Investment Commentary

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Market and Performance Summary

In the quarter ended September 30, 2006, the S&P 500 Index increased 5.7% while the KIG composite rose by 6% (net of fees). For the year, KIG and the S&P 500 have increased 7% and 8.5%, respectively.

Although it is gratifying to report constructive quarterly results, we know that, just like our slight underperformance year-to-date, it is not hugely meaningful. Given our approach, on a quarter-by-quarter or even year-by-year basis our results can differ dramatically from our benchmark's. But over the long term we believe that the merits of our conservative and disciplined approach are clear. For instance, over the past three years the KIG composite has generated a compounded annual growth rate of 15.9% while the S&P 500 has returned 12.3% over the same period. An even more informative time frame would be the six and one-half year period since the stock market peak of March 31, 2000. Over that time period the KIG composite has increased by 38% (on a cumulative basis, after fees) while the S&P, including dividends, is still underwater, down about 1%. We achieved these results using the same characteristically risk-averse methods we still use now. We know you've heard us say it before, but patient long-term investing really does yield handsome rewards.

Why is it that we can underperform over certain short periods of time but continue to soundly beat our benchmark over longer periods? We believe it has to do with the mindset with which we embrace the mission of investing versus the one that is largely adopted elsewhere. For the most part, it is our feeling that most "investors" are not concerned with determining what a business is really worth or in making superior long-term judgments of the probable return of an investment over its life, but rather with what the market will value the stock at, under the influence of mass psychology, a month or two hence. What this does, consciously or not, is stop them from buying a stock at $20 per share even if they believe, on any long-term valuation basis, it is worth $30, if they think it may fall to $15 first. Thus, their focus is on anticipating what value the rest of the market may place on a security a few months out (an impossible thing to do with any sustainable success), while our focus is on what the business will look like a number of years in the future.

In other words, we don't spend our time trying to predict how investor sentiment might change; we spend it on predicting how the business will change- things like industry growth, competitive positions, market share changes, cash generation and financing needs. We love buying those $30 stocks at $20 regardless of whether there is first an interim trip to $15.

To us, investing is, and always will be, an exercise in the otherwise perfectly dispassionate calculation of discounted cash flows. There's really no room in the calculation for what others are likely to think or do. There is no input for human emotion.

Contributors/Non-Contributors

Positive results for the quarter were attributable primarily to contributions from our portfolio holdings in the consumer discretionary, information technology, and health care sectors. Stocks that moved higher by 10% or more during the quarter were retailers such as **Abercrombie & Fitch (NYSE: ANF)**, **CarMax (NYSE: KMX)**, and **Bed Bath & Beyond (NDAQ: BBBY)** as well as technology companies **Motorola (NYSE: MOT)** and **Microsoft (NDAQ: MSFT)**. Drug holdings **Pfizer (NYSE: PFE)**, **Abbott (NYSE: ABT)** and **Schering Plough (NYSE: SGP)** had strong performances as investors appeared to rotate into more defensive-type names. Insurance companies **American International Group (NYSE: AIG)** and **Assurant (NYSE: AIZ)** rose substantially as did **McDonalds (NYSE: MCD)**, **CDW (NDAQ: CDWC)**, **Accenture (NYSE: ACN)** and **Procter & Gamble (NYSE: PG)**. While only a handful of stocks were down during the quarter, you are entitled to hear about those as well. Among the most notable performance detractors were **Sprint-Nextel (NYSE: S)**, **Mercury General (NYSE: MCY)**, **Clear Channel (NYSE: CCU)** and **Dell (NDAQ: DELL)**.

Dell has been an albatross since our initial purchase earlier this year. Once considered a must own growth company by much of Wall Street, Dell has seen its revenue growth slow in recent years and its share price suffer accordingly; falling from the mid $50 level reached during the height of the technology bubble to below $30 when we began purchasing it. Admittedly not as large as it once was, we believe Dell still possesses an enviable competitive position in the computer hardware market and feel the company has the resources, including the managerial leadership, financial strength and cultural resiliency, necessary to turn its business results around. And although we may ultimately be proved incorrect in our analysis and investment thesis, we won't alter our current position just because the short-term stock price movement hasn't yet rewarded our conviction.

All else being equal, we feel optimistic about our portfolio composition. If you recall, last quarter, we wrote *"For some time we have believed that the spread between high quality and low quality assets is too low. As the spread normalizes, our portfolios should be in position to benefit. One of two things will happen; either low quality trends downward toward high quality implying little downside for our portfolios, or high quality trends upward creating* *decent upside."* Towards the end of this past quarter, we actually began to see both of these scenarios coming to fruition as our composite portfolio certainly trended upward while industries such as natural resources, basic materials, transportation and industrials all were in negative territory for the quarter. While we know never to extrapolate short-term data into the future indefinitely, it was nonetheless nice to see that rationality was creeping back into the market.

