2020, and 2022.

What gives us confidence in the long-term success of great businesses is the fact that people and companies **adapt** to adverse or changing conditions. Wars, pestilence, famine, recessions... and even Fed policies can cause headaches for businesses and investors, but these situations are not static. Consumers get used to higher prices and interest rates, and then respond by adjusting buying behavior. Companies change input sourcing, product mix, pricing and marketing. While policymakers and regulators can be slow and rigid, individuals and businesses are flexible. People generally find a way.

Our overall portfolio returns were negative in 2022, but nearly all of our companies managed well through adversity. A number of stalwarts bucked the trend and showed gains or very small losses. Others did fine business-wise, but still suffered market-like declines. A few were standout percentage losers. Our portfolio managers’ individual fund commentaries (see our website) provide more detail on the “impact players” for each fund, but we’ll give a little extra color on a couple apparent “clunkers” that we feel very good about. Each was down about 50% in 2022 and down from its pre-Covid high, but our estimate of their business values **grew** during the last three years of Covid disruption and interest rate hikes.

CarMax (KMX) is the largest U.S. chain of independent used car retailers (240 stores and growing). Covid disruptions of the new car market caused a spike in used car prices in 2021, which in turn led to a spike in KMX earnings per share (EPS). Then in 2022, prices softened, and a shortage of used cars that fit KMX’s criteria caused earnings to drop sharply. The stock traded from a 2020 Covid panic low of \$44 to a 2021 high of \$155 and then back to a 2022 low of \$55. We trimmed positions in the upper end of the range, but with a calendar year decline of 54%, KMX was a detractor from our results. We think the market overreacted to KMX’s 2022 EPS decline and that the company’s investment thesis is very much intact. KMX EPS rose steadily over the 10+ years prior to Covid, and the fact that used car market distortions interrupted its earnings growth streak should have no bearing on its growth over the next 5-10 years.

CarMax’s business model is solid, the customer experience is good, they have national reach for sourcing cars, their online offering is strong, their profit margins are reasonable and sustainable; and they are taking share of a growing market. Despite a challenging backdrop, we applaud management’s decision to continue (albeit at a slower pace) investments in initiatives that will drive future growth, rather than simply cutting expenses to “defend earnings.” This adds to our confidence that the 3–5-year outlook for the stock is very good, regardless of Fed tightening or general market trends.

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Liberty Broadband (LBRD) is a long-time holding that we have written about before. The stock is down over 50% from its 2021 high and sells at a substantial discount to our estimate of its intrinsic business value. LBRD is a holding company whose primary asset is a 26% interest in Charter Communications (CHTR).

Charter is the second-largest domestic cable company. Its primary growth engines are providing broadband services and reselling Verizon wireless service. It generates lots of excess cash which it uses to expand its subscriber base and to buy back its own shares. The stock has been weak as investors have worried about competitive threats from fixed wireless broadband and the company's pace of buybacks. CHTR stock was arguably ahead of itself at over \$800 per share in 2021, but it seems clearly undervalued at \$339 as of the end of 2022.

The LBRD holding company is a vehicle for buying CHTR shares at a discount. It is controlled by John Malone, cable legend and investment winner, alongside the company's president and CEO Greg Maffei. We have invested in cable/broadband companies for over 30 years, often via Liberty entities. Sometimes valuable assets can be "trapped" inside a holding company, but Malone and Maffei are masters of extracting full value from complex corporate structures. With patience, we think LBRD's value will be realized.

Outlook

We're in a bear market and "stuff happens" in bear markets. Small disappointments trigger fears of much worse. Nervous or over-levered investors sell to ease their anxieties or to meet margin calls. Speculations of all kinds – SPACs and "meme" stocks; other "asset classes" like crypto and NFTs – tend to lose their appeal.

Eventually the selling dries up. Value-oriented investors and strategic buyers come for the bargains. These are investors who are focused on the value of the underlying businesses. Usually, a little buying by these bargain hunters restores confidence and, for no apparent reason, stocks bounce off the bottom. Bear markets tend to end when least expected.

Thanks again to our shareholders for bearing with us in these volatile times. We appreciate it.

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IMPORTANT DISCLOSURES

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As of 12/31/2022, the following portfolio company constituted a portion of the net assets of Balanced Fund, Hickory Fund, Partners III Opportunity Fund, Partners Value Fund, and Value Fund as follows:

- CarMax, Inc.: 0.0%, 4.3%, 4.3%, 2.6%, and 2.3%.
- Charter Communications, Inc.: 0.8%, 0.0%, 0.0%, 0.0%, and 0.0%.
- Liberty Broadband Corp.: 0.0%, 6.6%, 5.0%, 3.4%, and 3.7%.
- Verizon Communications, Inc.: 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%.

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 Funds before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com.

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