

NEWSLETTER
SECOND QUARTER 2022



Guided by value.



KOVITZ

MARKET INSIGHTS
SECOND QUARTER 2022

“*And if you close your eyes
Does it almost feel like you’ve been here before
How am I gonna be an optimist about this?
How am I gonna be an optimist about this?*”

| “POMPEII”, BASTILLE

To state the obvious, this past quarter was pretty rough. The U.S. stock market¹ fell 16% as the sell-off in tech and other high-flying sectors in 2021 spread into the rest of the market. With a recent market bottom 23% below the last peak, the current market drop achieved the dubious honor of cracking the Top Ten list of the worst market drawdowns of the past hundred years. Please, hold your applause.

To make matters worse, bonds², which usually perform better when stocks are doing poorly, declined another 5% as interest rates ticked higher. The only thing investors seem to be bullish on right now is pessimism.

This pessimism is not just confined to the minds of investors, but it is pervasive in the minds of consumers as well. The University of Michigan Consumer Sentiment Survey recently touched an all-time low over the course of the survey’s 40-plus year history. Almost certainly, this is in large part a reaction to the highest level of inflation seen in about, well, 40 years.

Additionally, according to a May survey conducted by CNN/SSRS, only 23% of respondents rated economic conditions as “very good” or “somewhat good”. This was the worst reading on this question since 2011 when the economy was still recovering from the trauma of the Global Financial Crisis. Furthermore, a whopping 89% of respondents said they had heard some or a lot of bad news about the economy lately against only 23% who reported hearing some or a lot of good news.

Curiously, as we find ourselves mired in the third major stock market drawdown in the last four years, we have started to notice a familiar rhythm to these events.

1. Down 5%: Investors shrug. This happens all the time, sometimes over the course of only a couple days. Pundits and advisors talk about maintaining a long-term focus and boast of “buying the dip”.
2. Down 10%: Investors start to take notice, but most maintain their resolve. People start throwing around Warren Buffett quotes about what happens when the tide goes out and being greedy when others are fearful. It is comforting because everyone is saying the same thing.
3. Down 15%: Some cracks start to appear in the bravado espoused when stocks were just a few percent higher. CNBC trots out their infamous “Markets in Turmoil” graphic. You still see some Buffett quotes, yet they are said a little softer and with a hint of caution. Investing time horizons start to shorten as the conversation turns towards preserving capital and shifting assets to what is working now.
4. Down 20%: Investor psychology really starts to come unhinged. With losses mounting, time horizons compress to zero. The airwaves are absolutely dripping with negative headlines. Perma-bears who have been sitting on the sidelines predicting a market crash since 2010 appear everywhere to pat themselves on the back and spread their gospel of fear. (No one asks them about the gobs of money they lost for their clients by foregoing gains over the past decade.) And it just snowballs from there.

¹ All references to the returns of “stocks” or “the stock market” reflect the returns of the S&P 500 Index Total Return

² Represented by the Bloomberg U.S. Aggregate Bond Index



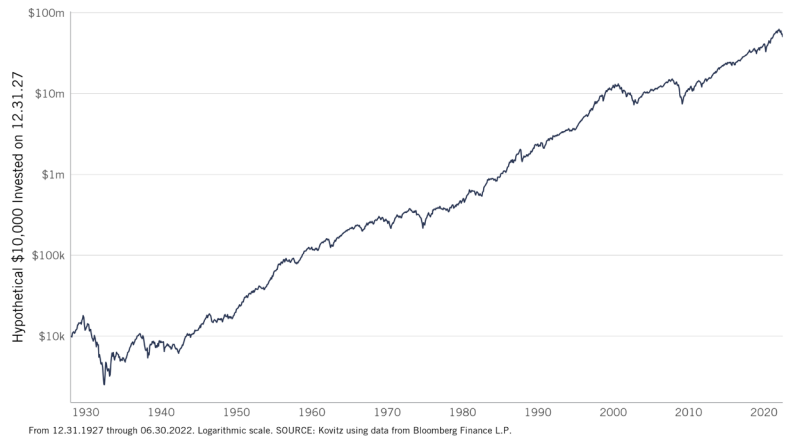
To be clear, every impulse expressed above – from the overconfidence in the early stages to the panic in the latter stages – is incompatible with a successful process to manage one’s financial affairs.

What we strive for at Kovitz – for both ourselves and our clients – is to foster a value- and process-driven approach to investing and financial planning to guide us through tough times. This foundation allows us and our clients to approach periods of market mania and periods of market distress the same way – with clear eyes, a long-term focus on meeting financial goals, and a hint of cautious optimism.

