

NEWSLETTER
FIRST QUARTER 2023



Guided by value.



KOVITZ

MARKET INSIGHTS
FIRST QUARTER 2023

*You're either runnin' round in circles or you're runnin' out of time
Everybody somewhere either 12, 3, 6 or 9
The times they are a-changin'
We're here to turn the page
It's the same old story but it's told a different way*

| **“THE MORE THINGS CHANGE”, BON JOVI**

Time. You can't touch it. You can't make more of it. You certainly can't buy it. It seems to slow down or speed up according to one's perspective. A day for a parent with a newborn baby can seem like a month. But looking back on those early years as the child grows up, they seem to have gone by in an instant.

The passage of time brings change and it can seem like the pace of change is always speeding up. Technological change, the speed of information, the speed at which markets digest news . . . it can seem like everything, everywhere, is changing all at once. Consistent with that sentiment, arguably the most impactful event in financial markets in the first quarter of 2023 – the failure of Silicon Valley Bank (SVB) – was notable for how rapidly it happened.

After markets closed on March 8th, the bank announced it would need to raise capital to bolster liquidity as bonds held on the bank's balance sheet had lost value (on paper) as interest rates advanced throughout the prior year. With customer deposits highly concentrated among businesses and individuals operating in early-stage tech companies and the vast majority of those deposits above the FDIC's \$250,000 insurance limit, things went from bad to worse quickly when a small number of venture capital firms who had influence over many of SVB's customers called for their companies to withdraw deposits from the bank. By the morning of March 10th, just 40 hours after the initial news broke, SVB could not meet customer requests for withdrawals and regulators took over the bank.

Despite a number of characteristics that made Silicon Valley Bank's situation especially precarious, their troubles touched off what can only be described as a panic with regard to regional banks. The SPDR Regional Banking ETF¹ fell 23% over the course of three days, and the Federal Reserve announced a new emergency lending facility that could be used to shore up short-term liquidity for institutions in need.

Perhaps surprisingly, the rest of the stock market responded with a collective yawn to the hullabaloo engulfing the banking sector. From the close prior to SVB's attempted capital raise through the end of the quarter, the stock market² actually gained 3% – including a -7.5% drag from the Financials sector. For the quarter, stocks gained 7.5% seemingly due to the growing view – supported by moderating inflation and given a boost from the sell-off in regional banks – that the Federal Reserve would soon halt or reverse course on their yearlong rate-hiking cycle. This was best exemplified by the entire Treasury yield curve from 2-yr through 10-yr declining about 0.4% in parallel fashion despite the Fed continuing to raise the overnight fed funds rate by a total of 0.5% during the quarter, including a quarter-point increase after the SVB failure.

While the speed of the events surrounding Silicon Valley Bank's failure – compounded by the volume and frequency of commentators ghoulishly predicting a repeat of the 2008 Global Financial Crisis – may have been jarring, the ever-shrinking timescale at which events unfold is no different than in the past. Past advancements in the speed of information that we take for granted in modern times were just as marvelous to someone a hundred or more years ago as cutting-edge advancements in communications, AI, or semiconductors are today.

Consider that up until 1820³, when steam-powered locomotives began hauling people and materials on a road covered with iron rails, neither a person nor information could travel any faster than a medieval knight, a soldier of the Roman Empire, or the Ancient Greeks.

¹ The SPDR Regional Banking ETF trades under the symbol “KRE” and holds the shares of 144 companies classified as regional banks according to GICS, the Global Industry Classification System.

² All references to “stocks”, “the market”, or “the stock market” are represented by the S&P 500 Index and its total return, unless otherwise specified.

³ The date of the first railroad is hotly debated amongst train aficionados. This is the first year in which a steam locomotive was used in commercial operation.



As late as the Civil War, before the transcontinental railroad was built, it could take several months to get from one side of the United States to the other and up to six months was not unusual. To get from New York to San Francisco, there were three options: One, make your way to Chicago or St. Louis, travel by covered wagon across the Great Plains, then through the Rockies, and finally over the Sierra Nevada range. Two, sail to Central America, walk through the mosquito-infested jungle across the isthmus of Panama, and then catch a ship in the Pacific Ocean, not knowing when such a ship would arrive or depart. Or, three, sail all the way around the tip of South America and back up to California, a trip of approximately 13,000 miles.

Imagine the wonder of an early settler in the new state of California in the 1850s who endured such a journey and then, by the 1870s, could return to New York by train in a matter of days. This traveler could also let whoever they were going to visit know of their impending arrival via a telegram in an instant.

