

Investment Commentary

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Kovitz Investment Group

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This newsletter has been prepared by Kovitz Investment Group, LLC, an investment adviser registered under the Investment Advisers Act of 1940. This Investment Commentary is a quarterly newsletter for our clients and other interested persons. Within this newsletter, we express opinions about the direction of the market, investment sector and other trends. The opinions should not be considered predictions of future results. Discussion in this newsletter relating to a particular company is not intended to represent, and should not be interpreted to imply, a past or current specific recommendation to purchase or sell a security. The information contained in this newsletter, which is based on outside sources, is believed to be reliable, but is not guaranteed and not necessarily complete. Past performance does not guarantee future returns.

Market and performance summary

The equity portion of the accounts managed by KIG, in aggregate, declined in value by 3.8% in the third quarter, lowering the calendar year gain to 6.9% (net of fees and transaction costs). Year-to-date, the KIG composite has outperformed the 1.5% return of the S&P 500, our standard performance benchmark. So while the quarter was a forgettable one, we are not unhappy with our results so far this year as we continue to outperform by a respectable margin.

The quarter was rather volatile and there was a great deal of variability in the performances of the individual stocks in the portfolio. Strong gains by **Kohls (NYSE: KSS)**, **Motorola (NYSE: MOT)**, **Home Depot (NYSE: HD)**, **McDonalds (NYSE: MCD)**, **Laboratory Corp (NYSE: LH)** and **BJs Wholesale (NYSE: BJ)** were offset by losses in **Cardinal Health (NYSE: CAH)**, **Merck (NYSE: MRK)**, **IAC/InterActive (NASDAQ: IACI)**, and **St. Paul Travelers (NYSE: STA)**.

Speaking of Merck, on September 30th, it gave the market a nasty surprise when management said the company would stop selling Vioxx, its \$2.5 billion-a-year arthritis and pain relief drug. Merck pulled the drug after a recent study revealed that long-term use of the drug could increase the risk of heart attack and stroke. Data accumulated prior to this study did appear to indicate a slightly higher incidence of cardiovascular events for patients taking Vioxx, but this information was well known throughout the medical community and indicated on the drug's label. While we will never make excuses for our mistakes, the company's action for a voluntary recall did catch us by surprise (and apparently most other investors as evidenced by the one day 10 point drop in its share price).

After thoroughly analyzing the situation (though admittedly, some of the issues and exposures are not readily analyzable) we made the decision to hold the stock. Excluding all earnings contribution from Vioxx and

its next generation product Arcoxia and taking into consideration the potential legal liability associated with patient lawsuits (where culpability and causation may be difficult to prove), we felt the stock was too cheap to sell. While it's certainly possible the company may cut its dividend, cash flow remains healthy even excluding lost sales from Vioxx, and should continue to support a healthy dividend yield that's currently in excess of 5%. And even after suffering a couple of recent clinical trial setbacks, the pipeline of potential new drugs is not bare. However, given the known risks we did not feel comfortable adding to our position or buying for new clients. Our analysis is ongoing and the situation remains fluid.

Many of our portfolios were adversely affected during the quarter when Cardinal Health, a leading pharmaceutical distributor, revealed that an informal SEC investigation into the company's accounting had been expanded beyond its initial scope. The company also disclosed that its negotiations with the pharmaceutical manufacturers regarding the transition of their drug distribution business from a buy-and-hold to a fee-for-service business model were proceeding more slowly than anticipated. While certainly not welcome news, we believe the accounting irregularities were fairly minor and will result only in a reclassification of certain revenues and will not affect the company's cash flow, which remains robust. We also believe Cardinal will ultimately be successful in its business transition and the risks inherent in this evolution are priced into the stock at current levels. Its business is also well diversified which should buffer the potentially uneven results coming from the distribution business. But again, owing to the innate risks, we have not yet increased our position for existing client accounts or made a purchase for new clients. We will however, harvest the loss for tax purposes as an offset to the realized capital gains we have taken so far

this year. As of the writing of this letter, the Company's stock recovered significantly after it released its delayed 10-K (annual report) with no major surprises.

While we feel all of the stocks we make the decision to purchase are undervalued to some degree, we fully realize that the odds are stacked against us that we will be proved right on every decision. It is for this reason that our investment philosophy's primary focus is on minimizing our mistakes (through strict selection criteria and being extremely price conscious), and have confidence that our good decisions will greatly outnumber the poor ones enabling us to garner a strong overall portfolio return relative to our benchmark. As much as we would like to, we cannot invest in equities without subjecting our portfolios to some financial risk: the uncertainties of business (and the economy to some extent) do not allow for this. We can only trust that our ability to differentiate a good business from a poor one and to recognize a fair price to pay for that business will lead us to make a preponderance of good decisions. Importantly, having a few stocks with current yet unrealized losses does not cause our confidence to waiver nor stop us from making that next decision.