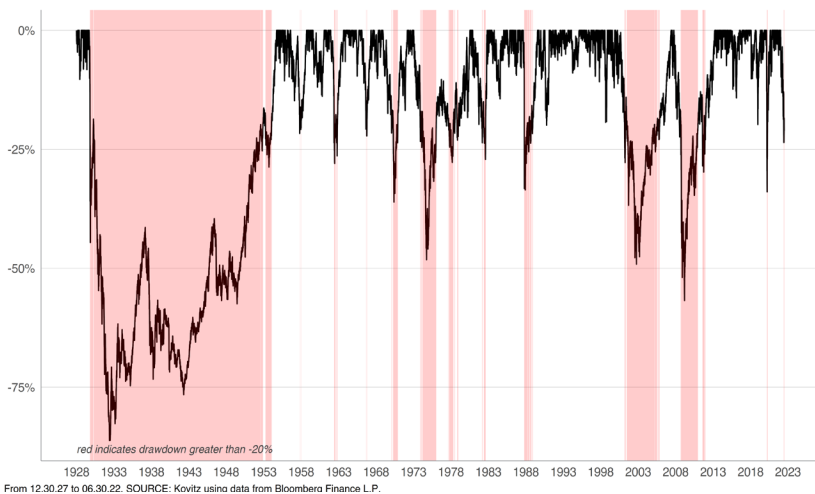
And there are several reasons to feel a sense of optimism in the face of the recent market carnage.

First, we know optimism pays off in the long run. Over the last century, through depressions, recessions, wars, world wars, cold wars, disease, bubbles, busts, frauds, and everything else, \$10,000 invested in the stock market in 1928 would be worth about \$50,000,000 today. To (obnoxiously) quote ourselves from three months ago: “. . . history has shown us that the twin engines of human ingenuity and market-based capitalism are exceedingly good at driving capital to its highest and best use, and, over time, this process breeds progress, prosperity, and profit.”

THE REWARD FOR OPTIMISM AND STAYING THE COURSE



THE PSYCHOLOGICAL COST OF OPTIMISM AND STAYING THE COURSE



Any reward as handsome as this does not come without a cost. In this case, that cost is the psychological toll of withstanding the numerous sell-offs and drawdowns and fending off the “fight or flight” instinct trying to get us to act rashly. As the chart of stock market drawdowns shows, this is no small thing.

That leads us to our second cause for optimism: we plan for this. When we partner with our clients’ to determine how they can best achieve their financial goals, we don’t assume stocks will return a level 9% per year every single year without interruption. We know there will be periods of volatility and we plan for it.

In terms of being on plan, note that stocks have returned 71% over the last five years, or a compound average of 10.5% per year. This is quite satisfactory even though that brief five-year period now encompasses three of the 14 largest drawdowns of the past century, including declines of 19% in 2018, 34% in 2020, and now 23% in 2022.

Third, despite rampant talk of a recession and fear coursing through the markets, the vast majority of economic indicators aren’t exactly lining up with the sentiment. Oddly enough, according to the same CNN/SSRS survey referenced earlier, there is an incredible 30 point gap between respondents describing their own situation as “fairly well” to “very well” vs. describing the overall economy as “doing well”.

Credit card and mortgage delinquencies are near all-time lows. Leisure travel is at all-time highs. Household debt service relative to disposable income remains lower than any level recorded prior to 2020. Retail sales adjusted for inflation are down from the COVID-induced boom in demand for goods, but remain more or less at levels consistent with pre-COVID trends. The list could go on.



Much of the credit for the above is due to the fact that the job market remains very tight. The U.S. economy is still *adding* about 400,000 jobs per month. The unemployment rate has fallen since the beginning of the year from 3.9% to 3.6%, which is just above the all-time lows set just prior to the onset of COVID. The number of job openings has remained stable at around 11 million with nearly two job openings for every unemployed person. In fact, outside of a handful of notable exceptions, virtually every business continues to report difficulty filling open positions.

For perspective, let's compare the current job environment to the beginning of the Global Financial Crisis in 2008. The stock market peaked in October 2007 and reached a similar decline to that of 2022 in September 2008, right around the time Lehman Brothers failed. At that point, the economy was losing 460,000 jobs per month and climbing. The unemployment rate had risen from 4.7% to 6.1%. The number of job openings had fallen 31% to 3.2 million and there were approximately three unemployed persons for each job opening. The situation would continue to deteriorate, but it was already looking pretty grim.

Even inflation - the cause of so much angst - has been giving mixed signals as of late. While the headline CPI continued to set new highs north of 8% this quarter, the Federal Reserve's preferred measure - Core PCE - has moderated from a year-over-year peak of 5.3% in February to 4.7% in June. This latter measure excludes the impacts of food and energy. While these are very real expenditure categories for consumers, the Core PCE measure is preferred by the Fed because its policies have very little ability to influence these highly volatile categories. With core inflation coming down, the prices of many commodities well off their mid-June highs, and the spread between real and nominal yields on U.S. Treasury bonds narrowing, perhaps - and we do mean perhaps - the Fed's tough talk on inflation and raising rates by a surprise 75 bps in June have begun to have the desired impact on the market's expectations for future interest rates and inflation.

As any therapist will tell you, you can't tell someone else how to feel. We are not so naïve as to think highlighting some positive aspects of the economy will change consumer sentiment across the country. Nor will it change the minds of any clients who are feeling a bit uneasy about the immediate future. After all, no one under the age of 60 has experienced inflation as an adult at the level we are now experiencing, and coming on the heels of COVID and its various unprecedented economic impacts, it's only natural that a certain amount of unease would accompany such a change.

