Investment Commentary

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Market and performance summary

The equity portion of the accounts managed by KIG℠ finished the quarter up 1.5% bringing the year-to-date return to 4.9%. This compares to the performance for the S&P 500 of 3.6% for the quarter and 2.8% year-to-date. The NASDAQ increased by 4.8% in the quarter and is down 0.6% for the year.

Even though we continue to outperform on a year to date basis, we underperformed rather significantly during the quarter. This can be primarily attributed to our no exposure posture towards the energy sector, which rallied 20% during the quarter. The energy sector's rise certainly has some fundamental underpinnings ($60 barrel oil comes to mind), but we'd wager that much of its recent move has been driven by unfailingly positive investor psychology. Market pundits have been calling the sector a "must own" for money managers and many have heeded the call. But we suspect that the reason your average money manager would want to own it has less to do with fundamentals and more to do with the fact that they are being judged against a benchmark that includes those very energy concerns and an unwillingness to risk short-term underperformance through a lack of representation. As this is a notoriously fickle bunch, it would not surprise us if they pile out of the sector just as quickly as they've moved in. Indeed, once the quarter ended we began to see evidence of this.

Why do we remain under-allocated to energy? Because we invest based on periods longer than this quarter or next, we have to focus on what we believe the market clearing price for energy will be on a long-term basis. And, since we readily concede that we don't feel that we have an "edge" in knowing what the price of oil is going to be 3 years from now, and given the importance of that single variable to the valuation of most energy stocks, we would rather err on the side of caution. Given our staunch belief in the reversion to the mean hypothesis (see our *Spring 2003* newsletter), however, we would not be surprised to see current energy prices revert, perhaps significantly.

Company highlights and lowlights

Stellar quarterly performances were turned in by two of our largest positions, **Motorola (NYSE: MOT)** and **McDonalds (NYSE: MCD)**, which were both up over 20%. Investor sentiment seems to have turned more constructive on both of these Chicago-based companies. Motorola's new cell phone lineup has created somewhat of a marketing buzz and has served to bolster its global market share. Its current 18% share of worldwide handset sales firmly cements the company as a strong second to industry leader **Nokia (NYSE: NOK)** (another top 10 KIG holding). Motorola's new management team led by former Sun Microsystems executive Ed Zander has rejuvenated the entire organization by refocusing the corporate culture on the creativity and innovation that first made the company a force in the telephony industry. Sales and profits have been boosted by renewing Motorola's reputation for cutting-edge technology. While the "hip" handset lineup (featuring the sleek RAZR model, the thinnest phone in the industry) garners the headlines, our focus continues to be on the significant improvement in operating margins that has fueled recent earnings growth. Management's game plan has been relatively straightforward: cut unnecessary costs and streamline the supply chain and manufacturing processes. Zander has also brought new discipline to an area that has been sorely lacking at headquarters - an emphasis on increasing returns on invested capital. Examples include the spin-off of its capital intensive semiconductor business, a focus on higher end (and higher margin) handsets, and the potential sale of its automotive products unit. With the valuation still reasonable, further improvement in these areas will be a key to continued price appreciation.

McDonalds has been undergoing a rejuvenation of its own. New (and tasty) product innovations have continued to support positive domestic same store sales trends, while European sales seem to have finally awakened from their economic induced slumber. Further bolstering the ebullient mood surrounding the company have been calls for McDonalds to leverage its significant real estate holdings. One plan that has recently been floated by an activist hedge fund is to separate the company owned restaurants from its franchising operation and real estate holdings, then borrow against the untapped value of the real estate and return the money to shareholders. While this scheme is certainly creative and would no doubt boost the share price if enacted, we have our doubts that McDonalds' management will go down such a path. Separating the company owned and franchise businesses could destroy, or certainly dull, the creation and innovation that has spurred the company's recent renaissance. It could also have the effect of driving a wedge between the company and its franchisees, a naturally precarious relationship as it is.

Of course we always want our management teams thinking about shareholders, but we don't believe that means their goal should necessarily be to maximize (goose) short term price movements of its stock at the expense of sustainable long-term earnings growth. If the choice is short term price appreciation/long term value destruction versus short term price stagnation/long term value creation, we would opt for the latter. Our preference for the company? We'd like to see McDonald's management maintain its focus on improving the dining experience (better tasting food, consistent food delivery, short wait times, fast drive-through service) and, as important, continuing to allocate capital in a wise fashion. Over the past three years the company has used its free cash flow to pay down $1.7 billion in debt, buy back over $1 billion of stock, and increase its dividend by 129% (2.05% current yield). This is what creates long term price appreciation.