Market returns can come from only two places: expansion of the price-earnings multiple or growth in profits. Based on the valuations of our current portfolio holdings and their business outlooks, we are optimistic about either one or both of these happening over a reasonable time period into the future.

Top 10

While we generally run what we consider to be concentrated portfolios (30-35 stocks), when we have a high degree of conviction on a certain name or names we naturally want to make its position size larger relative to other holdings so it will have a more meaningful impact on the portfolio. Because of this added concentration, the performance of the top 10 holdings typically will have a significant influence on the overall performance of the portfolio. That said, we thought instead of you wading through your monthly statements it may be helpful to update you on what are currently the 10 largest positions in a representative account (as a reminder, if you are a newer KIG client, some of these companies may have not recently traded down to a level that has the requisite margin of safety that we insist on before purchase).

A Funny Thing Happened (on the way to the hard landing)

A month or so ago, as we began to lay out our thoughts for this quarter's letter, we thought we were going to have to be the bearer of some not so good news as the negativity pervading Wall Street had continued to dampen equity returns. Basically, we were setting up to prepare a dictum about how this is a long-term campaign and that patience and discipline are now more important than ever (blah, blah, blah...). But before we could say "Stay the course!" the funk seemed to lift and stocks began what turned out to be a nice move to the upside. It is yet another reminder (the list is getting long) that the vagaries of market psychology should never be utilized to make, or even influence, investment decisions, and that macroeconomic forecasting (i.e. guessing) should not be confused with investment strategy. Too often, investors mix an objective to deliver superior long-term returns with strategies and behaviors rooted in short-termism.

Our strategies have always, and will continue to be, more long-term in nature. Things like staying within our circle of competence, thinking independently, remaining unemotional, and filtering out the noise serve as the basis for how we expect to deliver exceptional returns. As Benjamin Graham said, "Investing is most successful when it is most businesslike."

Only a month or two ago the headwinds appeared strong as many investors fretted over an economy that was perceived to be overheating and that the imminent threat of inflation would force the Federal Reserve to continue its interest rate raising campaign. Worries also existed that tensions with Iran would

TOP TEN HOLDINGS AS OF SEPTEMBER 30, 2006

Company	Primary Business	S&P Sector
Berkshire Hathaway	Insurance, consumer and building products	Financial
Home Depot	Retail building supply/home improvement	Consumer Discretionary
Motorola	Cell phones, wireless networks	Information Technology
Walt Disney	Media networks, parks and resorts	Consumer Discretionary
Wal*Mart	Retail and warehouse operator	Consumer Staples
Gap Inc.	Casual apparel retailer	Consumer Discretionary
Microsoft	Software development and products	Information Technology
Procter & Gamble	Diversified consumer products	Consumer Staples
Royal Caribbean	Cruise line operator	Consumer Discretionary
Johnson & Johnson	Medical devices, pharmaceuticals	Healthcare

keep oil prices oppressively high. But these fears receded and were quickly replaced by a new one; the economy would slow demonstrably, possibly tipping us into a recession. Fast forward to today and neither of these scenarios is getting much play. Peace and tranquility now rule the roost: The Fed is assumed to be done raising rates (and may be close to cutting them), oil prices are falling and the moderation of the economy will lead to a soft landing as opposed to a hard one. It's good old Goldilocks time (not too hot, not too cold), or whatever Wall Street jargon you prefer to justify higher stock prices. Alas, remember, you are reading this with a lag. By the time we finish writing, editing, producing and mailing we would not be surprised if the tide has turned again. If this is the case, however, we are confident in our portfolio's ability to weather the storm. Generally, our companies have durable businesses, sturdy balance sheets and strong brands with pricing power. Typically, these conservative holdings-unlike risky cyclical issues- do not depend on perfect economic conditions and frenzied earnings growth to continue to generate cash.

Our long held belief, which the past few months only serves to reinforce, is that macroeconomic and geopolitical concerns only serve to deflect attention from what's important- strong business fundamentals and low valuation. We have more confidence in our ability to value businesses than to predict the direction of the economy or the shifting tides of the elusive crowd. As Mr. W. E. Buffett once noted, "Why scrap an informed decision for an uninformed one?"