However, we do express hope that it will influence the actions of our clients. In this case, the required action is simply to stay the course. You planned for times like this. We planned for times like this. As a result, it's okay to be optimistic - even if it is just a tiny bit.

Your Kovitz Team



KOVITZ

CORE EQUITY COMMENTARY
SECOND QUARTER 2022

MARKET AND PERFORMANCE SUMMARY

During the second quarter of 2022, the Kovitz Equity Composite¹ (the “Composite”) decreased by 18.5%, net of fees. By way of comparison, the S&P 500 Index was down 16.1% while the Russell 1000 Value Index fell 12.2% for the same period. Year-to-date through June 30, the Composite has fallen 22.5% while the S&P 500 and the Russell 1000 Value are down by 20.0% and 12.9%, respectively.

The stock market, as measured by the S&P 500, had its worst two-quarter start to the year since 1970. Accelerating inflation and rising interest rates have been the primary culprit of the sell-off as the investment community, perhaps spoiled by a decade of low and stable inflation which kept interest rates at historically low levels, has had to hastily digest a transition away from this accommodative environment.

It is precisely because we had been indulged for so long that the inflation numbers beginning last year came as such a surprise to investors, economists, and even the Federal Reserve. Early on, the inflation surge was explained away by the reopening of the economy after the COVID shutdown and stressed supply chains around the globe, which kept expectations about future inflation somewhat muted. However, with global supply chains still snarled more than a year after COVID vaccines became widely available and the conflict in Ukraine causing a supply shock in oil and various other commodities, reported inflation has remained stubbornly high and market expectations of inflation have been rising. In turn, market forces and the Federal Reserve’s hawkish pivot have driven up interest rates. Interest rates, as we’ve discussed in these commentaries many times, are like gravity to stock valuations. As they increase, they exert a downward pull on prices.

In the first six months of the year, this pull has been exceedingly forceful. As Howard Marks, co-founder of Oaktree Capital Management, observed, “In the real world, things generally fluctuate between *‘pretty good’* and *‘not so hot.’* But in the world of investing, perception often swings from *‘flawless’* to *‘hopeless.’* Market manias and panics will always be with us. They are a feature of financial markets because greed and fear are a feature of human psychology.”

As investors, we face the challenge of developing an investment process that insulates us from these destructive psychological forces and, ideally, allows us to exploit the fragilities of other market participants. At Kovitz, we are anchored by an investment philosophy that views investing not as following blips on a computer screen or on your mobile phone, but as becoming a partner in the long-term ownership of a business. Long-term investment success is usually not the result of forecasting next month’s inflation print or predicting how geopolitical events ultimately work out, but by owning small pieces of a collection of financially strong and competitively-advantaged companies. The companies we tend to focus on have above-average financial strength, earn returns on capital employed in the business above their cost of capital, have management teams that understand how to increase intrinsic value per share, and have a long runway to either invest in future growth or return excess cash to shareholders.

Over time, we expect that this diversified portfolio will be able to compound our internal measure of owner’s earnings at a double-digit rate through a wide variety of macroeconomic scenarios and business cycles. While their share prices might diverge sharply from their intrinsic value in the short- to medium-term, continuing to own high-quality businesses that compound profits over the cycle is something we believe ultimately creates substantial value for our clients.

It is also worth noting that volatile times are when active management and thoughtful portfolio construction can earn their keep by dynamically seizing opportunities that present themselves. We have demonstrated in 2008 (financial crisis) and March of 2020 (COVID-19) that our process can thrive in this type of environment. Today, we continue with a similar playbook, upgrading business quality at attractive prices and not overreacting to short-term declines in stock price in excess of the change in a business’ value. Stock picking has not mattered much over the past decade as most everything moved up, but we believe it will be far more important in the decade ahead.

As we have regularly voiced, we have no special insight or general view on where the market will trade in the short-term. We don’t know where the bottom will be or if we have already seen it. We do know the stock market exists to serve investors, not instruct them. This speaks to the importance of distinguishing between the fundamentals of a business and the price movement of its stock. The best way to be reasonably sure of capturing and compounding the return of equities is to ride out their sometimes significant, but often temporary, declines. As Peter

¹ The 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.



Lynch so memorably said, “The real key to making money in stocks is not to get scared out of them.”

Kovitz has been managing clients’ money for more than two decades. During that time, we have experienced 9/11, the Iraq War, the subprime mortgage calamity that led to a Global Financial Crisis, the downgrading of the U.S. Debt, Brexit, the China Trade War, COVID-19, Russia’s invasion of Ukraine and most recently, surging inflation. These events, and others, have caused multiple stock market corrections and several bear markets over this time period. Despite this, clients who have been with us from the beginning have multiplied their original equity capital by more than 11 times (vs. roughly 8 times for the S&P 500).

Though it is tempting to use world events to try to smartly time moves in and out of the market, we don’t think it can be done on any consistent basis and will likely lead to worse outcomes than standing pat, secure in the knowledge that tolerating the ups and downs of the market is the entry price for satisfactory long-term equity returns.

We are fortunate to have clients who share our belief in a long-term-oriented strategy. This is more than a small advantage as it enables us to focus on generating wealth instead of short-term trading.

