# VALUE FUND

**4Q 2016 Quarterly Commentary**

Weitz | FUNDS®

### Investment Style: Large-Cap Value

The Value Fund's Institutional Class returned +1.27% in the fourth calendar quarter, compared to +3.82% for the S&P 500 and +3.83% for the Russell 1000. For the calendar year, the Value Fund's Institutional Class returned +3.13%, compared to +11.96% for the S&P 500 and +12.05% for the Russell 1000.


**Co-Portfolio Managers**

Brad Hinton, CFA & Dave Perkins, CFA


## Calendar Year Contributors

**Liberty Broadband** is a holding company for Liberty's ownership stake of Charter Communications. Shares of Charter, and cable companies broadly, have performed well in the wake of the U.S. election. Although much remains to be seen, investors generally believe that regulatory pressures will ease as a result of a presumably more "industry friendly" Federal Communications Commission (FCC) as well as a Justice Department that may look more favorably on further industry consolidation. Investors are also hopeful that either the FCC or a Republican-controlled Congress will revisit actions of the previous FCC, including the more controversial actions taken as part of its "Net Neutrality" packages. We have invested in Liberty Broadband because we like the operating strategy at Charter, and while regulatory relief would certainly be a benefit, it's not an explicit part of our investment thesis. Liberty Broadband shares trade at a discount to their underlying Charter investment due to the added complexity of Liberty's involvement. We are confident Liberty's management will ultimately collapse this discount, thereby making Liberty Broadband a cheaper opportunity to invest in Charter's future.

**Berkshire Hathaway** is a conglomerate holding company owning subsidiaries engaged in a number of business activities. Shares benefited from optimism that a combination of higher interest rates, lower taxes and increased domestic activity would increase earnings at Berkshire's insurance and industrial businesses.

**Range Resources** is an independent producer of natural gas and natural gas liquids (NGLs) based in Fort Worth, Texas, with operations in the Marcellus shale and emerging Terryville field. Range's stock cooled some during the second half of the year following a strong first half rebound from its January lows. A more normal start to winter and low overall drilling activity has led to much needed draws on natural gas storage, with present levels now below the 5-year average for the first time in almost two years. Near-term gas prices have rebounded accordingly, but uncertainty around mid-cycle gas prices continues as oil drilling activity resumes (increasing competition from "associated" gas production) and Appalachian pipeline capacity increases significantly later this year. Range should be a direct beneficiary of the latter, supporting the company's 20% production growth aspiration in 2018. While gas prices will likely always be volatile, we believe that at $2.75 or better, Range shares offer significant value.

## Calendar Year Detractors

**Liberty Global** is the largest international cable company, with operations across Europe providing video, broadband Internet, fixed-line telephone and mobile services to its customers. Throughout 2016, Liberty Global suffered as the translational impact of a stronger U.S. dollar muted its reported financial results. Liberty's revenues and expenses are generally denominated in the local currencies of its European operations, but its dollar denominated stock can create mismatches from time to time. Shares weakened, particularly in the wake of this summer's "Brexit" vote, as the UK is the company's largest market. Shares have recouped some of these losses as the market has further digested the Brexit event. Meanwhile, the results from the company's new build program in the UK appear to be solid, and the pace of adding newly connected homes should accelerate into 2017. We remain confident in management's plans to drive cost efficiencies and their new build investment strategy to provide future growth.

**Allergan** - Please refer to Quarterly synopsis.

**Endo International** is a specialty healthcare company engaged in developing, manufacturing, marketing and distributing branded pharmaceutical and generic products and medical devices. Endo experienced significantly worse-than-anticipated erosion at Qualitest, its legacy generic drug platform. The competitive environment changed quickly, and we were slow to recognize it. After conversations with both management and a couple of the larger drug buying consortiums, we could not gain comfort in the durability of Endo's now lower earnings base. The company's balance sheet and potential legal obligations (liabilities relating to the company's legacy vaginal mesh products) leave less room for error given growth challenges on the branded side of Endo's business. Considering the erosion in our investment thesis, questions about management's ability to identify and navigate risk, and a growing list of unknowns surrounding the business, we elected to close our position in the second calendar quarter and refocus our capital in more attractive opportunities.

