October 12, 2018

Longleaf Partners Fund Commentary

3Q18

Longleaf Partners Funds

Longleaf Partners Fund gained 2.70% in the third quarter, on pace to meet our absolute annual goal of inflation plus 10% but lagging the S&P 500 Index's 7.71%. Year-to-date (YTD) the Fund gained 3.39%, while the Index rose 10.56%. The Fund compounded at 7.13% over the last 12 months, below our absolute goal. By contrast, the Index delivered 17.91%, capping off a 9-year bull run with a gain almost 2X its average long-term return. The Fund's relative results in the third quarter, the last year and the last 3 years have been primarily about what has gone right for the Index, rather than poor results at the companies we own.

A concentrated set of companies drove much of the S&P 500's 1-year return. Minus companies in the Information Technology sector, Amazon (part of Consumer Discretionary) and Alphabet and Netflix (both part of Communication Services), the Index would have approximately returned a more modest 8%. While a limited number of stocks often drive most of Index returns, the big drivers over the recent past have been mega technology-related companies that have now grown to a combined size that makes it very unlikely mathematically that they can grow by similar multiples over the next 5 years. We find it difficult to assess with confidence the next 5 years' landscapes and competitive advantages of most technology related businesses and/or think their current multiples imply a growth rate that has no room for inevitable bumps in the road. As was the case in the late 1990's, our requisite margin of safety to hedge against capital loss makes us avoid companies priced for perfection, and, when those dominate, the Fund underperforms.

Average Annual Total Returns (9/30/18): Since Inception (4/8/87): 10.43%, Ten Year: 8.06%, Five Year: 6.15%, One Year: 7.13%.

Returns reflect reinvested capital gains and dividends but not the deduction of taxes an investor would pay on distributions or share redemptions. Performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by visiting longleafpartners.com.

As reported in the Prospectus dated May 1, 2018, the total expense ratio for the Longleaf Partners Fund is 0.95%. The expense ratio is subject to fee waiver to the extent a fund's normal annual operating expenses exceed 1.50% of average net assets.

Beyond the absence of the high-flyers, two other things have held back the Fund's relative returns. First, just as in previous overvalued markets, cash from successful sales has built in the absence of qualifying new investments. The Fund's 18% average cash position over the last year cost approximately 300 basis points versus the Index but obviously incurred no risk of capital loss. Second, five companies based outside of the U.S. comprised 28% of the portfolio and subtracted 112 basis points from performance over the last year. The rising dollar, tariffs and geopolitical uncertainties, such as Brexit, all contributed to Non-U.S. stocks rising just 2.7% (measured by the MSCI EAFE Index) in the last year, while the overpriced U.S. market appreciated over 6X that amount. The Fund's foreign holdings - LafargeHolcim, CK Hutchison, CK Asset, CNH and Fairfax - each have growing, quality, global businesses led by capable management teams and we view them as superior or comparable to their U.S. peers, even though they trade at lower multiples.

Although we believe the Index will face a correction and revert to its long-term average return at some point, our ability to compound at a real double-digit rate does not depend on what happens to the Index. With around twenty holdings, performance in any given year usually comes from just a few stocks. Company-specific events and management-led outcomes drive the Fund's investment results, which generally have little to do with what drives the broader index. Stock prices often move up in a short number of days as sentiment quickly changes. For example, CenturyLink was the Fund's largest contributor for the quarter and YTD as management delivered results that many had doubted, and the stock gained 26% over just 3 days in 2018. CNH rose 18% in less than two weeks after raising guidance, having its debt upgraded, and appointing a new CEO. Park Hotels began a 3-month 34% rise with news of HNA's plan to sell its 25% stake.

Living patiently with idiosyncratic payoff patterns can be difficult but is necessary. More often investors make decisions based on stock price performance without regard to the direction of a company's underlying business value. Chasing performance puts capital at risk, with the danger usually realized too late. We usually do not know when payoffs among our portfolio companies will occur, but most values are appreciating, and many current holdings offer significant upside potential with our management partners pursuing restructuring, substantial repurchases at deep discounts and sales of assets or entire businesses.

Contributors/Detractors

(Q3 Investment return; Q3 Fund contribution)

CenturyLink (17%,1.65%), the global fiber infrastructure company, was the Fund's largest contributor. Quarterly EBITDA grew 5% year-over-year (YOY) on nearly 300 basis points of margin improvement. The company's Business segment revenues showed a slight decline due to management's appropriate decision to eliminate unprofitable customers. Looking ahead, the company is improving customer service while reducing network, billing and inventory expenses. With free cash flow (FCF) ($3+/share) easily covering the dividend ($2.16/share), CenturyLink is reducing debt and expanding in select areas of enterprise and consumer broadband. Late in the quarter, CFO Sunit Patel announced his departure to oversee the merger integration at Sprint and T-Mobile. Patel has been a valued partner during our investment with Level 3 and CenturyLink. Although the stock pulled back upon the announcement, Patel's departure does not impact our appraisal of the company. Interim CFO Neel Dev is a well prepared 14-year company veteran who has worked directly under Patel for the last 6 years and overseen much of the successful merger integration.