There was some good news in the quarter. **Oxford Health (NYSE: OHP)**, often the subject of takeover rumors, realized that fate when **UnitedHealth Group (NYSE: UNH)** swooped in to buy the managed care company only days after talks ended with another potential suitor. We spend the majority of our time thinking about what companies are worth, looking at the economics and the competitive positioning of the business and determining what an intelligent private owner would pay to buy that business and hold it forever. Based on Oxford's strong brand image and its unique competitive niche on the East Coast, we had long believed that its private market value was greater than its public market price.

So then... What about margin of safety?

Our margin of safety principle, which we have referred to many times in these pages as one of our core investment tenets does not guarantee against losses in stocks we own. Instead, if a stock passes our screening criteria for business quality and our valuation models suggest it's significantly undervalued, we believe only that the *probability* of large loss is severely diminished, not that it absolutely can't or won't happen. In the aggregate, we feel that if we assemble a portfolio that includes 25-35 names that meet our margin of safety criteria, overall portfolio risk will be properly managed. We further manage risk in the portfolio management process by scaling into positions and closely monitoring position sizes to make sure no one position becomes too large a percentage of the overall equity portion of the account. In other words, properly managing the overall book will deaden the impact of losses, even significant losses in a small percentage of the holdings. The key is to keep the mishaps small in relation to our collective decisions.

Short-term performance may very well largely be a matter of luck anyway. In order to evaluate the skill and diligence of an investment manager and to separate the element of luck you need to examine results over a long period of time. Looking at the five year period since September 30, 1999, a period encompassing various market cycles, KIG equity portfolios have *increased* a cumulative 51% (8.5% on an annualized basis) net of fees and costs. For the same time period, the S&P 500 has *declined* in excess of 6% (negative 1.3% per year). We don't believe that these types of results could have been generated by maintaining a short-term focus. In fact, our decisions are never geared toward outperforming on a quarterly basis but rather are focused on increasing wealth over long stretches of time. Also, these results have been produced despite the fact that from time to time we may suffer some setbacks in individual names.

Recent portfolio activity— Our sells

While we primarily sat on our hands in terms of portfolio maneuvers in the second quarter, this quarter proved to be in stark contrast as we were active on both the buy and sell side; such will be the case when you are guided by valuations and not the calendar. All of our sell actions except for one were for our favorite reason- the stock prices increased to what we believe represented fair value for the businesses. These companies, with holding periods of one to three years and gains ranging from 26% to 82% (based on aggregate average purchase prices for the KIG composite and including dividends), were **Jack-in-the-Box (NYSE: JBX)**, **Allstate (NYSE: ALL)**, **Lafarge (NYSE: LAF)** and Oxford Health.

The exception was St. Paul Travelers, which was sold at a loss of approximately 15% on average. It was only last quarter that we extolled the virtues of the St. Paul and Travelers merger and our confidence in the future of the combined entity. But our analysis and intelligence gathering does not stop once we purchase a company for the portfolio, in fact our efforts are in a sense stepped up in order to make sure what we bought is really what we thought we bought. Most times, the information gleaned post purchase confirms our original investment thesis. However, there are times we uncover new information or reassess risks that put our original investment thesis to the test. When this happens, portfolio changes need to be made regardless of whether that action is contrary to what we believed (and publicly stated) even less than 90 days ago.

Some investment advisors tend to sweep new pertinent information opposing their initial beliefs under the rug, hoping to be bailed out of their investment at a later date by an acquisition or perhaps a bull market. We, on the other hand, realize that we are going to make mistakes (that's about the only thing we can really be sure of) and try to be intellectually honest with ourselves (and our clients) at the point and time the mistake

becomes obvious (or at least becomes a higher probability event). Instead of merely postponing the day of reckoning and hoping things can turn around, we take swift action to remove the offender from the portfolio. Hope is not one of our investment strategies.

In the case of St. Paul we were confronted with two new pieces of information. The first involved the adequacy of the loss reserve levels of the combined entity. We had believed that the merger made sense for strategic reasons of increasing scale and capital base, two hugely important characteristics of successful insurance companies. Soon after their first quarter reporting results as a combined entity it became evident that this may not be the case and instead of the whole being greater than the sum of the parts, the opposite may be a more likely outcome- the small problems of two companies can mushroom when combined.