Big is Beautiful

We continue to believe that the large-cap and so-called mega-cap (market caps over $50 billion) universes continue to offer tremendous absolute and relative value in the market. Stocks still exhibit very narrow quality spreads meaning that some of the best run companies appear to be trading at little to no premium, and in some cases at a discount, to the average public company. We believe that the large and mega-businesses we own trade at attractive earnings yields (the inverse of a price-earnings multiple) vis-á-vis the prevailing risk-free treasury rate (currently under 5%) and have the potential to generate larger and larger earnings coupons in the future compared to the fixed ones offered by the bonds.

If the "bears" are right and they turn out to be only average businesses, well, they are already priced as such. But, if as we expect, they show earnings growth that is superior to the average company, they should perform as superior stocks. And if we're right, not only do we make money with the higher earnings growth, but we also think it is highly likely that we will also make money from expansion of the price-earnings multiple.

A fair question to pose is how this state came to exist. While we long ago ceased trying to figure things like that out and have learned never to be surprised by anything the market may conjure up, we also know that it is never in our best interest to assume that the market is right- it often seems to fool even itself. However, we did come across an interesting perspective on this subject in Robert Torray's August 1, 2006 letter to shareholders of the Torray Fund. He writes,

> *"The duration of this downturn (referring to the time since the bull market peak of early 2000) has left investors disillusioned and in a mood to try almost anything to improve results. Many have shifted to alternative investments like hedge and private equity funds, commodities and currencies. Money has also been flooding into larger developing countries in emerging markets, despite their turbulent history, risky fundamentals and eye-popping advances.*
>
> *"Meanwhile, investors continue to chase commodities and the stocks of companies that produce them. Even though oil, gold, silver, copper and so on, have generated virtually no inflation-adjusted returns in over a hundred years, large pension funds and other institutions have committed billions of dollars to them. None apparently had the slightest interest at half the price or less a few years ago... In spite of this reality, their current popularity is just what we would have expected, and a telling contra-indicator, given the tendency of institutions to load up on assets that have already risen sharply in price, and sell those that have either done nothing or gone down.*
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> *"Unfortunately, a lot of the funding for this activity has come from the sale of high quality, large capitalization domestic stocks of the type held in our Fund. This has effectively kept a lid on their values, perhaps giving the impression something's wrong with them. Nothing could be further from the truth. A similar pattern surfaced in 1998, when investors piled into vastly inflated tech/telecom and dot.com stocks, while nearly everything else went begging. Just as that cycle reversed, this one will too. At that point money should flow back to the safety and liquidity of high quality companies, bolstering their long sagging valuations."*

Our recent transactions, both on the buy and sell side, generally reflect our desire to upgrade portfolio quality given the minimal cost to do so. As Arnie Vandenberg of Century Management said recently, *"It's kind of like if you went to the best part of town and could buy a house for less than you could in the worst part of town."* He goes on to say only in the stock market does the best

TWENTY LARGEST U.S. COMPANIES BY MARKET CAPITALIZATION		
Company	**Ticker**	**Market Cap**
Exxon Mobil	XOM	$387 billion
General Electric	GE	$360
Microsoft	***MSFT***	***$269***
Citigroup	***C***	***$248***
Bank of America	BAC	$240
Pfizer	***PFE***	***$207***
Wal*Mart Stores	***WMT***	***$204***
Procter & Gamble	***PG***	***$198***
Johnson & Johnson	***JNJ***	***$188***
American Int'l Group	***AIG***	***$172***
JP Morgan Chase	JPM	$163
Altria	MO	$161
Berkshire Hathaway	***BRK.A / BRK.B***	***$144***
Cisco Systems	CSCO	$141
Chevron	CVX	$137
AT&T	T	$130
IBM	IBM	$125
Google	GOOG	$123
Wells Fargo	WFC	$123
Intel Corp.	INTC	$112

merchandise occasionally sell cheaper than the lower grade merchandise. As such, currently our portfolios contain 8 of the largest 20 (and 7 of the top 10) stocks by market cap as evidenced in the chart above (current holdings in bold).

While there are other smaller, quality companies in our portfolios, these eight high-quality businesses can be characterized by strong brand names, high customer loyalty, pricing power, cost advantages and participation in growing long-term markets.

Charlie Munger once described the key to investment success as "patience and aggressive opportunism." Typically, that is how we attempt to operate- patiently wait for attractive opportunities to present themselves and then pounce. In this case the order has been somewhat reversed. We seized upon these large caps when the valuations presented themselves but knew we may need to bide our time patiently; waiting until the market began to reward them with the premium valuations we believe they deserve. However, we're very comfortable if time is our greatest risk. We'd rather grab them right now than when everybody else is trying to buy.