## Quarterly Contributors

**Berkshire Hathaway** - Please refer to Calendar Year synopsis.

**Wells Fargo** is a diversified financial services company. Shares rose materially during the quarter largely due to three tailwinds. First, the U.S. election results provided a boost to all bank stocks on expectations that industry regulatory burdens may ease. Second, higher interest rates and a steeper yield curve raised prospects for net interest margin (NIM) expansion. Third, the company took additional steps to address the "bogus account" scandal, including high-level management changes. The company's very low-cost deposit base, ubiquitous distribution, ample capital and diverse business lines further our continued confidence. Wells Fargo's stock trades at less than 14x expected earnings and a modest discount to our value estimate.

**Twenty-First Century Fox** is a diversified media and entertainment company. Sentiment has been generally positive as investors were reminded of the power of live, must-have content. The month of October featured two of the most widely watched presidential debates in history and five of seven World Series games that delivered the best ratings in over a decade. Investors have been further comforted by Fox's presence in all of the major "skinny bundles" announcements and new online Pay-TV distribution packages. Finally, in December, Fox announced an offer to acquire the remaining shares of Sky plc. The announced offer for Europe's premier satellite Pay-TV and content (sports and entertainment) company resolves a long-standing question of how to resolve Fox's 39% minority stake in the entity. We continue to be encouraged by the prospect for continued improvement at Fox's domestic channels and continued growth opportunities internationally.

## Quarterly Detractors

**Liberty Global** is the largest international cable company, with operations across Europe providing video, broadband Internet, fixed-line telephone and mobile services to its customers. In early November, Liberty Global reported third quarter results that were generally positive. The early results from the company's new build program in the U.K. appear to be solid, and the pace of adding newly connected homes should accelerate into 2017. The strength of the U.S. dollar continues to be a headwind from a reporting standpoint–though most of the company's revenues, expenses and borrowings are matched to their local currencies. We remain confident in management's plans to drive cost efficiencies and new build investment strategy to provide future growth.

**Allergan** is a global specialty pharmaceutical company focusing on the development, manufacturing, marketing and distribution of brand name, biosimilar and over-the-counter pharmaceutical products. Following a brief post-election rally, the majority of the biopharmaceutical sector retreated to prior price levels as capital continued to flow out of healthcare and into industries seen as potential beneficiaries of policy shifts under the new administration. After downwardly revising future growth expectations in August and again in early November, Allergan has become a "show me" story. Patent challenges for Restasis (dry eye treatment) and Namenda XR (alzheimer's drug) may continue to weigh on the stock in the near term, though each contributes only a small percentage of our estimate of the company's overall intrinsic value. Over the next 3-5 years, we believe the company will have healthy mid-single digit (or better) operating profit growth. 80% of the company's recently announced $10 billion accelerated share repurchase program is complete at an average price below $200 per share. We believe this will prove to be a prudent use of excess cash in the long run. Future capital deployment and late-stage pipeline success remain potential positives over the next 12-24 months. We continue to believe Allergan shares present compelling value at current prices.

## Quarterly Detractors *(Continued)*

**McKesson** distributes drugs, equipment and health and beauty care products throughout North America and portions of Europe. The company also delivers software solutions and outsourced services to hospitals, pharmacies and other healthcare organizations. Shares of McKesson declined in October as the company experienced unexpected competitive losses from its core independent pharmacy customer base. The source (price competition) and magnitude of these developments led to a downward revision in McKesson's earnings power and undermined one of the pillars of our investment thesis – that drug wholesalers operate within a competitive, but otherwise rational, oligopoly. Our estimate of McKesson's business value declined, and we elected to close our small position at a modest loss.

## New Holdings

**Visa** is the world's largest electronic payment network. The company recently closed on its acquisition of Visa Europe, allowing it to provide a fully integrated network to clients, which should result in increased market share and lower costs. We believe Visa will compound nicely as worldwide payment volumes grow, developing countries switch from cash to cards and the company uses its technology and network to participate in all forms of electronic payments.