The chart below summarizes annualized performance over various standard time periods ending June 30, 2022, and cumulative performance results from January 1, 1997 through June 30, 2022 for the Composite.

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

Average Annual Total Returns								Cumulative
	Quarter to Date	Year to Date	1 Year	5 Year	10 Year	20 Year	Since Inception	Since Inception (1/1/97)
Core Equity Composite	-18.5%	-22.5%	-16.7%	7.3%	9.8%	7.5%	9.9%	1018%

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

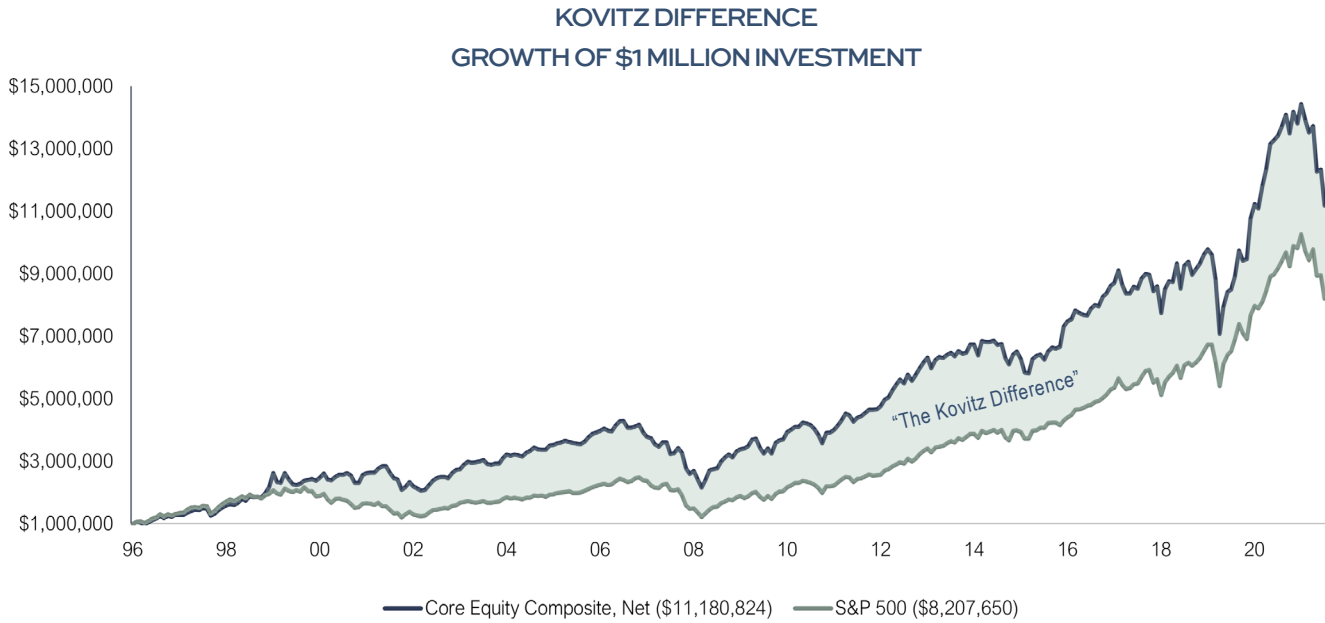
Average Annual Total Returns							Cumulative
	Year to Date	1 Year	5 Year	10 Year	20 Year	Since Inception	Since Inception (1/1/97)
S&P 500	-20.0%	-10.6%	11.3%	13.0%	9.1%	8.6%	720%
Large Cap Value (Russell 1000 Value)	-12.9%	-6.8%	7.2%	10.5%	7.9%	8.1%	623%
Small Cap Equity (Russell 2000)	-23.4%	-25.2%	5.2%	9.4%	8.2%	7.7%	559%
International Developed (MSCI EAFE)	-19.6%	-17.8%	2.2%	5.4%	5.3%	4.2%	187%
International Emerging (MSCI EM)	-17.6%	-25.3%	2.2%	3.1%	8.4%	7.1%	477%
Gold	35.8%	45.1%	11.7%	-1.9%	0.8%	0.2%	6%
Commodities (CRB)	25.7%	37.0%	12.0%	0.9%	4.0%	3.6%	145%

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.



Below is a graph of the Kovitz Composite's cumulative return since inception relative to the cumulative return of the S&P 500 over the same time period. The shaded area represents the Composite's excess return over the benchmark.



Source: Kovitz using data from Bloomberg Finance, L.P.

PORTFOLIO ACTIVITY

Historically, extreme downside volatility has created opportunities. We do not think this time will be any different. Volatility, which oftentimes leads others to act rashly, routinely creates inefficiencies in the pricing of public markets' securities that can be leveraged to exploit deviations between current market prices and long-term intrinsic values. It has certainly brought an improved opportunity set that is allowing us to both add new high-quality franchises to client portfolios and take advantage of price dislocations in several of our current holdings where the companies continue to execute well in a difficult environment.

This process is not without its challenges. Being nearly fully invested, adding new positions requires us to make some tough capital allocation decisions regarding several long-standing positions. Still, our north star remains finding the right balance between collecting the best businesses we can and buying these businesses at prices that we believe offer the best possible returns. This quarter's transactions move us further towards that objective.