The second issue revolved around their exposure to asbestos litigation, and a new unanticipated (perverted?) use of the bankruptcy system to exploit gaps in the typical insurance contract. Quantifying asbestos litigation exposure, even prior to this new development, had been a controversial subject for some time in the insurance industry where logic, reason and even ethical decency has been turned on its head by claimants with no current signs of illness (except a clear bout of greed) who have been securing settlement awards with former employers and their insurance companies. Being as absurd as it was, it was long assumed that the government would eventually be able to step in and put the perverse process back on its correct track- to pay out awards to only those who were truly harmed by asbestos exposure. While it's possible that some type of reform could be forthcoming, with a sharply divided House and Senate we place low odds on anything meaningful coming to pass. The latest bankruptcy-related development tipped the balance of our opinion against continuing to hold the shares.

What's new?

Turning to the new purchases, it was just last quarter we lamented the fact that we were finding it difficult to identify investment ideas that met our criteria for purchase. We were firm in our conviction, however, that we would not commit client capital just for the sake of appearing active, and were rather content to wait for situations where we believed we were receiving more in value than we were paying. Our patience paid off somewhat as we added three new positions and increased our stake in an existing holding. We also used what we believed to be temporary declines in prices of several existing holdings to initiate positions in accounts for new clients.

Still, the cupboard of new purchase opportunities remains largely bare. Our business owner/private market value methodology is just not turning up that many attractive prospects. Most of the businesses that we find appealing (those in our "Universe" which was described in detail last quarter) seem to be selling at prices we believe represent fair value (i.e. little upside potential). In every case, however, we think only about what the business is likely to do, not what the market, the Fed, or the economy might do.

Our three new purchases were Motorola, **WellPoint Health Network (NYSE: WLP)** and **Furniture Brands (NYSE: FBN)**. Motorola, a global provider of wireless handsets and telecom infrastructure, is going through a rebirth of sorts. A new management team has refocused the company on its core strength of innovation and has radically reengineered its processes, cutting a tremendous amount of fat out of the cost structure. We believe Motorola will benefit from a superior product portfolio and increased operating leverage through its restructuring and consolidated sourcing. The company also recently spun off its capital intensive semiconductor business, which should increase free cash flow and future returns on capital.

WellPoint is a managed care provider serving approximately 15 million members primarily in California. WellPoint markets its products and services using the exclusive Blue Cross Blue Shield (BCBS) names. With its planned merger with **Anthem (NYSE: ATH)** (another holding of ours) being objected to by the California insurance commissioner, the price of the stock declined to levels we felt did not incorporate the value of the franchise as a stand-alone entity. The BCBS name is an extremely valuable brand, which we believe will enable the company to continue to garner enrollment growth higher than the overall industry and drive premium growth. As important is its continuing investment in technology and infrastructure and its disciplined underwriting focus that should enable the company to continue keeping a firm control over its medical cost trends. We believe this top line growth coupled with tight cost controls will continue to spur margin expansion and earnings growth. We considered the completion of the merger with Anthem (something we're not counting on) as a free call option as we believe that the opportunity was not being valued by the market.

For longer term clients, Furniture Brands is not a new name. In fact this is the third separate time in the past four years we have purchased shares in this furniture maker whose primary brands include Thomasville, Drexel Heritage, Broyhill and Lane. We did well with each of our prior two experiences with Furniture Brands and the price has once again fallen to levels where the risk reward appears attractive.

We added to our stake in Home Depot, making it our largest current holding. Fears over rising interest rates, a slow-down in housing and competitive pressure from rival Lowe's has served to depress the valuation of the home improvement retailer to levels that we feel do not fully recognize the value of the franchise or its long

term prospects. We believe new management led by Bob Nardelli, a former General Electric (NYSE: GE) executive, continues to improve the company operationally (distribution logistics, centralized purchasing, inventory management) while store remodels and renewed focus on customer service have aided same store sales and increased the average customer purchase amount. We believe the market continues to be overly pessimistic concerning future earnings growth, but pessimism has always been one of our strongest allies (not because we're necessarily negative people, mind you, but because it seems to produce such good prices).

Other existing positions we added for many new accounts included **Abercrombie & Fitch (NYSE: ANF)**, **Anthem**, **IAC/InterActive** and **Medco Health Solutions (NYSE: MHS)**. Each of these was discussed in prior letters. Also, for new accounts with no exposure to the pharmaceutical industry we took a small position in **Pfizer (NYSE: PFE)**.

Give me an Alpha...