**Thermo Fisher Scientific** provides analytical instruments, equipment, reagents and consumables, as well as software and services for research, analysis, discovery and diagnostics across most of the globe. Thermo is well-diversified by both product and end market, boasting strong defensible market positions and reputable brands. Roughly three quarters of the company's revenues are recurring in nature (consumables and services), consistent with our preference for subscription-like cash flow streams. Its portfolio of businesses is characterized by stable pricing, relatively acyclical organic growth and consistent excess cash generation. We believe the life sciences tools and diagnostics industry is a "good neighborhood," characterized by relatively high entry barriers, high customer switching costs and rational competitive behavior. Currency headwinds and investor rotation toward more cyclically-exposed areas of the industrial and healthcare sectors left Thermo's stock largely unchanged the past 18 months while our estimate of business value grew nicely. We took advantage, initiating a position at, what we believe is, an attractive valuation.

**Amazon.com** is an e-commerce and cloud computing company. We believe that Amazon has built a global competitive advantage that will allow it to obtain a material share of the worldwide retail (not just e-commerce) market over a long period of organic growth. Amazon's strong, customer-obsessed culture is unique among technology and retail firms, which has provided several new long-term investment opportunities. In addition to the retail business, the company's

## New Holdings *(Continued)*

Amazon Web Service (AWS) business has built significant share and scale within the infrastructure as a service market. AWS business is highly profitable and participates in a large and growing market.

**CVS Health** operates a nationwide network of nearly 10,000 retail pharmacies, the nation's second largest pharmacy benefits manager (PBM) in Caremark, and sizeable specialty and long-term care pharmacy platforms. This is the fund's second go around with CVS, having last owned it back in 2013. CVS' stock has been under pressure for most of the last 18 months after peaking during the summer of 2015. After nearly five years of consistent market share gains, the Caremark PBM suffered several client losses over the course of 2016. In addition, CVS also announced that its retail pharmacies would no longer be part of several important networks in 2017. These lost volumes will likely result in no earnings per share growth this year. These near-term negatives drove the stock down to a price that we found attractive. While management will need to navigate several risks over the course of the next couple of years, we believe CVS' stock price provides an attractive valuation in the mid-$70s.

We have no doubt, though, that just as stocks and bonds have been mispriced on the high side recently, they will be mispriced on the low side again someday.

Click to read Value Matters: 4Q16 Letter to Investors

## Eliminated Holdings

**Express Scripts** is the largest stand-alone pharmacy benefits manager (PBM) in the U.S., helping health benefit providers improve access to (and the affordability of) prescription drugs. The ongoing impasse with its largest customer (Anthem), an evolving competitive landscape, and public finger pointing between so-called middlemen and drug manufacturers as to the source of persistent drug inflation led us to (once again) test the assumptions underlying our notion of Express's business value. Our additional diligence suggested an increased probability of Anthem not renewing with Express Scripts in 2019. In addition, the likelihood that competitive or industry pressures offset a portion (potentially even all) of other future profit-per-script drivers seem to have increased, particularly for Express. This combination made the risk-reward trade-off less compelling, and we elected to close our position in Express across the funds following the post-election rally in November.

**EOG Resources** is an independent producer of crude oil and natural gas, with operations focused in the major producing basins in the U.S. (namely the Bakken, Eagle Ford and Permian). EOG boasts some of the highest quality hydrocarbon producing assets in North America as well as a culture firmly centered on return on invested capital. Its unique ability to continually reduce both costs and the capital employed in the production process places the company among the most efficient producers of oil and gas in the world. We purchased shares in EOG in the fall of 2015 amid significant downward pressure on oil prices. Management's ability to unlock an inventory of over 4,000 high-return wells (assuming $40 oil prices) within its existing acreage through continued process improvements, in addition to its successful acquisition of Yates Petroleum, exceeded our expectations and rightly excited investors. With oil prices rebounding and EOG's discount to value narrowing, we sold our shares during the fourth quarter at a nice gain. We would gladly own EOG again at the right price.