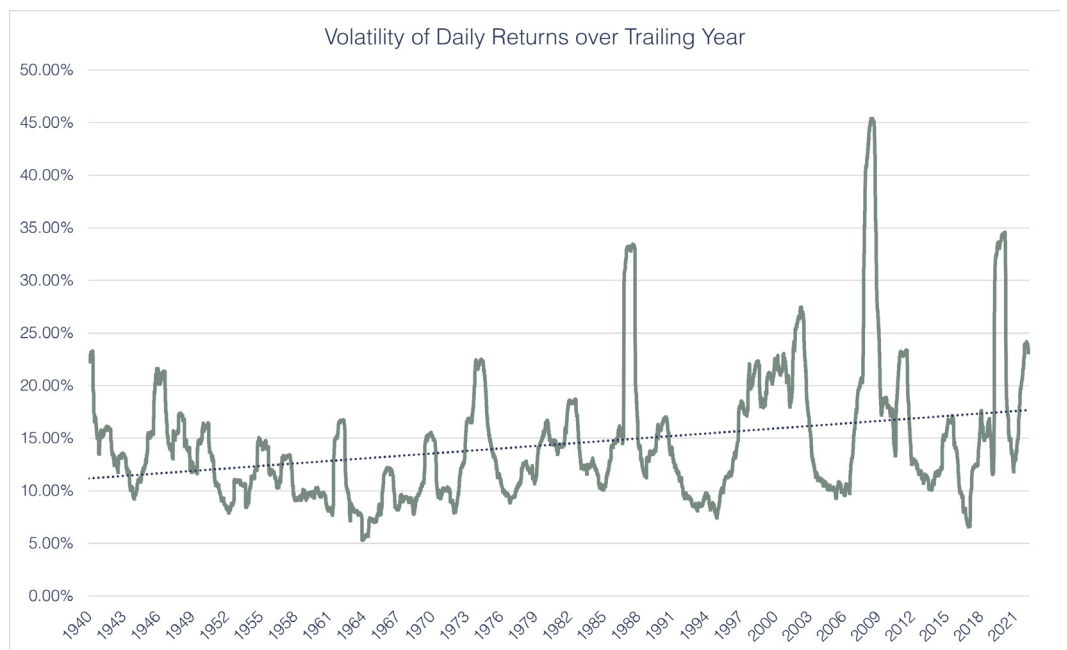
In fact, prior to the railroads being built in the US, it took so long to do anything that most Americans weren't concerned with time at all. It was light or it was dark. That's what mattered. Travel back before the Civil War and ask a stranger on the street "What time is it?" and you would probably get a funny look instead of an answer. Even if you got an answer, that answer was highly subjective. What time it was in one town might not line up with the time used by another town. What difference did it make if the clocks in Chicago and Milwaukee lined up to the minute if it took a couple days (on a good horse with only necessary stops) to travel the relatively short 90 miles between the two cities?

While the pace of innovation always seems like it is speeding up (it is!), that has always been the case. Human knowledge and technological change have consistently advanced over time. Married to a market economy, this progress has consistently produced a return on capital employed. And this return on capital employed by businesses large and small has led to growing wealth of countries and their citizens. A relevant representation of this phenomenon is the extraordinary growth in the market capitalization of US and global stock markets over time. Even during times of particularly disruptive change, stocks, when viewed over a reasonably long time horizon, have been the best way for an individual with a similarly long time horizon to participate in this creation of wealth.

More information, more data, and more news, all faster and faster, has led to an arms race among certain types of financial firms. One side effect of this arms race is the trend towards increasing daily volatility in the stock market over the past 70 years. Even more apparent is the increase in the number and magnitude of periods of extreme volatility, such as that experienced by regional banks in March.

Figure 1:
Volatility of Daily Returns over
Trailing Year

SOURCE: Kovitz using data from
Bloomberg Finance L.P.





Importantly, just as it's true that people, information, and ideas travel faster today than they did 70 years ago, it's also just as true today as it was then that the daily movements of markets matter little to a long-term investor. Today's "Breaking News" is tomorrow's forgotten story. Today's world-changing technology will be taken for granted a decade from now.

Yet, an owner of a diversified portfolio of prudently managed businesses generating returns on their capital as they push progress forward year after year will benefit handsomely over time – as long as this process is not unnecessarily interrupted by the twin human follies of fear and short-term thinking.

Avoiding the temptation to act rashly amid the seemingly ever-increasing noise and daily volatility in financial markets won't always be easy, but the below chart should offer some solace. Over the past century, despite the seemingly ever-increasing noise and daily volatility in financial markets and a litany of financial crises, wars, amazing technological achievements, and everything in between, stocks have generated satisfactory returns over any 30-year period within that timeframe.

Focusing on short-term volatility will only have you running around in circles.

Figure 2:
Trailing 30-Year Annualized Returns

SOURCE: Kovitz using data from Bloomberg Finance L.P.



KOVITZ NEWS

At the end of the quarter, Kovitz closed on two exciting new strategic acquisitions that have further deepened our alternative investments offerings and brought on a great addition to our wealth management group.

Origin Investments – Based in Chicago, Origin is a multi-family real estate private funds manager currently offering four distinct strategies positioned to thrive across a full market cycle.

Newman Schimel Wealth Management – Based in Deerfield, IL, Newman Schimel brings to Kovitz a team of highly experienced wealth advisory professionals that serve high-net-worth and ultra-high-net-worth clients.

Kovitz is dedicated to growing through strategic partnerships with like-minded businesses that enhance our organization's value proposition and service capabilities to clients.



KOVITZ

CORE EQUITY COMMENTARY
FIRST QUARTER 2023

MARKET SUMMARY

During the first quarter of 2023, the Kovitz Equity Composite¹ (the “Composite”) increased by 9.14%, net of fees. By way of comparison, the S&P 500 was up 7.50% while the Russell 1000 Value Index rose 1.01% for the same period.

While the quarter ended with a strong return, intra-quarter moves were more of a roller coaster ride. Coming off a rough December where equities fell across the board, investors were heartened by a favorable inflation report to start the new year, which created some hope that the Federal Reserve would be able to slow its pace of interest rate increases. There also seemed to be an expectation that the peak terminal rate – the rate at which the Fed stops tightening – could turn out to be lower than feared. Stocks responded positively with a mid-single digit return for January.