While we're on the subject…

Though it may seem to some that our views are out of step with "conventional" market thinking (so what else is new?) regarding rapid stock gains, we only want to be associated with organizations whose goal is to create enduring value. Most of the time, this happens over periods of years and not quarters. Everyone wants to get rich quickly, almost assuring that they won't. But as we've been prone to point out, contrarian thinking and the discipline to focus consistently on the long-term is a must in order to outperform the equities markets over long stretches. Temptation is always there to let news flow and short-term results drive one's investment choices, but history has shown that abandoning long-term thinking in an attempt to boost short-term results is almost always counter-productive.

Our get rich slowly philosophy is supported by our performance track record. Since inception (1/1/97 through 9/30/05, a period of 8.75 years), the KIG equity composite has returned an annualized 14.8% (net of fees) compared to 7.6% for the S&P 500. On a cumulative basis, these annual returns translate into KIG being up 235%, vs. the S&P 500's 90%. On a dollars basis, a $1 Million investment made with KIG on 1/1/97 would be worth $3.35 million vs. $1.9 million if invested in an S&P 500 index fund. Moreover, these outsized returns were achieved with only slightly more volatility than the S&P 500.

Short term performance obsession, while not new, seems to be becoming a more potent market dynamic with each passing quarter. Not many market participants (notice we didn't say investors) seem to be interested in whether companies are attempting to create long term value. Most are interested in quick, short run price bursts because they don't necessarily intend to hold the shares for very long. This changes the dynamic of the investment (trading?) decision and shifts the focus from the underlying

fundamentals of a company to something more ephemeral (sexy story, hot sector, near-term catalyst, etc.). But we're not lamenting. Quite the contrary, we smell an opportunity. An interesting consequence of this short term performance chase is that it has bid up prices on lower quality companies while simultaneously dampening the prices on higher quality ones. We believe that our advantage is in identifying high quality names selling at below intrinsic multiples. Given that many of these quality names possess significant competitive advantages, ultimately the multiples will expand to reflect this. Of course we don't know when this "Wonderland" type of market will reverse course and begin paying up for quality. As Bill Nygren (portfolio manager of the Oakmark and Oakmark Select mutual funds) is fond of saying, "In investing, the line between "early" and "wrong" can be very fuzzy." While we may be in fact early here (it's happened before), in the interim we hope to continue to upgrade the quality of your portfolios in a similar fashion to what we did this quarter (see Quarterly activity below).

... Now back to our regularly scheduled program

One of the worst performers for the quarter, falling 11.8%, was **Gap (NYSE: GPS)**. While its Old Navy and Banana Republic brands have performed reasonably well, the flagship Gap chain continues to struggle with its fashion mix (dull) and as such has had trouble driving traffic to its stores leading to anemic same store sales and pressured gross margins. We continue to like Gap (even more so at current levels) as we believe that the market embeds low expectations (i.e. no growth) and that the upside from getting the product right continues to be greater than the downside from getting it wrong.

The fact that the market is pricing Gap as a no growth enterprise excites us. No, it's not that we like no growth enterprises. It's that the market's pricing mechanism always embodies conventional thinking, which generally believes that recent trends will continue. As contrarian investors we often believe that recent trends will reverse. If the market is correct and indeed Gap shows no growth, then the downside from these levels should not be great. If we are correct and Gap shows growth, even minimal levels of it, then the upside may be plentiful.

We care a lot more about what management is doing, which is very well documented, than what they are saying. We can learn almost everything we need to know about management by looking at the numbers. Through experience, some painful, we have realized that face-to-face conversations are not necessary and can actually be counter-productive. We have yet to hear management warn of an existing problem that, if not resolved, would result in a dramatic drop in share price. But that's what we care about.

We are encouraged by what Gap management is doing-demonstrating sound fiscal prudence and intelligent capital allocation. Seeing that growth opportunities were somewhat limited in the increasingly competitive apparel retail market, the company slowed new store development, closed unprofitable stores and spent its considerable free cash flow (yep, they still generate gobs of it) on sprucing up existing stores, buying back stock ($2.5 billion worth), paying down debt and increasing its dividend payout. With Gap shares trading at a low valuation and its balance sheet in excellent shape we believe time is on our side as we patiently wait for the market to be proven wrong.

