

Investment Commentary

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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 sectors and other trends. The opinions should not be considered predictions of future results or recommendations to clients of specific securities for purchase or sale. 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

In the first quarter of 2004, the equity portion of the accounts managed by KIG, in aggregate, was up 8.0%, outpacing the 1.7% increase in the S&P 500 over the same time period. The NASDAQ, which had a phenomenal run in 2003, lost some momentum, declining 0.4% in the quarter.

Over the last twelve months, KIG has produced an equity return of 44.6% compared to 35.1% and 49.4% for the S&P and NASDAQ, respectively. Looking out over the last five years, the minimum time period we believe sufficient to judge the value of an investment manager, KIG's average annual equity performance has logged in at 11.1% (69% on a cumulative basis), whereas both the S&P and NASDAQ have been in negative territory, minus 1.2% and 3.8% annually, respectively. In other words, based on achieving those performance numbers, \$100,000 invested in equities with KIG five years ago would be worth approximately \$169,000 today, while the same amount invested in the S&P would be worth slightly over \$94,000.

{KIG's returns are based on a composite for all fee-generating equity portfolios with a minimum of \$100,000 in equity investments for which it has full discretionary investment decision-making authority, and is calculated using a time-weighted, monthly, geometrically linked rate of return formula, net of costs and *net of an assumed 1.25% annual management fee*. The S&P and NASDAQ are both reported *gross of fees* and costs, and assumes dividends are reinvested in the index.}



As we have stated before (ad nauseam?), we believe that this performance can be largely attributed to turning a deaf ear to "market trends" and by not responding to emotional instincts, but instead adopting a rational, unbiased approach to stock research and selection. Our process for constructing portfolios, admittedly conservative, focuses squarely on minimizing

risk in each investment decision, primarily by making sure we invest in quality businesses we can understand and that sell at reasonable prices. We apply this investment discipline confidently and consistently, regardless of short-term market events. While it may seem counterintuitive to associate conservatism with outperformance, our historical results (as well as those of other successful long-term investors throughout history) suggest otherwise.

Top, flops and our ever-present focus on ops (Operations)

The strength in the quarter was broad-based. Particularly strong performing holdings in your portfolios were specialty retailer **Abercrombie & Fitch (NYSE: ANF)**, which increased by 37% and pork producer, marketer and distributor **Smithfield Foods (NYSE: SFD)** which was up by 31%. Some of your health care concerns had nice quarters, including managed care provider **Anthem (NYSE: ATH)** (+21%), diagnostic testing company **Quest Diagnostics (NYSE: DGX)** (+14%), and drug distributor **Cardinal Health (NYSE: CAH)** (+13%). Restaurant holdings were also strong with **Jack in the Box (NYSE: JBX)** rising 17%, **McDonalds (NYSE: MCD)** (+15%), and **Brinker (NYSE: EAT)** (+14%).

The fact that some of the stocks mentioned above appreciated significantly was not surprising to us as, is the case with all of our holdings, we believed there existed a large gap between our assessment of intrinsic value and the current market price. The timing,



however, was unexpected. There did not seem to be any catalyst or piece of important information that should have caused the gap to significantly narrow now. Typically, stocks we own have a tendency to sit for long periods with this gap intact. As other investors begin to appreciate the opportunity presented by that gap it tends to narrow and then close. Sometimes this occurs over a short period of time, but more often than not, it's a longer process.

This is why we know we must always remain patient, even to the extent it borders on boredom. We have never been able to successfully time price movements (can anyone?) either in individual stocks or the market as a whole, so we don't fool ourselves into thinking we can. It's also exactly why we've adopted an investment philosophy incorporating a long-term focus with specific concentration on company fundamentals and valuation. We don't think of ourselves as just traders of pieces of paper or quotes on a screen which fluctuate daily, nor would we allow ourselves to be blown about by the vagaries of changing short-term perceptions that have little to do with a company's long-term business value. The only way we feel we can be successful long-term investors is to think like business owners, patiently monitoring the long-term progress of the companies we own (and are looking to own). To us, stock ownership must be the same as business ownership. Focusing on the fundamentals and ignoring pretty much everything else has, and will continue to be, our recipe for success.

Everything was not necessarily all rosy this quarter as we also held some under-performing stocks. These included Midwest bank **U.S. Bancorp (NYSE: USB)**, which was down 7% during the quarter, grocer **Safeway (NYSE: SWY)** falling 6% and pharmaceutical companies

Schering Plough (NYSE: SGP) (-7%) and **Merck (NYSE: MRK)** (-4%).

Does the above list concern us? Not really. We realize that it is impossible to not only predict when the valuation gap will close but also its path to closing. It may very well widen first before closing. Leon Levy, founder of Oppenheimer Investments, in his memoirs "The Mind of Wall Street", uses an interesting analogy for the market. He muses, "It's all a matter of perspective. In slums and ghettos, residents associate the neighborhood with crime and privation and can't wait to leave. The architect or builder buying the brownstone sees a valuable, once proud building that can be had for a song. The buyer has no memory of the area's unhappiness and instead focuses on its glorious future. The same principle applies to every transaction on the stock exchange: the buyer is looking to the future; the seller often is burdened by knowledge of the stock's history."