However, as February rolled around, two new critical data points appeared to rain on the disinflation narrative. First came the blockbuster January jobs report, which showed over 500,000 new jobs created, more than doubling expectations. This was followed by a hotter-than-expected Consumer Price Index (CPI) reading that included upward revisions to the prior month's data. These stronger-than-anticipated data points caused many market participants to back away from expectations that major central banks around the globe were nearing an end to monetary tightening and were now likely to stay hawkish for the coming months. Bets on cooling inflation and lower rates now seemed misplaced and investors hit the sell button. From stocks to fixed income and commodities, just about everything fell in a reversal of January's spirited rally.

As if that wasn't enough for investors to dwell on, a banking crisis flared up in early March. The epicenter of the trouble revolved around three niche deposit institutions, each with similar, but unique characteristics in contrast to a typical bank. Each had an undiversified deposit base (predominantly technology-related companies) and a high percentage of uninsured deposits (amounts over the \$250,000 FDIC insurance limit). Each of these banks also purchased longer-duration bonds when interest rates were much lower and suffered large mark-to-market losses as interest rose swiftly. From there, fear spread to other deposit institutions with even the slightest similarities to the original three banks. While there have been some spillover effects to certain regional banks, the issue seems well-contained at the moment and does not appear to be a systemic indictment on the state of the banking industry. The industry is much better capitalized than it was before the Great Financial Crisis and with much higher quality loans and assets on bank balance sheets. As such, this “crisis” was really one of fear, and not facts.

However, with the Federal Reserve jacking up rates to slow the economy down to deal with inflation and the resulting tightening of financial conditions, there were bound to be some cracks that emerged in the financial system. Fortunately, with lots of practice from navigating the 2008 Global Financial Crisis and its aftermath, the Federal Reserve, Treasury Department, and other regulators have become somewhat adept at dealing with fissures in the banking system, implementing creative solutions, and drumming up support of the larger banks to take part in those solutions.

Although catastrophe appears to have been avoided, issues stemming from the banking flare-up are likely to include higher borrowing costs and tighter lending standards, which would likely slow economic activity. Incidentally, this may also take some of the burden of slowing inflation off the shoulders of the Federal Reserve, who may now be closer to pausing future interest rate increases as this slowing, coupled with rate increases so far, may be just enough to bring inflation down further toward the Federal Reserve's target.

The clearest takeaway from the past few weeks is that many of the financial world's assumptions about how the rest of 2023 would play out have been upended. While unfortunate for those with time horizons less than one year, uncertainty such as this can create opportunity for those who think and act with long-term conviction. As described below in the “Portfolio Activity” section, we were able to make several adjustments that we believe improved the quality and prospective growth of the portfolio.

¹The returns for the equity portion of your individual account will differ somewhat from the Composite due to variations in account holdings, cash position, and other client-specific circumstances.



APROPPOS OF NOTHING

Among all the investor angst suffered during the quarter, Bloomberg Markets points out in a recent article that the biggest fear for some of the largest institutional money managers is not the Fed, interest rates, or geopolitical tension, but in missing the next market rally. Go figure.

COMPOUNDERS

The ideal business is one that earns very high returns on capital and that keeps using capital at those high returns. That becomes a compounding machine.

| WARREN BUFFETT

In the past, we have talked about the marvels of compound interest, which Albert Einstein referred to as the eighth wonder of the world. Typically, compounding relates to investment returns where earning “interest on interest” can lead to extraordinary results over time. However, the concept also applies to a company that, through its possession of a durable competitive advantage, can grow exponentially by reinvesting its earnings back into the business and earn the same high returns on that capital year after year. We refer to these companies as “compounders” and identifying such companies and purchasing them at fair prices is at the core of our investment process.

We admit this may be conceptually abstract. The best metaphor we know for visualizing compounding is the snowball effect. Imagine a small snowball that is pushed down a snow-covered hill. As it rolls, it continuously picks up snow and, by the time it reaches the bottom of the hill, it is a giant snow boulder. The original, small snowball *compounds* during its travel down the hill. The bigger it gets, the more snow it packs on with each revolution and ends up being multiples of its original size.

Compounders have many of the fundamental attributes we covet. Besides being a high-quality franchise with high returns on capital employed, compounders generally possess dominant and durable intangible assets (i.e., brand strength), pricing power, high gross margins, and minimal financial leverage. Another characteristic of these businesses is a seasoned management team that has demonstrated a history of disciplined capital allocation and efficient use of free cash flow.

We believe Visa (V), a current portfolio holding, is one the best examples of a compounder we have come across. Visa’s network acts as a toll collector on global money movement in exchange for enabling secure and near frictionless financial transaction capabilities. High returns on capital, nearly 70% EBITDA margins, and sustained secular tailwinds (i.e., cash to credit) have made it one of the great compounders of the modern era. Since its 2008 IPO, total shareholder returns have grown roughly 23% per, on average, and its market capitalization stands at roughly \$450B..

Visa’s business model is a classic example of the “network effect”. The network effect is a powerful competitive advantage and describes any situation in which the value of a product, service, or platform depends on or “grows with” the number of buyers, sellers, or users who utilize it. In the case of Visa, its network effect has grown over time as more Visa credit card holders led to more merchants accepting credit, which led to more merchants signing on to Visa’s network, which increased the value to card holders, and so on. This type of positive feedback loop is a hallmark of the strong network effect.