To continue our effort to explain various financial statistics often used to evaluate investment managers, we present the following brief discussion on alpha. In the first quarter, in what is probably looking like a romp through the Greek alphabet, we described beta, the sensitivity of a stock's or portfolio's returns to the returns of some market index. Or put another way, volatility or the systematic risk due to general market conditions that cannot be diversified away. Now we will discuss alpha, a counterpart of beta. The term is sometimes referred to as "Jensen's alpha" (named after Michael Jensen, a Harvard Business School professor and University of Chicago graduate) and is used to determine the risk-adjusted performance of an investment manager.

Alpha measures the difference between a fund's actual returns and its expected performance, given its level of risk (as measured by beta). A positive alpha figure indicates the fund has performed better than its beta (i.e. its risk) would predict. In contrast, a negative alpha indicates a fund has underperformed, given the expectations established by the fund's beta. Some investors view alpha as a measurement of the value added or subtracted by a fund's manager.

For the mathematically inclined we include the formula which derives alpha.

Jensen's Measure is calculated as:

$$\alpha_p = \bar{r}_p - [r_f + \beta_p (\bar{r}_m - r_f)]$$

Where:

\bar{r}_p = Expected total portfolio return

r_f = Risk free rate

β_p = Beta of the portfolio

\bar{r}_m = Expected market return

For example, a portfolio that rises while the market is rising, but by an amount greater than by what would be expected based on the portfolio's beta (or risk profile), has a positive alpha. In this case, the portfolio manager is earning excess returns or is "beating the market" with his/her stock picking skills.

Running through some numbers, let's assume a portfolio returned 12% over some time period and has a beta of 1.0, while the market returned 10% over the same time period. We will assume that the interest rate on a 90-day treasury bill (an estimate of the annual risk free rate) is 2%.

Using Jensen's formula, alpha equals:

$$\alpha = 12\% - [2\% + 1.0 (10\% - 2\%)] = 2\%$$

In this case, the portfolio manager out-performed the market on a risk-adjusted basis by 2%.

In the case of KIG, we have been tracking our equity performance on a composite basis since January 1, 1997 (7 $\frac{3}{4}$ years). Over that period, our composite has returned an annualized 14.6% with a beta of 0.96, indicating that these results were obtained with a composite portfolio that had a slightly lower volatility relative to the overall market. Over the same time period, the S&P 500 has had an annualized return of 7.03%. Based on these figures, assuming a risk free rate of 2%, and using the formula for alpha set forth above, KIG has generated an annualized positive alpha of approximately 7.8% over this period. ■

Client alert

As we transition to our new broker-dealer, Kovitz Securities, as a matter of regulatory compliance and client protection, we can no longer accept checks made payable to Kovitz Investment Group or Kovitz Securities. Instead, please make checks payable to **Pershing, LLC** (our clearing firm), and if possible please try to remember to put your new account number (it starts with the letters ADV) on the check in the memo section. In the event you want to forward a check made out to you personally (or to the name of the account), please write on the back of the check, "Pay to the order of Pershing LLC", and then sign it. Thank you in advance for your cooperation.

“It’s not solely the capacity to make great shots that makes champions, but the essential quality of making very few bad shots.”

Tommy Armour, former golf pro

“We try to *price*, rather than *time*, purchases. In our view it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?”

Warren Buffett, 1994 Berkshire Hathaway Shareholder letter

About KIG

Kovitz Investment Group, LLC is comprised of a diverse group of investment professionals who combine experience in asset management with a thorough understanding of financial markets. The KIG team consists of portfolio managers, equity analysts, bond specialists, and financial advisers. The portfolio managers/analysts possess vast and varied educational and professional backgrounds. As a group they hold advanced degrees in Business Administration (MBA), Taxation, Law (Juris doctorate) and Public Policy (MPP), and professional designations, including Chartered Financial Analyst (CFA), Certified Public Accountant (CPA), and Certified Financial Planner (CFP). Each portfolio manager is responsible for equity research, strategy and implementation.

KIG's approach to investing in equities is based on the methodology pioneered by Benjamin Graham, and as further

developed and modified by Warren Buffett and Charlie Munger of Berkshire Hathaway. We consider investments in common stocks as units of ownership in a business. We don't, therefore, regard ourselves as just traders of stocks, but rather as part-owners of a tangible business. Our primary interest lies in acquiring and holding securities of exceptional businesses at suitable prices. As such, we seek to allocate investment capital on the basis of justifiable premises, valid logic and hard evidence, not popularity or emotion.

While we strive to maximize return, we believe that the primary and overriding investment criterion should be safety of principal with a focus on minimizing permanent loss of capital. Our approach is focused on maximizing long-term net worth and not necessarily on generating short-term performance.



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