Our investment discipline demands us to appreciate and acknowledge both constituencies in Mr. Levy's analogy. Through our research effort, we do just that. First, we must understand the "property" from the old residents' point of view. However, once we are aware of the significant historical events we must "forget" them and think more like the architect.

We spend a great deal of time learning about a company's history, getting comfortable with its competitive position, historical margin structure and returns on capital, cash flow characteristics and management's allocation of capital decisions, to name just a few of the factors we explore. We then focus on the reason we are getting the opportunity to buy in at what we must believe are artificially low prices: is it a problem or issue that is temporary in nature, or possibly resulting from non-company specific or external sources

(investor panic, negative market sentiment), or is it a problem that might be manifesting itself through a fundamental, more permanent change? If we can get comfort that it is due to one of the former reasons and the valuation makes sense from a risk/reward standpoint, then we make the investment.

Because we understand that these forces are inherent in every investment, we never panic when stocks we hold decline in any given quarter.

Recent portfolio activity

You may recall, over the past several newsletters we have commented on the dearth of acceptable new investment ideas we have been able to uncover. We lamented that the rising tide of the market had lifted most boats, making valuations unattractive for the overwhelming majority of stocks in our universe of investable companies. But, we noted, we would never force activity only for the sake of appearing active (recall the Ted Williams analogy of waiting only for those pitches in his comfort zone). Inactivity is always preferable to activity that results in doing something stupid. While successful investors must be willing to endure stretches of inactivity and boredom, they must also be ready and willing to act when opportunities arise. This was the case in the first quarter as we had one of our most active periods in a quite a while, adding seven new ideas and eliminating three.

While health care continued to prove fertile investment ground for us, this quarter we were able to find suitable opportunities for purchase in many diverse industries ranging from retail to finance to internet

services (yes, an internet company). Most importantly, each stock was acquired at prices that appear to reflect meaningful discounts to readily ascertainable business values.

In the health care sector, we added pharmaceutical, consumer health and medical device giant **Johnson & Johnson (NYSE: JNJ)** and pharmaceutical and diagnostic and nutritional product maker **Abbott Laboratories (NYSE: ABT)**. We believe investors have short-term concerns about certain parts of each of these businesses. But we will always buy stocks of companies whose shares are depressed by short-term issues if the long-term outlook is bright. We also purchased shares of drug distributor **Amerisource Bergen (NYSE: ABC)**.

Kohl's (NYSE: KSS) operates 563 family-oriented specialty department stores in 37 states. Kohl's saw its phenomenal run of 25%+ annual earnings growth come to an end in 2003 as its earnings declined for the first time as a publicly traded company. With most investors heading for the exits, we sensed an opportunity. Delving into the reasons for the earnings shortfall we determined, to the best of our ability, that a fundamental shift had not taken place. Rather, we believe the primary cause for the stumble was maintaining store level inventories too high just as consumer spending slowed. Subsequently, heavy discounting was necessary to bring inventories back in line. Even the finest companies slip-up on occasion and we believe Kohl's continues to be well positioned to resume an earnings growth trajectory, albeit at lower than historic levels.

Marsh & McLennan (NYSE: MMC) is the country's largest insurance brokerage outfit with additional lines of business in management consulting and investment management. MMC's troubles were much easier to spot as its investment management subsidiary, Putnam,

became enmeshed in the mutual fund trading scandals. As the negative headlines persisted, the stock fell to levels that we believed were attractive even assuming no earnings contribution from the Putnam unit.

Additionally, we invested a small portion of some portfolios in **InterActive Corp. (NASDAQ: IACI)**. IACI is a multi-brand interactive commerce company transacting business worldwide primarily via the Internet and television. Its portfolio of companies collectively enables direct-to-consumer transactions across many areas, including travel, home shopping, ticketing and personals. It's most recognizable brands include travel service companies Expedia and Hotels.com, the Home Shopping Network, Ticketmaster, LendingTree (mortgages) and Match.com (dating). Admittedly, this is an area where historically we have had little representation, but it wasn't necessarily out of lack of interest. It had more to do with the fact that valuations of the industry leaders always appeared excessive to us. However, IACI's valuation, based on our estimates of free cash flow, appears reasonable and each of its businesses is dominant in its category with their moats (competitive position) continuing to widen.

The three positions sold (**Supervalu (NYSE: SVU)**, **H&R Block (NYSE: HRB)**, and **American Eagle Outfitters (NASDAQ: AEOS)**) during the quarter reached our assessment of fair value (i.e. at prices that did not appear to reflect meaningful discounts to readily ascertainable business values). While Supervalu and H&R Block provided a nice return on investment (SVU- approximately 110%, including dividends, over 2 ½ years, HRB- approximately 50%, including dividends, over 1 ¼ years), we basically broke even on American Eagle. This was a situation where, based on our continued analysis post purchase, we ratcheted down our initial assumptions, thereby lowering our fair value estimate.