Each day that has passed since its introduction in 1958 (via a predecessor company), Visa’s network continues to grow. This in turn makes it harder and harder to displace and creates a barrier to entry from new competition. Keeping competitors at bay is extremely important in being able to hold your pricing and margin structure. Today, Visa connects 3.5B card credentials (consumers) and 13,000 issuers (banks) on one side, and 70M+ merchants and 3,000 acquirers (merchant’s bank who process the transaction) on the other. The scale and ubiquity of their two-sided network is unparalleled around the world (ex-China) and allows them tremendous power with each participant.

It’s also important to understand what Visa is not. It is often wrongly characterized as a financial institution. Visa is not a bank. Visa does not issue credit/debit cards (despite the logo on your card). Visa does not take on any balance sheet risk. Rather, Visa is a digital infrastructure and technology business. Visa’s propriety VisaNet network serves as both the heart and gatekeeper of global commerce where 15 cents of every \$1 spent offline, and 43 cents of every \$1 spent online flows through their rails.

While the global macroeconomic and geopolitical outlook remain in a state of considerable flux, it’s imperative that we look through these short-term issues and focus on company fundamentals, which will be around much longer than the current conditions.



Focusing our research on companies who possess compounder-like characteristics that can be purchased at reasonable valuations is the best way we know to bridge this timing gap.

PERFORMANCE SUMMARY

The chart below summarizes annualized performance over various standard time periods ending March 31, 2023 and cumulative performance results from January 1, 1997 through March 31, 2023 for the Composite.

KOVITZ CORE EQUITY COMPOSITE² ANNUALIZED AND CUMULATIVE EQUITY PERFORMANCE (NET OF FEES)

	Average Annual Total Returns							Cumulative
	Year to Date	1 Year	3 Year	5 Year	10 Year	20 Year	Since Inception	Since Inception (1/1/97)
Core Equity Composite	9.14%	-11.25%	20.01%	7.88%	8.77%	9.26%	10.01%	1,122%

The table below lists the results for the same time periods as above for the S&P 500 and many of the other benchmarks widely held as investments via a style-box approach.

OTHER MARKET INDICES ANNUALIZED AND CUMULATIVE EQUITY PERFORMANCE

	Average Annual Total Returns							Cumulative
	Year to Date	1 Year	3 Year	5 Year	10 Year	20 Year	Since Inception	Since Inception (1/1/97)
S&P 500	7.50%	-7.73%	18.60%	11.19%	12.24%	10.37%	8.74%	803%
Large Cap Value (Russell 1000 Value)	1.01%	-5.91%	17.93%	7.50%	9.13%	9.15%	8.17%	685%
Small Cap Equity (Russell 2000)	2.73%	-11.63%	17.48%	4.67%	8.01%	9.73%	7.73%	607%
International Developed (MSCI EAFE)	8.65%	-0.79%	13.65%	4.15%	5.59%	7.91%	5.27%	285%
International Emerging (MSCI EM)	3.97%	-10.39%	8.17%	-0.55%	2.38%	9.62%	5.46%	304%
Gold (S&P Gold)	8.11%	0.67%	5.93%	7.13%	1.31%	8.33%	6.12%	376%
Commodities (S&P GSCI)	-5.91%	-20.74%	30.97%	4.84%	-1.31%	4.62%	3.77%	164%

Source: Bloomberg Finance, L.P.

²The returns for the equity portion of your individual account will differ somewhat from the Composite due to variations in account holdings, cash position, and other client-specific circumstances. Please refer to the last page for a complete GIPS compliant presentation, along with important disclosures.



PORTFOLIO ACTIVITY

Much of last quarter's research effort focused on re-underwriting most positions in the portfolio with the aim towards measuring and testing our conviction in each. We scrutinized our assumptions behind each investment with a single goal – to reduce or eliminate lower conviction positions and increasingly concentrate our capital in those investments where we had the greatest conviction and a narrower range of outcomes (particularly to the downside).

Based on these exercises, we made several modifications to the portfolio that we believe improve the quality and prospective growth of the portfolio.

We initiated one position during the quarter.

PPG INDUSTRIES (PPG)

PPG is the second largest coatings company in the world with #1 or #2 positions in six of its eight end markets. Those end markets are diverse, ranging from branded house paint to sophisticated aerospace and electric automobile battery coatings, where PPG is a technology leader. We believe that a good proportion of end markets are poised to grow ahead of GDP in the near-to-medium term as vehicle and aerospace production continue to recover, China emerges from COVID lockdowns, electric vehicle penetration continues to increase, and infrastructure stimulus and supply chain near-shoring continue. In recent years there has been an adverse raw material cost cycle that has depressed PPG's earnings, but evidence points to imminent relief. Historically, this has been a good time to own coatings companies as their price increases tend to stick, but costs fall. PPG's balance sheet is also strong, providing the opportunity for accretive capital allocation going forward.

With solid growth prospects, cost relief, continued good capital allocation, and a durable competitive position, we think PPG is an attractive investment at this juncture.

We increased the weightings of several existing positions, including the following.

AMERICAN EXPRESS (AXP)

American Express has been a long-standing holding. Throughout this time, we have seen their moat attacked multiple times, major partnerships end (e.g. Costco), a global stoppage of travel, which drives a significant portion of card spending and is a significant reward used to attract or retain cardholders, and consistent fears that they would not be able to reach the newly affluent generations of Millennials and Gen Z. Not only has American Express survived all of these events, but the company and brand have thrived as the world emerged from the COVID era.