Allergan (15%, 0.69%), the pharmaceutical company, added to the Fund's results in the quarter. Allergan's Medical Aesthetics portfolio, consisting of Botox, Juvederm and Coolsculpting, grew revenues 12%. Despite the stock's recent performance, the price ascribes little-to-no value for Allergan's promising late-stage mental health, migraine and macular degeneration research and development pipeline projects. During the quarter, CEO Brent Saunders sold the company's dermatology drug portfolio to Almirall for a good price and increased the share repurchase program by $2billion. The stock trades at a low-double-digit multiple of next year's FCF, despite Botox's growing consumer franchise, insulation from systemic healthcare cost pressures and large non-earning assets in the pipeline.

CK Hutchison (10%, 0.64%), a conglomerate of telecommunications, health & beauty, infrastructure, global ports and energy, was a contributor in the quarter. CK Hutchison reported strong first half results, with YOY revenue and EBITDA up +16% and +19%, respectively. Interim dividend per share grew by 11.5%, the first double-digit increase in the past decade. The company highlighted the strength of its Retail segment, which is the largest health and beauty retailer in the world with over 14,000 stores, 12 brands and 130 million loyalty members that contribute over 62% of sales. Oil price recovery added to Husky results. In the first half, revenue increased by 37% YOY and EBITDA by 47%. In the quarter, CK Hutchison announced the sale of its interests in several infrastructure projects at a 12X earnings and redeployed the proceeds to acquire an Italian telecom joint venture at 5x earnings. Management also repurchased the company's discounted shares in the quarter for the first time in almost 2 years.

CNH Industrial (CNHI) (13%, 0.64%), the maker of Case and New Holland agriculture equipment (AG) and Iveco trucks (CV), added to performance. CNHI reported strong Q2 results with sales growing 13% YOY at constant currency and EBITDA up 30%. Management upgraded its FY18 forecast. The AG segment continued to improve, with sales up 18% YOY. Increasing replacement demand for high horsepower NAFTA row crop equipment is driving AG margins higher. Cash generation was strong, and S&P Global raised CNHI's credit rating by a notch within investment grade. The company continued to return excess capital to shareholders in the form of dividends and buybacks. New CEO Hubertus M. Mühlhäuser, who has both AG and breakup experience, joined in the quarter.

United Technologies (12%, 0.56%), the industrial conglomerate, contributed in the quarter. Aerospace revenues grew high single-digits, and the Rockwell Collins acquisition is scheduled to close soon. Climate, Controls and Security segment revenues increased steadily at 4%. Otis Elevators had smaller growth but a 10% increase in new equipment orders. Missed quarters, confusion around the company's strategy and the temporary growing pains for Pratt & Whitney's geared turbofan (GTF) engine allowed us to purchase the stock cheaply three years ago, but these worries are all fading. CEO Greg Hayes and the board are considering separating the company's three businesses, which would likely result in further value recognition.

CNX Resources (-20%, -1.27%), the Appalachian natural gas exploration and production (E&P) company, detracted from performance in the quarter. The company disappointed the market on a few metrics – some that the company can do better on itself, some outside of its control – that did not impact our long-term appraisal. To the positive, the company closed the sale of a Utica joint venture for $400 million. Additionally, former partner Noble finally sold the last of its ownership of CNX's midstream master limited partnership, removing an overhang and enabling CNX to operate the business more flexibly. CEO Nick Deluliis and CFO Don Rush continued repurchasing discounted shares at an annualized double-digit pace, which is very rare in the E&P world.

General Electric (-16%, -0.95%), the reorganizing aviation, healthcare and power company, declined after announcing a technical problem with an H-series gas turbine blade. Based on management's assessment, we view this as a temporary issue that should not impact the Power segment's long-term value – much like United Technology's GTF issues during our first 1-2 years of owning it. The extreme negative sentiment around the company, however, caused the stock price to overcompensate for any disappointing news. More importantly, GE Aviation and Healthcare, which constitute a large majority of our appraisal, grew on strong orders and revenues. Over the last year, GE sold nearly $18 billion of businesses for higher prices than we carried them. On October 1, the company announced that board member Larry Culp, former CEO of Danaher, would become CEO and Chairman, replacing John Flannery. We were excited when Culp joined the board in April, given his success at Danaher, and we believe he can accelerate GE's turnaround that Flannery initiated. In the next year, it is possible that GE's Healthcare segment could be spun off or sold to one of several suitors willing to pay a fair price. Energy (Baker Hughes) also is a candidate for monetizing. Transportation is slated to be a separate entity by this time next year. We believe that, as the company's structure simplifies and divestitures further strengthen the balance sheet, the stock should more properly reflect the values of these strong assets, which we believe to be worth more than$20/share.