We initiated three new positions during the quarter:

ANALOG DEVICES (ADI)

Analog Devices (ADI) is a leader in the design and production of high-end analog semiconductors. These chips bridge the gap between the physical world and digital devices by sensing and measuring physical inputs and converting that information to a digital signal. They create solutions to solve design challenges in the industrial, consumer, communications, and automotive industries. For example, for an automobile tire pressure warning light to turn on, a chip is needed to convert the analog (physical) signal into a digital (0's and 1's a computer can use) signal. The company has close to majority market share in the key segments of data converters and amplifiers, high returns on capital, high and stable gross margins, a strong balance sheet, and high free cash flow conversion. All of this points to an extremely high-quality company.

While digital semiconductors receive the bulk of investor attention because of their use in high-tech applications, the analog market is defined by relatively low average selling prices, exceptionally long and recurring product life cycles (more than 50% of their revenue is from products that are 10+ years old), low capital intensity and most importantly, high gross and operating margins. These are attributes to which we pay attention. ADI's economic moat is built around the unique talents and experience of its analog engineering team, where many of its key



scientists apprentice for the company for years before moving on to specialize in application-specific products. The ability to find solutions for customers is oftentimes more important than the price of the product itself. This results in higher-than-average selling prices (versus competitors) and creates a virtuous circle where ADI's high gross profits are recycled back into R&D to drive future high margin revenue opportunities.

The stock of a business we covet rarely gets to levels we find extremely attractive without some short-term worry that Wall Street is grappling with. The concern facing the company at the time of our purchase, which is less about ADI itself and more about the semiconductor industry as a whole, was whether the current capacity additions being undertaken to address the deficit in supply will collide with a potentially looming recession and lead to overcapacity in the industry. This is entirely possible, yet such a concern conflates short-term earnings effects with an impact to long-term business value.

We believe that the analog market is likely to prove to be less cyclical than other parts of the semiconductor market and benefit from the added tailwinds of being intertwined with important trends, including electric vehicles, factory automation, advanced communication, digital healthcare devices, and growth in connected devices of all kinds (i.e., the Internet of Things). These are the factors we believe will have the most meaningful impact on ADI's intrinsic value as a business, not whether the industry is over- or undersupplied in the next year.

INTERCONTINENTAL EXCHANGE (ICE)

Intercontinental Exchange (ICE) operates global commodity and financial products marketplaces. While ICE is perhaps best known as the owner of the New York Stock Exchange and for its ICE futures products, roughly half of the company's revenue and the majority of its profits are derived from providing subscription data and technology solutions to financial institutions, corporate customers, and mortgage industry participants.

ICE occupies a leading and often dominant position in the markets it competes in, exhibits very high returns on capital employed, high and increasing net income margin, has ample opportunities to continue to reinvest in and grow their business, and is run by a management team that has shown itself to be shrewd allocators of capital over a two-decade timespan.

Despite the proliferation of trading venues over the past couple decades as trading activity transitioned from physical locations to electronic platforms, exchanges that survive actually show attributes of natural monopolies. Since market participants are best served by accessing the markets with the most depth and volume, an exchange that reaches a critical mass of volume attracts more participants, which moves larger share of volume to that exchange, which attracts more participants, thus creating a strong network effect. This, combined with attractive economics, led to a wave of consolidation among the exchanges during the 2000s and early 2010s. Through a series of acquisitions during this time, ICE established itself as a global leader in the trading of equities, options, and energy and commodity futures.

While being the primary trading venue for a given security has many benefits, one of the most lucrative aspects is that it produces a wealth of proprietary data that ICE can then repackage into subscription-based services. Over the last decade, ICE also began branching out into mortgage technology solutions used by lenders and loan originators and fixed income trading and data products. These businesses further transition ICE towards sources of recurring subscription-based revenue and away from exposure to transaction-based revenues.

PACCAR (PCAR)

PACCAR Inc. designs, develops, manufactures, and distributes light, medium, and heavy-duty trucks and related aftermarket parts. Its lineup of trucks includes the Kenworth, Peterbilt, and DAF nameplates. The company also offers finance and leasing services to its customers and dealers.

While commercial truck manufacturing may not appear to be fertile ground for investment opportunities, PACCAR has many of the attributes evident in some of the world's best businesses. Over its long operating history, PACCAR has demonstrated both operational skill and sound strategic capital allocation to gain meaningful levels of market share on the four continents that account for 70% of global truck profitability. Last year marked the largest new model refresh in company history, and we expect improved fuel efficiency and advanced safety and driver assistance systems to drive further market share gains.

Through methodical and incisive investments over the past decade, management has scaled up a highly successful replacement parts



distribution business to service its dealers and the growing fleet of trucks in service. Vertical integration into engines and powertrain components is pulling through an increasing flow of profitable replacement parts, which now accounts for about 40% of PACCAR's profits.