American Express sports leading card growth with the aforementioned generations, a revamped, diversified marketing and rewards program, and more acceptance across the globe than ever before. Importantly, they have maintained industry-leading returns on equity among financial company peers. Trading at a below-market multiple despite being a substantially better business than the average S&P company, we find the shares quite attractive. Should a recession come to pass, we believe their position is substantially improved and that a sustained hit to earnings is unlikely.

JACOBS (J)

We re-entered our Jacobs position last year as noise around near-term earnings created an opportunity for us to rebuild a stake as our estimates of fair value were moving higher. We believe Jacobs is in a sound position to re-accelerate organic revenue growth given a solid backlog of higher-margin projects. Project funding from the 2021 Infrastructure Investment and Jobs Act, capital expenditures related to domestic semiconductor supply, and capacity additions for biotechnology are all trends providing tailwinds to Jacobs' businesses.

KEYSIGHT TECHNOLOGIES (KEYS)

Keysight Technologies operates in the test and measurement industry where they sell both hardware and software that supports customers R&D and manufacturing efforts in a wide array of disciplines ranging from commercial communications, industrial automation, the "Internet of Things", aerospace and defense applications, automotive electrification and autonomy, semiconductors, and personal electronics. While this business is not a household name, you are almost assuredly using many products every day that were developed using Keysight equipment.



Through management actions and strategic M&A orchestrated over the last several years, the management team at Keysight has massively advanced the company's competitive position versus their peers. Looking forward, we believe the company's moat will continue to grow stronger as they leverage significant scale advantages (their annual R&D investments are larger than all of their competitors' revenue except for one), tight integrations with their customers that have become only stickier through software applications that are vital to scientific productivity, and an ability to manufacture specialty integrated circuits at the company's in-house semiconductor fab that allows Keysight to meet customer needs as they attempt to solve leading-edge technological problems.

For shareholders, this translates to a dramatically improved margin profile of the company (e.g. gross margins have expanded from the mid-50's to mid-60's) and a business aligned with several important secular growth drivers. Currently, there is concern about how the possibility of a recession could impact the near-term earnings profile of the company. While we share some of the market's concern regarding possible macro weakness denting near-term demand, we are focused on the fact that much of the future advancement in a wide area of technical fields will need an ever-expanding set of integrated hardware and software solutions that Keysight is best positioned to provide. As a result, we believe the company will emerge from any cyclical drawdown with an ability to continue to drive double digit earnings growth in a normalized environment.

PHILIP MORRIS (PM)

While the War in Ukraine had the potential to severely disrupt Philip Morris' Eastern European business, the company has navigated the turmoil relatively well with sales minimally impacted. But the most important piece of news over the last three months is that the company completed its acquisition of smokeless tobacco maker Swedish Match (maker of the popular Zyn Pouches) at a very attractive price. Just as important, Philip Morris bought the rights from their former parent company Altria to market IQOS, their leading Heat-Not-Burn reduced risk device, in the United States starting in 2024.

The combination of these events has increased our confidence that Phillip Morris will have a sustainable path towards high-single-digit to low-double-digit organic earnings growth for the foreseeable future. At the same time, we view their product portfolio and history of execution as evidence that they are pulling ahead of the rest of the industry in establishing brand loyalty for their reduced-risk products as the world continues to transition away from combustible cigarettes.

To fund new purchases made during the quarter, we decreased several existing positions.

ALPHABET (GOOG/GOOGL)

Alphabet has been a one of our largest positions for almost a decade now. Throughout that time, we have largely regarded their Search business as one of the most impressive businesses we've studied. Google Search possesses enviable economics and a competitive moat that we consider nearly impenetrable. Over time, we saw multiple attacks on Alphabet's business and our thesis on the strength of their position was reinforced each time. In fact, Alphabet usually emerged in a stronger position with better economics after the emergence of any threat. With YouTube, a dominant display ad placement network, various embedded "call options" the company possesses, such as Waymo, a leader in developing autonomous driving software, and a very reasonable valuation, Alphabet remains a company we want to own.

That being said, it has become increasingly apparent that rapid innovation in the realm of Artificial Intelligence (AI), underscored by Microsoft's recent partnership with ChatGPT creator OpenAI to enhance Bing's search capabilities, may be leading to a period of intensifying competition and a change in the way people interact with search and the Internet. We have tremendous respect for Microsoft CEO Satya Nadella and believe Microsoft is in a very different technical position than when prior attempts were made to position Bing as a legitimate competitor to Google Search.

Working to Alphabet's advantage, we largely believe that the company's multiple advantages in artificial intelligence, data, customer habits, and distribution through the Android operating system and paying to be the default search provider on iPhones likely remain intact. However, unlike times past, our confidence in Alphabet coming out of this evolution in a stronger position is not as high and, as the digital advertising market has grown and gotten closer to maturity, Alphabet also does not have the benefit of massive expansion in their addressable market in front of them. If nothing else, major competition between two large, sophisticated players with vast resources at their disposal may dent some of the near-term economics of Alphabet's position in search. As such, we no longer believe that Alphabet deserves as high a weighting in the



portfolio and we have modestly reduced the position to manage our risk exposure.

Note that Alphabet still trades at roughly 16x consensus estimates after accounting for the huge stockpile of cash the company has built up. That is a valuation more typical of a decidedly average business, which is not what we believe Alphabet is even after considering developments discussed above. Over the course of the coming year, we expect that Alphabet's management team will unveil some significant competitive responses. In fact, with eight products that have at least one billion daily active users, there is a very real possibility that the mass adoption of consumer AI applications will end up playing into Alphabet's strengths. Expect more to come as we continue to research and assess both the threats and opportunities afforded by AI.