Portfolio Activity

During the quarter, we began purchasing one new business, which remains undisclosed while we work to build the position. The market's big gains in the quarter reduced our on-deck list of prospects, as prices moved away. We sold CONSOL Energy, the coal business that spun off from gas company CNX Resources in November of 2017. Since separating, the stock gained 93%, after strong production led to increased earnings guidance.

Outlook

Because it is a challenging time for disciplined value investors to buy discounted, quality businesses, the Fund's cash remained high, ending the quarter at 10.6%. Cash has been a performance headwind in this strong market, but we are disciplined buyers and will seek to avoid putting capital at risk of loss. We are confident that we will find additional qualifiers, as individual companies fall out of favor or the whole market pulls back.

The Fund's high-60%s price-to-value ratio (P/V) is based on our discounted FCF appraisals, which are growing and potentially understated, especially to the extent that our management partners are successful in their pursuit of value recognition. Many companies we own are in whole or have parts that are more valuable to others, and acquisition multiples are notably higher than our long-hand appraisal math. We have CEOs with a history of monetizing assets and selling companies at fair prices, including Jeff Storey at CenturyLink, Victor Li at CK Hutchison and CK Asset, Ynon Kreiz at Mattel, Nick Deluliis at CNX, Tom Baltimore at Park Hotels, Brent Saunders at Allergan, Prem Watsa at Fairfax and Greg Hayes at United Technologies. Transactions offer upside optionality not imbedded in the stock price or our appraisal.

As important, our appraisals should grow, as our management partners focus on the competitive strengths of their companies, drive higher margins and reinvest FCF prudently, including into discounted shares. Whether by internally-driven operations or externally-focused capital allocation, rising values ultimately pull stock prices higher. The timing is usually unpredictable, and big performance spikes occur regardless of the broader stock market's direction. As the managers and largest collective investor in the Partners Fund, we are confident that our CEOs can create more of the idiosyncratic, large payoffs that have driven the Fund's successful long-term results.

See following page for important disclosures.

Before investing in any Longleaf Partners Fund, you should carefully consider the Fund's investment objectives, risks, charges, and expenses. For a current Prospectus and Summary Prospectus, which contain this and other important information, visit longleafpartners.com. Please read the Prospectus and Summary Prospectus carefully before investing.

RISKS

The Longleaf Partners Fund is subject to stock market risk, meaning stocks in the Fund may fluctuate in response to developments at individual companies or due to general market and economic conditions. Also, because the Fund generally invests in 15 to 25 companies, share value could fluctuate more than if a greater number of securities were held. Mid-cap stocks held by the Fund may be more volatile than those of larger companies.

The S&P 500 Index is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. An index cannot be invested in directly.

P/V ("price to value") is a calculation that compares the prices of the stocks in a portfolio to Southeastern's appraisal of their intrinsic values. The ratio represents a single data point about a Fund and should not be construed as something more. P/V does not guarantee future results, and we caution investors not to give this calculation undue weight.

"Margin of Safety" is a reference to the difference between a stock's market price and Southeastern's calculated appraisal value. It is not a guarantee of investment performance or returns.

Brexit ("British exit") refers to the June 23, 2016 referendum by British voters to leave the European Union.

EBITDA is a company's earnings before interest, taxes, depreciation and amortization.

Free Cash Flow (FCF) is a measure of a company's ability to generate the cash flow necessary to maintain operations. Generally, it is calculated as operating cash flow minus capital expenditures.

Price / Earnings (P/E) is the ratio of a company's share price compared to its earnings per share.

As of September 30, 2018, the top ten holdings for the Longleaf Partners Fund: CenturyLink, 11.8%; CK Hutchinson, 7.5%; LafargeHolcim, 6.5%; FedEx, 6.3%; Mattel, 6.1%; CNX Resources, 5.4%; GE, 5.3%; Park Hotels, 4.9%; Fairfax, 4.9%; Allergan, 4.8%. Fund holdings are subject to change and holdings discussions are not recommendations to buy or sell any security. Current and future holdings are subject to risk.

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