How about one more company update? **Berkshire Hathaway (NYSE: BRKA and BRKB)** shares have done a whole lot of nothing, down 1.9% in the quarter and 7% for

year. Berkshire is not your average company and if an investor doesn't do the requisite homework it may seem hard to get your arms around its unique structure. But if one spends the time necessary to understand its various businesses one would likely come to the same conclusion we have- it's a tremendously undervalued entity. Berkshire's primary business is property and casualty (P&C) insurance (GEICO, General Re, National Indemnity). One of the primary attributes of the insurance industry is the concept of float, or the money policy holders pay up front in the form of insurance premiums that does not necessarily have to be repaid in claims for periods of up to several years. Float can be considered a low cost (and sometimes no cost or even negative cost) form of financing and for world class investors like Warren Buffett and Charlie Munger, a tool for generating superior investment results. Berkshire's float from its insurance operations currently stands at approximately $46 billion and has historically grown at a mid to high single digit rate.

Berkshire owns some wonderful non-insurance businesses as well in such disparate industries as energy, building products, newspapers, candy, ice cream, furniture retailing and fractional jet ownership. Most of these businesses generate substantial cash flow that can be sent back to headquarters for Buffett and Munger to allocate to its highest return use. What a business model! Berkshire also owns large stakes in publicly traded companies like **American Express (NYSE: AXP)**, **Coca Cola (NYSE: KO)**, **Gillette (now Procter & Gamble (NYSE: PG)**) and **Wells Fargo (NYSE: WFC)**.

This is the essence of Berkshire and this is what we value when we analyze the enterprise. The market appears to be concerned about other things that may or may not be important to its long-term value. We list a few of the market concerns below and our counter view.

- *The longevity of the 75 year old Warren Buffett.*

  Market concern- Investors shy away from Berkshire because they don't want to own it when the unavoidable happens- Buffett announces his retirement, or worse, dies.

  KIG view- We admit that there may be a temporary decline in the shares on either of those events, but we would look at it as potentially another buying opportunity. Buffet and Munger have built an enduring enterprise economically, organizationally, and ethically. Besides, our proprietary research has concluded that Mr. Buffett is immortal. (Even if he's not, as you know we try to make sure management's interests are aligned with those of shareholders, and Buffett constantly reminds us that his death will be more troublesome to him than to us.)

- *Regulatory issues at General Re (finite insurance related issues).*

  Market concern- Generally, investors are loathe to take positions in companies experiencing "headline risk", or the risk associated with continuous negative stories in the financial press, even if the issue involved is one with unlikely long-term implications.

  KIG view- In Berkshire's case, we feel the headline risk is a canard (i.e. sounds bad on the surface, but not likely an issue that will damage its competitive positioning). Historically, headline risk has enabled us to buy otherwise solid companies at cheap prices.

- *Recent hurricane related losses.*

  Market concern- Being that Berkshire has a leading market position in the P&C industry their share of the record insured losses is due to be large.

  KIG view- Berkshire has the strongest capital position in the industry and its balance sheet can readily absorb these losses (we estimate between $1.5 billion and $2.5 billion). While these hurricanes were particularly dramatic, a well-run and disciplined insurance company prices these types of events into their premium structure. And because of their financial strength they are and will continue to be the insurer of first choice for companies with large and complex needs.

- *A lot of cash on the balance sheet ($49 billion as of June 30, 2005).*

  Market concern - Doesn't want to pay for money market returns.

  KIG view- We can appreciate Buffett's dilemma; so much to do but so few opportunities of which to take advantage. His patient investment style has gotten him this far (2nd richest man in the world) and it would be rather audacious to suggest that he change it now. Eventually, the cash will be deployed and we can be pretty certain that when it is it will be in situations similar to Berkshire's historical return parameters.

Quarterly activity

During the quarter we established five new positions and increased our investment in three existing positions. On the sell-side we eliminated four positions and trimmed our exposure to three others. In other words, a fairly active quarter. To be clear, however, our goal is not necessarily to be active. One can be very active and very wrong. The goal is simply to make solid decisions and allocate capital on the basis of justifiable premises, valid logic and hard evidence and not popularity or emotion.

We added two more Dow Jones Industrial Average members, **Wal*Mart (NYSE: WMT)** and **Procter & Gamble (NYSE: PG)**, during the quarter, bringing our total ownership to a full one-third of the index membership (10 out of 30). No, we are not becoming Dow Jones closet indexers. It just seems to us that many high quality businesses are being priced as average companies. Five years ago, many high quality companies sold at valuations that far exceeded that of the market. From that point forward, these companies needed exceptional earnings growth just to produce average returns for its shareholders. What a difference a half-decade makes (to which severely burned investors who paid those rich multiples will attest.) Today many of these same high quality companies are priced in line with, or less than, the market. We believe that from this point average earnings growth will be enough to produce average returns, and we believe that these high quality companies should be able to provide above-average earnings growth and investment returns to shareholders.