ARISTA NETWORKS (ANET)

Much of what we liked about Arista when we initiated our position remains true to this day. They continue to generate impressive returns on capital with a long runway from which to re-invest, a high-caliber management team with a significant amount of personal capital tied up in the business, a net cash balance sheet, and products that are significantly differentiated from their competitors' while also being beloved by their customers.

What has changed? For one, the upgrade cycle we were expecting is now in full swing and has doubled the reported earnings of the company while the price-to-earnings multiple on consensus earnings has also expanded from the low 20's into the high 20's.

Much of the current growing excitement around Arista revolves around the need for advanced networking equipment that is increasingly becoming a bottleneck for the application of AI and other data-intensive computing use cases. We expect Arista's earnings this year will more than double what they were just two years ago, and we continue to believe Arista is among the best positioned companies in the world to capitalize on this trend over the medium- to long-term. However, we suspect the current rally likely captures a portion of this excitement before we have seen the full impact on fundamentals, which led us to pare back our position.

LAS VEGAS SANDS (LVS)

There have been several positive developments over the last few months for Las Vegas Sands. First, the company received a 10-year concession renewal for their Macau properties on favorable terms that basically maintained the status quo in the region. Second, China's abandonment of its 'Zero-COVID' policy has reopened travel lanes into Macau and Singapore and released significant pent-up demand. Third, renovations, including significant upgrades to their Singapore and Macau properties are nearly complete, and a major expansion of their Singapore property is on schedule to open in 2025. Lastly, LVS is making progress on a possible \$4B investment in a new casino and entertainment property in New York.

With much of the market fear around various downside scenarios dissipating, the stock price has rallied over 50% the past six months. This brought the stock price closer to our estimate of intrinsic value, which incorporated most of these developments in our modeling.

Looking out, we continue to believe LVS is the premier gaming operator with leading market share in what are arguably the two best gaming markets in the world - Macau and Singapore - due to their geographic proximity to large population centers, a growing middle and upper class in Asia, and limited competition enforced by government mandate. Further, management has built a strong relationship with local governments, possesses a very strong balance sheet, and has a long history of prudent capital allocation. Given the company's competitive position, should tourism and gaming activity in Asia recover to levels above those seen pre-COVID – as has been the case throughout the world as other geographies removed travel restrictions – the earnings power could possibly eclipse the prior peak levels by a substantial margin.

META PLATFORMS (META)

Meta has been a controversial name over the course of the last year. Meta was our primary detractor to returns throughout 2022 after falling 64% during the year. In response, the entire team dove into the name and led a complete re-underwriting of our thesis. We concluded that the Family of Apps business (Facebook Blue, Instagram and WhatsApp) remained very well positioned and that there remained plenty of incentives and opportunities for the management team to work on right-sizing the cost structure of the businesses. Following this past quarter's better than expected earnings release and public declarations of this year being the "Year of Efficiency", the stock advanced roughly 125% since last November.



Meta is a good example of how the volatility in a company's stock can at times be drastically greater than the volatility of the intrinsic value of the business. In Meta's case, management made a decision to reduce current margins and free cash flow for a multi-year period. This decision was made for long-term strategic reasons, but the market extrapolated the trough earnings level in a straight-line fashion. With the recent earnings release, management essentially said those trough levels are not a permanent state of affairs, and the market is now revaluing the business.

That said, the debate surrounding the business remains. If we were to ignore the costs of building out the metaverse within its Reality Labs division, the stock is trading at an attractive multiple in both absolute and relative terms. That said, we don't believe we can simply ignore the investment by the company into Reality Labs. This dynamic has led to a wider than typical range for our estimate of fair value. With the stock trading near the low end of our fair value range we believed trimming the position here was appropriate.

We exited one position during the quarter.

QUANTA SERVICES (PWR)

Quanta has been a top holding for roughly eight years. Over the course of that time, we largely believed that the earnings power of Quanta Services was more durable than the market gave it credit for as the company increased its capabilities as an outsourced service provider to utilities and moved away from a reliance on large, but lumpy, project-based revenue. We also believed the market was underappreciating the degree to which the company would benefit from several long-term trends related to the expansion and upgrade of the North American electric grid. Towards the end of 2020, the market began to appreciate this thesis and significantly re-rated the shares higher in advance of the near doubling of the company's earnings power. Today there is a great deal of excitement for the company as Quanta's abilities to help upgrade the grid are crucial for the move towards more renewable power sources and the move towards electrification of transportation. We continue to have confidence in our thesis and the business, but we think the shares are priced at the high end of our fair value range and see more attractive opportunities elsewhere.



KOVITZ

FIXED INCOME COMMENTARY
FIRST QUARTER 2023

MARKET AND PERFORMANCE COMMENTARY

Bonds had a bullish quarter after last year's historic bear market. Interest rates shifted lower as recession fears have left investors questioning economic and inflationary growth. When rates fall, bond prices rise. The widely quoted US Aggregate Bond Index¹ ("Agg") climbed nearly 3%. Despite rates ticking down, return expectations for the bond market remain relatively high. The Agg yields 4.4% compared to a 3.2% average over the last 20 years.