The founding Pigott family's material ownership and board involvement continues to foster a long-term mindset at PACCAR. We believe this perspective serves as a competitive advantage as the industry evolves into electric vehicle (EV) and autonomous capabilities. PACCAR is already producing and selling a substantial number of EVs, and its flexible, open-source-technology business model, combined with industry-leading, low-cost operations, provide it the basis to successfully evolve while continuing to lead in providing a low total cost of ownership for customers.

We exited two positions during the quarter:

COVETRUS (CVET)

Covetrus, the global distributor of animal health products and provider of technology and services to veterinary clinics, announced it had accepted an offer from a consortium of private equity firms to buy the company at \$21 per share, or roughly \$3 billion in equity value. The news was bittersweet as the offer came in at a nearly 40% premium to where the shares were trading before rumors began circulating, but we believe the price tag was below fair value for the business. Prescription management, where Covetrus partnered with vets to set up online pharmacies, was showing significant growth and rising profitability with a long runway ahead of it. Covetrus' core distribution business was also growing on the back of a long-lasting tailwind of humans increasing spending on their pets combined with growing profitability from the increasing penetration of proprietary and private-label branded products. Finally, in practice management software, where the company already had majority market share in the U.S., Covetrus had just introduced a new cloud-based system that tied their various modules, including prescription management, together into a single package, which would further ingrain CVET into their customers' businesses.

Nevertheless, with limited recourse to challenge the offer since one of the private equity firms involved in the transaction already owned 25% of the outstanding shares and the shares immediately trading up to the offer price, we decided to exit our position before the deal closed and redeploy capital into more productive uses.

CITIGROUP (C)

For some time now, we have considered our holdings in **Charles Schwab (SCHW)**, **JP Morgan (JPM)**, **Northern Trust (NTRS)**, and Citigroup as four components of the same position. This quartet combined the best-in-class online brokerage that has gathered net new assets at a mid/high-single digit rate for the last decade (SCHW), the premier money-center bank with a best-in-class management team and peer-leading high-teens returns on equity (JPM), a leading custodial, trust services, and wealth management firm (NTRS), and Citigroup. Citi was a traditional deep value stock purchased on the belief of the new management's ability to shed underperforming business lines, renew focus on the already strong consumer card and banking franchise, and ultimately drive a valuation reset higher as the bank has habitually traded at a significant discount to tangible book value.

Conversely, while Citi continues to trade well below the liquidation value of the bank and management is saying and doing the right things to improve the bank's operations, it is proving difficult to change the culture of a large, sprawling institution like Citigroup. We may be throwing in the towel too early on new management, but we felt alternative uses of this capital presented a better combination of risk and reward from current levels.

We also increased several existing positions during the quarter, including the following:

CARMAX (KMX)

With snarled supply chains limiting the ability of new car manufacturers to produce vehicles, CarMax saw increased demand for used vehicles in 2021. However, with fears of used vehicle pricing getting too high, mixed in with other macro fears, CarMax's shares have lost roughly a quarter of their value during the broader market sell-off that has occurred so far in 2022.



Despite the near-term volatility, we believe the company's competitive position in the used vehicle industry is not only as strong as ever but continuing to grow. CarMax continues to leverage its national footprint of large format stores and significant scale to offer a wide range of used vehicles at competitive prices. Currently, north of 70% of cars sold were purchased directly from consumers, enabling CarMax to rely less on the more expensive wholesale channel to acquire inventory. With reconditioning costs also lower than peers, CarMax is able to pass those savings on to customers to garner industry-leading market share and fast inventory turns.

For vehicles acquired from customers that don't meet CarMax's retail standards, the company also operates a large wholesale auction business. This business has shown impressive growth over the past year as CarMax has rolled out its "instant appraisal" tool online. This tool provides customers with an actionable offer for their vehicle within minutes. Completing the vehicle purchase life cycle, the company also operates a robust captive finance business that directly finances about 40% of vehicles sold.

Spurred on by online-only competitors Carvana, Vroom, and others, who showed that a substantial number of consumers are willing to purchase a vehicle online, CarMax has been rolling out a complete omnichannel offering of its own, which is ramping up nicely.

DOLLAR TREE (DLTR)

We increased our position in Dollar Tree on the premise that future earnings power is underappreciated by the consensus. Since our first purchase of the shares last October, there has been a fair amount of news. In November, activist investor Mantle Ridge disclosed a material stake in Dollar Tree that caused an immediate positive step-up in the stock's price. In December, Dollar Tree management announced that they were "breaking the buck" at the Dollar Tree concept, moving to a \$1.25 price point for all items (from \$1), which has been substantially accretive to earnings. This past March, the company announced that it had settled a proxy battle with Mantle Ridge, naming 7 new directors to its board, including former Dollar General leader, Rick Dreiling, as Dollar Tree's new executive chairman.

Even with the shares up substantially since our initial purchase, we think that there remains material upside. Mr. Dreiling, who has already placed several of his key operating lieutenants with the company, wrote the playbook on how to successfully operate a small-box discount retailer. We believe this playbook offers a great deal of potential to improve sales and profitability at the Family Dollar line of stores, which have been an underperformer since Dollar Tree's acquisition.