Interestingly, until recently we used Wal*Mart as an example of a great company but a bad stock. The example was meant to illustrate that even superior companies can be a bad investment if the valuation incorporates unreasonably high expectations. In the case of Wal*Mart, the shares peaked at $70 in 1999 when it earned $1.28 per

share, or 55 times earnings. Over the next six years, while Wal*Mart would more than double its earnings (13% compound annual growth rate- pretty darn good) its stock price would decline over 35%. The moral? When a company's shares are priced for perfection there just isn't much stock price upside regardless of how well the company does.

We also initiated positions in **Estee Lauder (NYSE: EL)** (cosmetics), **Foot Locker (NYSE: FL)** (athletic footwear retailer) and **Gannett (NYSE: GCI)** (newspaper publishing) and we increased our holdings of Berkshire Hathaway, Gap and **Disney (NYSE: DIS)**.

We also sold a fair amount of stock in the quarter. After a volatile holding period, drug distributor **AmerisourceBergen (NYSE: ABC)** reached our fair value assessment. We decided to exit our position in **MGIC Investment (NYSE: MTG)**, a mortgage insurance company and long time holding, over concerns that an overheated residential housing market could result in oversized and sustained insured losses. Seeing limited upside in both **Alliance Capital (NYSE: AC)** and **Safeway (NYSE: SWY)**, we thought it prudent to raise cash for other potentially promising ideas should the market present them.

As a standard course of our risk management guidelines, we trimmed outsized positions in **WellPoint (NYSE: WLP)**, **Abercrombie & Fitch (NSYE: ANF)**, and **Barnes & Noble (NYSE: BKS)**. Regarding the latter, because our holding period was less than one year sales were executed only in tax deferred accounts while covered call writing was utilized in taxable accounts that have granted us the ability to do so.

Another welcome

KIG is proud to announce another new addition to our firm. Edward Edens has recently joined our firm as a Director of Client Services and Portfolio Manager. Ed graduated from Augustana College in Rock Island, IL with a Bachelor of Arts degree in Business Administration and Finance. He received his MBA in Finance from DePaul University in Chicago. Ed has spent the better part of the last 15 years providing financial advice to and managing investment accounts for individuals, trusts, private foundations, pension and profit sharing plans, not-for-profit organizations and businesses. Prior to joining KIG in 2005, Ed was a Vice President and Senior Portfolio Manager with Wayne Hummer Asset Management Company. In this position, Ed built a new wealth management office in Hinsdale, which he grew to more than $100 million. Prior to Wayne Hummer, Ed was a Vice President and Senior Portfolio Manager at Harris Trust & Savings Bank in their Personal Trust Department. He is a published author and speaker on various investment matters. Ed is currently pursuing a CFA designation.

Parting shots

Investment annals are littered with examples of companies that with hindsight were labeled "value traps"; companies that appeared cheap based on historical earnings or sales only to see their fundamentals and earnings continue to erode and the stock gets even "cheaper". So why isn't there a similar concept and why aren't investors equally wary of "growth traps"? You know, buying a company at an exorbitant valuation because you believe sales and earnings are going to continue at supercharged levels, only to find that even above average growth is not good enough to support the shares.

Quotes

"… a three-year to five-year forecast. . . forces one to think long term and to avoid the destructive bile arising from the emotional whipsaws of fear and greed." – William H. Gross, chief investment officer at PIMCO

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 and Law (Juris doctorate), and professional designations, including Chartered Financial Analyst (CFA), Certified Public Accountant (CPA), and Certified Financial Planner (CFP).

KIG seeks long-term capital appreciation of client assets through high risk-adjusted returns. To accomplish this objective, the investment style emphasizes the preservation of capital and minimization of risk primarily by investing in mid to large cap companies believed to be significantly under-valued. We believe equities purchased at prices significantly below their intrinsic worth should protect capital from significant loss and should also appreciate substantially when the market ultimately recognizes business value.

KIG strives to achieve superior long-term performance through the purchase of equity securities of competitively advantaged and financially strong companies at prices substantially less than our assessment of their business value. We consider investments in common stocks as units of ownership in a business. We don't, therefore, regard ourselves as traders of stocks, but rather as part owners of tangible businesses. As such, we look to allocate investment capital on the basis of justifiable premises, valid logic, and hard evidence, not popularity or emotion. Our critical research and buy discipline gives us confidence to establish concentrated portfolios where our best ideas can have meaningful impact on performance.

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