The decline in interest rates available on longer-term bonds contrasted with the actions of the Federal Reserve. The Fed announced two more hikes this quarter, bringing their target rate to 5% from 4.5%. The Fed remains resolute in crushing the stubbornly high post-pandemic inflation rates. For now, they're willing to look past signs of economic stress, including the collapse of two large US banks. Fed Chairman Powell noted at their March meeting, "There are real costs to bring [inflation] down to 2%, but the costs of failing are much higher."

The lagged economic effects of tighter monetary policy are starting to show, but inflation needs to decline further before the Fed can pivot. We don't expect a quick resolution to this sluggish push and pull dynamic, and given the uncertainty, we expect volatility in the bond market will remain elevated. We are comfortable with our relatively defensive fixed income positioning as we patiently seek out opportunities to acquire mispriced securities that can arise from volatility.

REINVESTMENT RISK

The aggressive Fed rate hikes are forcing the bond market into a peculiar position known as an inverted yield curve. This is when yields on some short-term bonds are higher than the yield on those with a longer time to maturity. So, with "safe" one-year Treasuries yielding nearly 5%, why buy longer-dated bonds with lower yields?

The simple answer is that what seems attractive today might not be available tomorrow. Reinvestment risk, which tends to fly under the radar in most normal bond markets, is the likelihood that investors will reinvest bond maturities at lower yields than original positions. Short-term Treasury yields seem like a no-brainer, but if the Fed successfully slows the economy, reinvestment opportunities for those maturities could fall sharply with a drop in interest rates – impairing future returns. This is exactly what the current inverted yield curve is implying. The below chart shows yields currently available on various Treasuries today vs. the implied yield on bonds of the same maturity purchased one year from today.

Figure 1:
Treasury Yields - Current vs Expected

SOURCE: Kovitz using data from Bloomberg Finance L.P.



¹ Bloomberg U.S. Aggregate Bond Index.



We don't believe a lower interest rate environment is a foregone conclusion, but it's a risk we must balance. We believe structuring bond portfolios in a ladder is one of the most effective tools to mitigate that risk. If rates rise, we have some bonds maturing every year to systematically reinvest into higher rates. If rates fall as the market participants expect, we've locked in yields on most bonds for longer time periods.

We invest client bond portfolios with the intent of compounding wealth over longer-term investment horizons. During a period where we believe bond yields are attractive, we don't feel it's prudent to risk impairing long-term bond returns by staying too short and taking on substantial reinvestment risk.

BANKING CRISIS LESSONS

Rarely does fixed income portfolio management become the mainstream topic du jour, but when it does, you can be certain it's not for good reason. The largest story from the quarter was the collapse of two US banks, Silicon Valley Bank and Signature Bank, due to a material decline in the market value of their fixed income holdings and a swift withdrawal of deposits. A large Swiss bank, Credit Suisse, followed suit for similar reason.

The last time there was this much focus on the value of bonds held on bank balance sheets was during the Global Financial Crisis, which caused the downfall of Bear Stearns, Washington Mutual, IndyMac, and many more. Different from the events of this past quarter, that crisis highlighted overlooked *credit* risks in bank assets. Years of exuberance in the real estate market incentivized banks to bear ever-increasing and complex risks to supplement returns. The recent bank failures, dubbed the 2023 Global Banking Crisis, highlighted overlooked *liquidity* risks in bank assets. Once again, years of exuberant monetary policy incentivized banks to bear ever-increasing interest rate risk to supplement returns.

As the mantra goes, history doesn't repeat itself, but it often rhymes.

In both episodes, banks failed to manage seemingly simple bond risks. Their oversight seems shockingly obvious with the benefit of hindsight, but with any historic event, there are lessons to be learned from the recent bank failures:

- 1. Interest rate risk is real.** Silicon Valley and Signature banks were mostly invested in high-quality government-backed bonds with little to no risk of default. Their losses stemmed from interest rate hikes which decreased the value of their long-term bond holdings. Most describe losses of that nature as temporary declines that will disappear as bonds approach maturity. However, if forced to sell bonds to meet demand for bank depositor withdrawals, the losses represent a true impairment of capital, which is why we mitigate interest rate risk accordingly within client accounts.
- 2. Assets should match liabilities.** For an insurance company with long-term liabilities, long-term bonds make sensible investments. As rates rise, their assets and liabilities fall in value comparably. On the other hand, most bank liabilities are customer deposits which are payable on demand. Unrealized losses on assets are crystalized quickly in the event of a bank run. When managing fixed income portfolios for Kovitz clients, we believe a custom approach is appropriate to make sure fixed income positioning matches the liquidity needs and risk tolerance of each client.
- 3. There's no substitute for cash.** Neither bank ultimately had large enough cash reserves to protect them under stress. Bonds are on the safe side of the investment risk spectrum, but fixed income strategies are still subject to market risks and daily volatility. We design fixed income portfolios with enough liquidity to protect against most reasonable situations, but clients also need to protect themselves from the unpredictable. By its nature, the bond ladders we construct in client portfolios always have some portion of bond holdings coming due in the next year. We also recommend all clients have an emergency cash savings fund as part of their overall financial plan.

We are happy to report that we had no direct exposure to any of these bank failures and likely little overlap with any securities held on their balance sheets. We seemingly exit this crisis without collateral damage, but these events serve as important reminders of why we focus intently on mitigating risks within client fixed income portfolios.

⁶ Measured using the internal rate of return on all fixed income securities by account, gross of fees. Individual account returns will differ.