CHARTER COMMUNICATIONS (CHTR)

Charter is a cable telecommunications business offering internet, video, and phone service to households and businesses. Charter's business is noteworthy for its highly recurring revenues derived from a service their customers consider essential, often operating with limited local competition. Even though traditional video subscribers have been in steady decline for a number of years (primarily due to the growth in streaming services), growth in broadband internet subscribers has more than offset this impact due to its higher profitability. To further increase customer stickiness, Charter has also launched a mobile service where they leverage the fact that about 85% of data used on mobile phones comes through Wi-Fi vs. the cellular network. This allows them to avoid the costly build-out of a competing cellular network and offer a service at what is usually a fraction of the cost of typical mobile plan.

Charter benefitted handsomely from COVID-era work-from-home trends that increased demand for broadband. However, the shares have sold off over the past six months on concerns of slowing subscriber growth and increased competition from competing fiber and fixed wireless buildouts.

We find these concerns to be overblown. First, Charter spends generously to upgrade their infrastructure and increase the use of fiber in their footprint. Next generation equipment Charter is deploying will soon be able to offer symmetrical download/upload speeds of 1 Gigabyte per second (GB/s), which is more than sufficient to handle even the most data-intensive household's needs and very competitive with fiber. Second, fixed wireless deployments have typically been targeted at less densely populated rural areas where the mobile telephone carriers have excess capacity on their networks and cable broadband providers don't have much of a presence. Transitioning that business model to urban and suburban areas, where cellular networks are capacity-constrained and where the environment is littered with obstacles and interference that disrupt signals, will be far more difficult. Third, even with broadband subscriber additions slowing, Charter is still adding customers at a healthy pace. We expect this to continue due to Charter's incumbent advantages, competitive prices, and more-than-adequate speeds which are still the best available in much of their service area.



Add in modest price increases over time, increased operating efficiencies, and aggressive share repurchases, which are a hallmark of Charter's strategy, and we expect the company to grow free cash flow per share at a mid-teens rate while also benefitting from reversion to a valuation closer to historical norms as the company navigates through this latest round of concerns.

Finally, we decreased several existing positions during the quarter, including the following:

QUANTA SERVICES (PWR)

With shares of Quanta, a successful long-term holding, trading at all-time highs, the fight for capital within our portfolio began to favor other positions described above. While we believe some upside optionality still exists given the secular tailwinds behind electrical grid maintenance and expanding renewable energy generation, we felt it prudent to scale back the position.

ARISTA NETWORKS (ANET)

Investors have clearly moved away from the short-term concerns regarding quarterly market share dynamics that enabled our original purchase in September 2020 and have embraced the sustainability of Arista's competitive moat built around a unified software language, customer-obsessed culture, and increasing demand from hyperscale computing. In fact, our above-Street expectations for earnings power at the time of purchase have proven to be conservative. Arista's management team remains one of the best of all our portfolio companies and we are watching to see if they can replicate the success they have had in hyperscale data centers in the more mundane enterprise market, which could lead to a further step-change in earnings power. Regardless, trimming a small amount to put towards names with potentially higher return characteristics seemed sensible.



KOVITZ

FIXED INCOME COMMENTARY
SECOND QUARTER 2022

MARKET AND PERFORMANCE SUMMARY

In the words of Federal Reserve Chairman Jerome Powell, the Fed is “absolutely determined” to bring down inflation. They acted accordingly this quarter. The Fed raised short-term interest rates by 1.25% and unanimously approved a plan to shrink their \$9 trillion bond portfolio beginning in June. Given the Fed’s aggressive stance, short-term borrowing costs are expected to climb to over 3% this year, compared to near zero at the start of the year.

Fed rhetoric incited a surge in yields across the fixed income market this quarter. 10-Year Treasury bond rates touched 3.5%, high-grade corporate bond yields approached 5%, and new 30-year residential mortgages were being originated at 6% rates. These are all levels that have not been seen in the last decade.

Due to the inverse relationship between yields and prices, the bond market faced historic losses in the quarter. The most widely quoted barometer for the U.S. bond market, the Aggregate Bond Index, declined 4.7% and is now down 10.4% on the year². Bond losses of this magnitude feel unprecedented and for good reason. According to a recent study that encompassed centuries of asset returns, the last time the U.S. bond market suffered losses on par with 2022 was in 1842, around the time covered wagons were traversing the Oregon Trail³.

There is a bright side to this story for Kovitz fixed income investors. Our bond portfolios were shielded from much of the pain, declining less than half that of the broader fixed income market. The average Kovitz fixed income portfolio is down 4.6% this year⁴. The outperformance was largely attributable to our focus on bonds with limited time to maturity and those with adjustable coupon rates. In other words, we had designed portfolios to protect investors from rising interest rates.

Additionally, due to our defensive posture, large portions of our bond portfolios mature each year, and the proceeds can then be redeployed into the current yield environment. The prospects appear attractive. With the yield on the Aggregate Bond Index now at 3.7% versus 1.8% to start the year, it’s a good time to have cash to invest.