Only recently has the market begun to reward quality – we think it still has a long way to go.

KIGball

Having finally worked our way down our reading list to "Moneyball", Michael Lewis' chronicle of baseball's low-budget Oakland Athletics and their contrarian general manager, Billy Beane, we are sorry that we didn't get to it sooner. While we knew it would be a great read from a sports fan's perspective, we had no idea how much relevance it would have as an investment guide.

The story itself could be Hollywood material. A small market team with one of the lowest payrolls in the league somehow manages to become a perennial fixture in baseball's playoffs (4 times since 2001, including this year)- typically the realm of large market teams with big payrolls. But the book resonated with us primarily because Beane's theories about what is important in creating a successful baseball team run completely counter to conventional wisdom. His team's achievement proved that traditional yardsticks of success for players and teams were fatally flawed. Home runs? Overvalued by the market. Speed? Overrated. Defense? Not worth paying up for. Find players that get on base a high percentage of the time (walks are okay) and scoring takes care of itself. If you're a regular reader of these letters it probably wouldn't surprise you that our thinking about investments is about as opposite from Wall Street's as can be. We believe that some of Wall Street's traditional yardsticks are faulty. Earnings growth? Overvalued by the market. Hot sectors (momentum)? Overrated.

To illustrate how Billy Beane's managerial principles parallel our investment ideals, we've pulled some passages from the book and compared them to some of the tenets of our philosophy.

> **Beane:** "I get excited about a guy when he has something about him that causes everyone else to overlook him and I know that it is something that just doesn't matter."

> **KIG:** "We get excited about a stock that the market marks down for reasons that just don't matter to long-term business value."

> **Beane:** "The hardest thing is... [to] take a guy high (in the draft) no one else likes... it makes you uncomfortable."

> **KIG:** "You need confidence in your analytic ability, and a thick skin, to buy a stock that the market perceives to have issues. Typically, those issues, though, are more than adequately discounted in the share price. Investors tend to hate uncertainty. We're not crazy about it either but have learned to live with it."

Beane: "We don't get the guys who are perfect there has to be something wrong with them to get to us."

KIG: "We don't buy the market darlings- they tend to be overpriced by the market. We prefer to buy the stocks of quality business where there are low expectations built into the share price."

Beane: "Every deal you do will be publicly scrutinized by subjective opinion... you have to ignore the newspapers."

KIG: "An unwritten word does not sell newspapers. Journalists, and often times analysts, in their quest to create the sensational, often focus on things that are tangential or even unrelated to business value. You can't let yourself get scared out of a position because the tide of opinion is temporarily against you."

Beane: "When we stop trying to figure out the perception of guys [i.e. what others think of them], we've done better."

KIG: "Most investors pretty much engage in an exercise in mass psychology, trying to guess better than the crowd how the crowd will behave. Sticking to the fundamentals of the business- tracking cash flow, making sure competitive advantages remain sustainable and keeping an eye on how management is allocating capital- and pretty much ignoring everything else- is a recipe for longer-term out performance."

Beane: "The day you say you have to do something you're screwed. Because you're going to make a bad deal."

KIG: "Sometimes inaction is the proper course, if it has been taken after measuring all the measurable options. You may recover from the stock you don't buy. You may never recover from the stock you bought at the wrong price."

Billy Beane has been successful because he is able to see something in baseball players his fellow general managers don't or can't. Other GMs don't think a player will help their team, Billy Beane says he will. By investing in stocks you believe to be undervalued you're also making a contrarian bet. The market is saying these stocks are cheap for a good reason. You say they're not.

Does this qualify us to run a major league franchise? Probably not. Does it qualify Billy Beane to run money? Probably so. Regardless, contrarian thinking has served both us and the A's well.

Portfolio Activity

During the quarter we added two new positions and eliminated two. Additionally, we selectively increased the exposure to two existing holdings and trimmed our exposure to two others. Good things come in twos?

Our first new purchase, **Costco Wholesale (NDAQ: COST)**, the ubiquitous operator of no-frills membership warehouses, is an example of old research, new event. We have studied this company carefully over the years patiently building our knowledge bank of this exceptional business and were prepared to make an investment if the price ever got down to levels we felt represented exceptional value. That price came as the stock was marked down by impatient investors when the company slightly lowered its guidance for its fiscal fourth quarter. The market's tendency to cast temporary corporate trouble as permanent armageddon provides regular opportunity, and we believe this is one such situation. Costco's competitive situation in the retail landscape is unique as its shopping experience resonates with customers from all economic strata. The balance sheet is extremely sound with almost $3 billion in net cash and the company generates free cash flow even as they are building out their store base.