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Kovitz Equity Composite

Year	Gross Return	Net Return	Benchmark Return	Internal Dispersion	Composite 3-Year SD	Benchmark 3-Year SD	# of Portfolios	Composite Assets (\$mm)	Firm Assets (\$mm)
2013	34.36%	32.82%	32.39%	2.80%	11.19%	11.94%	208	291.2	3,023
2014	7.69%	6.43%	13.69%	1.82%	9.28%	8.97%	212	278.3	3,040
2015	-5.82%	-6.96%	1.38%	1.29%	11.36%	10.47%	238	287.3	2,703
2016	20.90%	19.49%	11.96%	2.10%	12.85%	10.59%	203	256.2	2,696
2017	17.81%	16.43%	21.83%	1.79%	12.28%	9.92%	219	314.7	3,139
2018	-9.97%	-11.09%	-4.38%	1.44%	12.86%	10.80%	211	265.1	3,674
2019	27.83%	26.32%	31.49%	2.45%	13.99%	11.93%	195	323.9	5,061
2020	16.14%	14.75%	18.40%	2.11%	22.34%	18.53%	184	353.5	5,990
2021	30.15%	28.60%	28.71%	2.03%	21.34%	17.17%	212	474.7	7,465
2022	-21.80%	-22.59%	-18.11%	0.89%	23.60%	20.87%	72	341.8	6,767

DISCLOSURES

Fees: Gross-of-fees returns incorporate the effects of all realized and unrealized gains and losses and the receipt, though not necessarily the direct reinvestment, of all dividends and income. Gross-of-fees returns are presented before management fees, but after all trading expenses. Prior to January 1, 2021, Composite net-of-fees returns were calculated by deducting model investment management fees, which are defined as the highest, generally applicable fees of 1.25% of equity assets and 0.50% of cash assets, from the gross composite return. Beginning on October 1, 2020, the Composite net-of-fees returns are calculated by deducting model investment management fees, which are defined as the highest, generally applicable fees for the strategy of 1.00% of all composite assets. The firm's current management fee schedule is as follows: 1.25% on assets below \$1 million, 1.0% per annum for assets from \$1 million to \$5 million, 0.85% per annum on assets from \$5 million to \$10 million, 0.75% per annum for assets from \$10 million to \$20 million, 0.65% per annum for assets from \$20 million to \$35 million, 0.55% per annum for assets from \$35 million to \$50 million, and 0.50% per annum for assets over \$50 million. Such fees are negotiable. Where applicable, the total bundled or wrap fee charged to each portfolio is dependent on the end client's financial advisor and wrap sponsor. The composite includes accounts that do not pay trading fees.

Prior to January 1, 2010, the Composite included the performance of assets that had been "carved out" of multiple asset class portfolios. When calculating performance, a hypothetical cash balance for each month was allocated to the carve-out on a pro-rata basis relative to the portion of each portfolio's assets that comprised the carved out asset class. Beginning January 1, 2010, changes in the GIPS standards caused the Composite to be redefined and all carve-outs to be removed from the Composite. Carve-outs formerly included in the Composite continue to be managed in the same manner as they were before being removed from the Composite.

Definition of The Firm: Kovitz Investment Group Partners, LLC (Kovitz) is an investment adviser registered with the Securities Exchange Commission under the Investment Advisers Act of 1940 that provides investment management services to individual and institutional clients. From October 1, 2003 to December 31, 2015, the Firm was defined as Kovitz Investment Group, LLC. Effective January 1, 2016, Kovitz Investment Group, LLC underwent an organizational change and all persons responsible for portfolio management became employees of Kovitz. From January 1, 1997 to September 30, 2003, all persons responsible for portfolio management comprised the Kovitz Group, an independent division of Rothschild Investment Corp (Rothschild).

Composite Definition: The Kovitz Equity Composite includes all fee-paying, discretionary portfolios managed to the Kovitz Core Equity strategy. The Kovitz Core Equity strategy utilizes a private owner mentality to purchase equity securities issued by companies with durable competitive advantages and strong balance sheets that are trading at a significant discount to their intrinsic value. The goal of this strategy is to maximize long-term total return. The Composite's inception date is January 1, 1997. The Composite was created on January 1, 2001. Effective January 1, 2000, the Composite no longer included portfolios managed by a manager who made a change in investment style. The persons currently responsible for managing Composite portfolios have been primarily responsible for portfolio management throughout the entire period shown. The minimum portfolio size to be included in the Composite is \$250,000 until December 31, 2021. Thereafter, the strategy minimum was raised to \$1 million. Portfolios in the Composite may occasionally make use of leverage and/or derivatives, but such use does not have a material effect on Composite performance. The use of derivatives is generally limited to covered call writing, and uncovered option writing is never used.

The benchmark for the Composite is the S&P 500 Index. The S&P 500 Index is composed of 500 leading companies in the United States, covers approximately 75% of the market capitalization of U.S. equities, and serves as a proxy for the total market. The S&P 500 Index returns do not include the effect of transaction costs or fees and assume reinvestment of dividends into the index.

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Valuations are computed and performance is reported in U.S. dollars. The measure of internal dispersion presented above is an asset-weighted standard deviation. The three year standard deviation presented above is calculated using monthly net-of-fees returns. The three year standard deviation is not presented when less than 36 months of returns are available. The risk measures, unless otherwise noted, are calculated gross of fees. A complete listing of composite descriptions and policies for valuing portfolios, calculating performance, and preparing GIPS reports are available on request. The composite includes accounts that do not pay trading fees.

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