THE 60/40 CONUNDRUM

The 60% stock and 40% bond investment strategy, which serves as an unofficial benchmark for balanced portfolios, has been coming under fire lately as both sides of the equation suffered meaningful losses in the quarter. In total, the 60/40 blend combined for a 12% drop⁵. That decline surpassed the worst quarterly drawdowns of the 2008 Global Financial Crisis and 2020 COVID-19 pandemic. While equities fell more during those latter two periods, bonds performed as intended by generating positive returns to offset severe equity declines. This has not been the case in 2022.

60/40 portfolios are designed to reduce investment risk through diversification. Stock and bond prices have been negatively correlated for the last few decades, meaning bonds can hedge a stock portfolio. The inverse relationship minimizes overall volatility and creates smoother returns that investors crave.

¹Measured Using the Bloomberg U.S. Agg Corporate Yield to Worst.

²Measured using the Bloomberg U.S. Aggregate Bond Index.

³McQuarrie, Edward F., Stocks for the Long Run? Sometimes Yes. Sometimes No. (July 23, 2021).

⁴Measured Using the internal rate of return on all fixed income securities by account, gross of fees.

⁵Measured Using the Bloomberg U.S. EQ:FI 60:40 Index.



QUARTERLY CHANGE IN 60/40 PORTFOLIO RETURNS



Source: Bloomberg Finance, L.P.

The bond market's hedging power relies heavily on interest rates falling during times of market distress – boosting bond prices while stocks are falling. Recent history was a perfect backdrop for this relationship. Rates were historically high in the 1980s, with 10-year Treasury yields peaking over 15%, and have been in a perpetual downtrend ever since.

The starting point today is much different. Rates have been at historic lows with limited room for bond prices to appreciate. Not only has this starting point handcuffed the bond market's conventional counterbalance, but inflation fears can impair both sides of the 60/40 portfolio simultaneously, as witnessed this year. If the era of ultra-low inflation experienced for much of the past decade is over, then inflation risk is not something to be dismissed by an investor with a balanced portfolio over the coming decades.

In our opinion, this conundrum can be solved with an unconventional approach to fixed income investing. Interest rate risk is the problem du jour for 60/40 investors, so it needs to be subdued for a bond portfolio to provide stability in an inflationary environment. In turn, the focus of our fixed income strategy remains on high-grade bonds with limited interest rate risk. We believe this subset of the fixed income market should hold value in any environment – recessionary or inflationary – and that's a hedge worth keeping.

KOVITZ POSITIONING

For most of the last two years, we believed low interest rates made owning bonds with longer maturities an unfavorably lopsided wager. With rates approaching zero, long-term bonds offered little income, almost no upside potential from future price appreciation, and a chance for meaningful losses if rates returned to more “normal” levels. Given our perception of the opportunity set, we decreased exposure to interest rate risk within client bond portfolios accordingly.

We are not in the business of betting on the direction of interest rates. We do not believe anyone has shown the ability to consistently and profitably time the direction of rates. Our primary goal as fixed income investors is capital preservation which requires us to balance interest rate risk and adjust our posture accordingly.

Price paid is the largest determinant of risk in our opinion. After historic declines across the bond market this year, we believe the risk factors underlying bond yields have largely rationalized and that higher interest income can once again protect investors from some degree of price volatility.

In other words, since we believe the bond market is reasonably “normal” today, we no longer feel an overly restrictive positioning is warranted. Therefore, we have been selectively deploying capital into maturities going as far as eight years, increased from our previous six-year cap. We are happy to offer clients the improved yields of these longer duration bonds without the feeling of sacrificing the true purpose of bond portfolios – principal protection.



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)
2012	20.59%	19.14%	16.00%	1.70%	14.20%	15.09%	172	160.4	2,404
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%	223	278.3	3,040
2015	-5.82%	-6.96%	1.38%	1.29%	11.36%	10.47%	263	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%	28.6%	28.71%	2.03%	21.36%	17.17%	216	479.3	7,465

DISCLOSURES

Fees: Returns shown incorporate the effects of all realized and unrealized gains and losses and the receipt, though not necessarily the direct investment of, all dividends and income. From the composite's inception through December 31, 2020, net-of-fee 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 January 1, 2021, the net-of-fee returns were calculated by deducting model investment management fees, which are defined as the highest, generally applicable annual fees of 1.25% on all assets in the composite. The fees are deducted on a monthly basis. The 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. Gross-of-fee returns are presented before management fees, but after all trading expenses.

Definition of the Firm: Kovitz Investment Group Partners, LLC (Kovitz) is an investment adviser registered 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 Core 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 inception date for this strategy is January 1, 1997, and the Composite was created on January 1, 2001. The minimum portfolio asset size for the Composite is \$250,000. The benchmark is the S&P 500.

Valuations are computed and performance is reported in US dollars. The measure of internal dispersion presented above is an asset-weighted standard deviation. The 3-year standard deviation presented above is calculated using monthly net-of-fees returns. The 3-year standard deviation is not presented when less than 36 months of returns are available. A complete listing of composite descriptions and policies for valuing portfolios, calculating performance, and preparing compliant presentations are available on request.

GIPS: Kovitz Investment Group Partners, LLC ("Kovitz") claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Kovitz has been independently verified by The Spaulding Group for the periods January 1, 1997 through December 31, 2020. The verification report(s) is/are available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

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