**McKesson** - Please refer to the Quarterly synopsis.

| Quarterly Top Performers | Return | Average Weight | Contribution |
|---|---|---|---|
| Twenty-First Century Fox, Inc. - Class A | 15.8% | 5.6% | 0.93% |
| Berkshire Hathaway Inc. - Class B | 12.8% | 7.0% | 0.89% |
| Wells Fargo & Co. | 25.5% | 2.1% | 0.53% |
| Liberty Broadband Corp. - Series C | 3.6% | 6.1% | 0.23% |
| Motorola Solutions, Inc. | 9.3% | 2.0% | 0.20% |

| Quarterly Bottom Performers | Return | Average Weight | Contribution |
|---|---|---|---|
| Liberty Global Group - Class C | -10.1% | 5.1% | -0.55% |
| Allergan plc | -8.8% | 5.5% | -0.48% |
| McKesson Corporation | -15.6% | 0.3% | -0.30% |
| Laboratory Corp. of America Holdings | -6.6% | 3.3% | -0.22% |
| Range Resources Corp. | -11.3% | 1.4% | -0.17% |

Contributions to performance are based on actual daily holdings. Securities may have been bought or sold during the quarter. Return shown is the actual quarterly return of the security or combination of share classes. Source for return shown is FactSet Portfolio Analytics.

***Past performance does not guarantee future results.*** *The investment return and the principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Average annual total returns for the Fund's Institutional and Investor Class for the one, five and ten year periods ended December 31, 2016 were 3.13%, 10.04%, 3.36% and 2.88%, 9.93%, 3.31%; respectively. The returns above assume reinvestment of dividends and redemption at the end of each period, and reflect the deduction of annual operating expenses, which as stated in the most recent Prospectus are 1.08% (gross) and 1.23% of the Fund's Institutional Class and Investor net assets, respectively. The returns above also include fee waivers and/or expense reimbursements, if any; total returns would have been lower had there been no waivers or reimbursements. The investment adviser has agreed in writing to waive its fees and reimburse certain expenses (excluding taxes, interest, brokerage costs, acquired fund fees and expenses and extraordinary expenses) to limit the total annual fund operating expenses for Institutional Class shares and Investor Class shares to 0.99% and 1.30%, respectively, of each Class's average daily net assets through July 31, 2017. Current performance may be higher or lower than the performance data quoted. Performance data current to the most recent month end may be obtained at www.weitzinvestments.com/funds_and_performance/fund_performance.fs.*

*Institutional Class shares became available for sale on July 31, 2014. For performance prior to that date, the above returns include the actual performance of the Fund's Investor Class (and uses the actual expenses of the Fund's Investor Class), without adjustment. For any such period of time, the performance of the Fund's Institutional Class would have been similar to the performance of the Fund's Investor Class, because the shares of both classes are invested in the same portfolio of securities, but the classes bear different expenses.*

*Comparative returns are the average returns for the applicable period of the S&P 500® and the Russell 1000® Indexes. The S&P 500 is an unmanaged index consisting of 500 companies generally representative of the market for the stocks of large-size U.S. companies. The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is the trademark of Russell Investment Group. Index performance is hypothetical and is shown for illustrative purposes only.*

*As of 12/31/2016: Liberty Broadband Corp.-Series C comprised 6.5% of the Weitz Value Fund's net assets; Berkshire Hathaway Inc.-Class B 7.1%; Wells Fargo & Co. 2.0%; Twenty-First Century Fox, Inc.-Class A 5.0%; Range Resources Corp. 1.4%; Liberty Global Group – Class C 4.9%; Allergan plc 6.1%; Visa Inc.-Class A 2.0%; Thermo Fisher Scientific Inc. 2.0%; Amazon.com, Inc. 1.1%; Motorola Solutions, Inc. 1.7% and CVS Health Corp. 1.1% . Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.*

*Investors should consider carefully the investment objectives, risks and charges and expenses of the Funds before investing. The Fund's Prospectus contains this and other information about the Funds and should be read carefully before investing. The Prospectus is available from Weitz Investment Management, weitzinvestments.com, 800-304-9745 or 402-391-1980.*

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