We also reduced our considerably large stake (due primarily to appreciation) in Smithfield from a roughly 6% equity position to 4%. While we continue to believe SFD's fundamentals are strong, its recent price appreciation has shrunk the gap between the market price and our estimate of fair value. We still believe there exists further upside in the shares, but we cut our stake to reflect a more prudent portfolio management posture.

Animal spirits stirring?

Not only were we active during the quarter, but the capital markets began to reawaken as well. There has been a noticeable step-up in deal activity in recent months and a couple of companies owned in your portfolios have been targeted as acquisition candidates (while others have been doing the acquiring). One of the valuation criteria we use is based on private market value, or what a business is worth to a strategic or financial buyer. While we aren't out shopping for acquisition targets, our business owner's mentality tends to lead us to companies others (including industry participants) will similarly find interesting. It's therefore not surprising to us that we are seeing some merger activity amongst our holdings. In fact, it was overdue as many companies had long been selling at prices we believed to be far below private market value. Apparently CEOs are just like other investors; idiosyncratic, superstitious, victim to fears of the unknown and more prone to buy only after stock prices have moved up.

Portfolio risk management- Beta

Accompanying each of these newsletters is a paragraph or two summarizing our equity performance relative to our benchmark. However, looking solely at these raw performance numbers is not necessarily the best way for you to judge the value we are adding as stewards of your capital. For example, an absolute return number does not shed any light on how much risk may be embedded in the portfolio. Significant out-performance on a short-term basis may be welcome, but may well prove illusory if the inherent risk assumed to provide it results in an impending crash.

With this in mind, we thought that we would lay the groundwork and provide you with the tools necessary to make more informed decisions regarding our performance and investment management style. In this and subsequent newsletters we will explain various measures used in the investment profession to describe and measure risk or risk-adjusted performance. This will help us further explain to you how we believe our investment philosophy can work to your advantage over time. Keep in mind that we do not manage your portfolios on a day to day basis using these risk measurement numbers, but that they are more of a description and an output of how we manage your money than an overriding upfront consideration in our management process.

One of the most common measures used to describe portfolios is “Beta.” Academically, Beta is the sensitivity of a stock’s or portfolio’s return to the return of some market index. It can also be considered systematic risk due to general market conditions that cannot be diversified away. In a broad sense, Beta describes how much a portfolio may go up or down in relation to an up or down move in the market. If a

portfolio has a Beta of 1, the portfolio tends to move in sync with the market (i.e. if the market goes up 5%, the portfolio should go up roughly 5%). If the portfolio has a Beta greater than 1, the portfolio goes up more than the market when the market goes up, but also goes down more when the market goes down. If the portfolio has a Beta less than 1 (which your portfolios tend to have), then theoretically when the market goes up, your portfolio does not go up as much as the market, but when the market goes down your portfolio tends not to go down as much as the market.

In our view, because Beta is just a model and since all models are only approximations of the real world, it is necessarily limited in its practical application. So what then can Beta tell us? In the case of your portfolios, we believe that a Beta less than 1 tells us that the businesses in which we invest and the prices at which we buy provide a buffer in difficult market conditions. We believe that this buffer allows your portfolios (i.e. the value of the businesses we own) to make steady progress over time as opposed to experiencing significant valuation fluctuations (it’s the fluctuations to the downside that are of concern to us). We liken this steady progress to the classic story of the tortoise defeating the hare; avoid periods of significant and continuous under performance that can severely impede the progress of maintaining, accumulating and compounding wealth.

Musings from Omaha

Having recently returned from the Berkshire Hathaway annual meeting in Omaha, we thought we'd share some of what we considered to be the highlights of the question and answer session (paraphrased for the most part) with Warren Buffet and Charlie Munger.

On diversification:

Buffett: *You'll occasionally see something that's so obvious that you'll load up on it... If you think you'll see an opportunity every week you're going to lose a lot of money.*

Munger: *The idea of excessive diversification is madness.*

On the madness of crowds:

Buffett: *The whole world in the late 90s went a little mad in terms of investments. How could that happen? Don't people learn? What we learn from history is that people don't learn from history.*

Buffett: *Wall Street is awash in money and talent, but you get these absolutely extraordinary swings... At the minimum, you want to protect yourself from this type of insanity from wiping you out and, better yet, make a profit from it.*

On the macro-economy and investing:

Buffett: *Going back to '59, I can't think of any discussions Charlie and I have had in which we've passed on something because of a view on macro conditions... Show us a good business tomorrow and we'll jump.*

On the mutual fund scandals:

Munger: *A significant fraction of mutual fund managers took bribes to betray their own shareholders. It was as if a man came up and said, "Why don't we kill your mother and we'll split the insurance money?" And many people said, "Why, yes, I'd like some of that insurance money." ■*

About KIG

Kovitz Investment Group, LLC is comprised of five portfolio manager/analysts, two bond specialists, two financial advisers, and three associates. The portfolio managers/analysts possess vast and diverse educational and professional backgrounds. As a group they hold advanced degrees in Business Administration (MBA), Taxation, Law (Juris Doctorate), and Public Policy (MPP). Also, as a group they hold five professional designations—three Chartered Financial Analysts (CFA) and two Certified Public Accountants (CPA). 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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