The second purchase came on the final day of the quarter (it took us that long to muster up the nerve) and saw us make our first foray into the energy sector with the purchase of **ConocoPhillips (NSYE: COP)**. COP is the third largest international, integrated oil and gas company in the United States, based on market capitalization, proved reserves, and production. The company operates worldwide with operations in more than 40 countries and has an approximate 20% stake in Lukoil, Russia's largest oil company. Now, we know what you're thinking- "Aren't these the guys that have had a no exposure stance on the sector?" Yes, that's been true, but let us explain. Our lack of exposure was not based on fundamental grounds but strictly valuation reasons. The crowd had moved into these names with such abandon that it was hard for us to envision any upside. And if the crowd's mood shifted suddenly the downside could be plentiful, which as oil fell from $75 a barrel to $60 is exactly what happened. Most energy related stocks fell anywhere from 15% to 25%. We still remain agnostic on the price of oil- in our minds it's still as likely to go down as up- but our valuation work on Conoco indicates that even at oil prices 25% lower than today's, the stock is fairly valued -- and at current oil prices or higher it is significantly under valued. Said another way, the risk component of the risk/reward analysis appears minimal.

The two positions exited were **Medco Health (NYSE: MHS)** and **Fossil (NDAQ: FOSL)**. Medco had been a long-time holding and we felt it had reached what we consider to be fair value. Fossil, which was held a short period of time by KIG standards, had made what we considered to be scant progress in improving its cost structure under a period of constrained revenue. While we are usually extremely patient in situations like this, we felt less comfortable with the predictability of Fossil's long-term earning stream and thought we could find better upside as we evaluate other opportunities.

We pared back positions in **Abercrombie & Fitch (NYSE: ANF)** and **Kohls (NYSE: KSS)**, the latter largely in tax deferred accounts, based strictly on valuation and exposure criteria.

New Team Members

As our client base and assets under management continue to grow it puts us in a position of strength to be able to add high quality and talented associates to our team. During the quarter, we added two such individuals.

Ken Fink comes to KIG from Northern Trust where he was a Senior Vice President and Senior Portfolio Manager with Northern Investment Counselors. Prior to joining Northern in 1996 Ken was an Assistant Vice President and Portfolio Manager at Harris Trust, a Portfolio Manager at Cole Taylor Bank and a Financial Analyst with First Chicago Corporation.

Ken received a B.A. degree from Taylor University, an M.A. degree from Ball State University and an M.M. degree from Northwestern University with a concentration in finance. He is a C.F.A. charter holder and is a member of the C.F.A. Institute and the Investment Analyst Society of Chicago.

Ken has spent nearly twenty years providing advice to and managing portfolios for individuals, trusts, private foundations, pension and profit sharing plans, and non-for-profit organizations. His vast experience in all areas of wealth counseling and portfolio management will further Kovitz Investment Group's ability to provide comprehensive investment advisory services to our clients. His primary responsibilities with Kovitz Investment Group will be the construction and management of client portfolios.

Joel Hirsh joins our equity research team as an analyst where he will focus on fundamental research. He comes to KIG from KeyBanc Capital Markets in Cleveland where he was an analyst in their basic materials group. He is a native of the Chicago area and Graduated from the University of Michigan with a major in Economics. Joel recently passed Level II of the Chartered Financial Analyst exam series. Joel expands the depth of our research capabilities. Joel will devote his time to screening companies, analyzing financial statements, modeling intrinsic value calculations and actively participating in investment committee meetings.

Quotes

"The voice of intelligence... is drowned out by the roar of fear. It is ignored by the voice of desire. It is contradicted by the voice of shame. It is biased by hate and extinguished by anger. Most of all it is silenced by ignorance"- Dr. Karl Menninger, psychiatrist

"If you can keep your head when all about you are losing theirs, maybe you haven't heard the news."- unknown

"But the market does not follow logic; it follows some mysterious tides of mass psychology. Thus earnings projections get marked up and down as the prices go up and down, just because Wall Streeter's hate the insecurity of anarchy. If the stock is going down, the earnings must be falling apart. If it is going up, the earnings must be better than we thought. Somebody must know something we don't know."- John Maynard Keynes

"It is far, far safer to be wrong with the majority than to be right alone."- John Kenneth Galbraith

"The crowd does not reason, it only thinks it reasons."- Gustave Le Bon, author, "The Crowd" (1895)

"Prediction is very difficult, especially if it is about the future"- Niels Bohr, physicist

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