

Investment Commentary

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Market and performance summary

The first quarter of 2005 proved to be a rather lackluster following act to the powerful 2004 year-end rally. Macro issues such as rising oil prices and remarks from the March Federal Reserve meeting regarding the building of inflationary pressures trumped generally positive company specific fundamentals as evidenced by December quarter earnings reports and a relatively light Q1 earnings pre-announcement season.

The current market sentiment reminds us of Robert DeNiro's line as Louis Cyphre in the 1987 film "Angel Heart"—"They say there is just enough religion in the world to make men hate one another but not enough to make them love." While enough angst permeated the market to cause slight dents to your portfolios, there was not enough of it to create many compelling new buy opportunities. Sort of the worst of both worlds, in our minds. For the quarter ended March 31, 2005 the equity portion of the accounts managed by KIG, on a composite basis, decreased by 1.4% (net of fees) outperforming our primary benchmark, the S&P 500, which fell by 2.15%. The NASDAQ declined by 7.95% in the first quarter.

Fueled by the Fed's inflationary posture, interest rates began their long awaited ascent. While we tend to discount most macro economic variables in making investment decisions (just show us a good business and we'll jump), we pay heed to interest rates because of their direct impact on business values (e.g. in our discounted cash flow analyses and corporate cost of money). However, we had felt for some time that rates were at unsustainably low levels and had anticipated this move up in our intrinsic value estimates. This may have been a factor that had kept us from deploying more cash into last year's rising market.



No window dressing required

Usually, a compelling argument can be made for higher or lower stock prices, higher or lower inflation, economic boom or recession. If you watch CNBC for any length of time (not that we would recommend it) you will no doubt hear both sides of each of these arguments from very knowledgeable and experienced market pros and economists.

Just as we are extremely leery of unbridled enthusiasm for stocks and the economy we are equally leery of doomsday scenarios. Either way we will refrain from making these types of predictions. It is something to which we will gladly let others allocate their time and energy.

Given current interest rates and corporate growth rates, in aggregate, the market appears fairly valued at current levels. In our opinion, upside for the market as a whole may be constrained—not a prediction, just an observation. After all, capital markets are not accommodating machines that crank out wealth for everyone on demand.

However, one of the key elements of our investment philosophy and the flexibility we are given by you, our clients, is that we don't feel we have to own the whole market for fear of falling behind our benchmark for a quarter or two. We can choose to buy stocks we feel are undervalued or not to buy them if they aren't. Our mandate is to grow your long term wealth in a sensible and responsible manner and beat our benchmark over periods measured in years, not months or quarters. We're grateful for not needing to respond to pressures faced by many other money managers, such as closet indexing by hewing to index sector weightings, and owning a slug of the market-moving heavyweights (when you otherwise wouldn't). We're fortunate not to have to participate in the window dressing process—the end-of-the-quarter ritual



that finds money managers paying high prices in order to add popular highfliers to their portfolios, after the run-up, or selling the dogs just prior to quarter end so they can trick their investors into thinking they have/have not been in them all along. (We've always wondered why their investors couldn't figure this out by the returns.) In any case, thanks.

Institutional envy?

Keeping up with the manager down the hall or down the street leads to all sorts of silliness, like abandoning good businesses just because you think the other guy might do the same and you want to be the first one out. To avoid the madness of the crowds (and in fact to take advantage of it), we tend to make investment decisions that may appear to go against the grain of conventional wisdom. Taking the contrarian view can be uncomfortable in the short-term, especially when value isn't realized by the rest of the "market" quite as quickly as we would like. But while it may test the bounds of our patience temporarily (and yours we're sure); we believe a contrarian viewpoint is essential to generate outperformance over the long-term.

But being a contrarian is not just about doing the opposite. We wouldn't run into a burning building because everyone else was running out of it. It is about understanding what expectations (i.e. growth, risk) are embedded in a current stock price and attempting to exploit it if we have a divergent view. Said differently, if we have a view that is at variance with the present consensus then taking a variant point of view presents a profit opportunity.

We're quite happy (relish is more like it) to line up against the big institutions and fund managers and do the opposite. Not because we think we necessarily have a brainpower or information advantage over these investors. Our advantages are less subtle: discipline, patience, flexibility and a long-term perspective.

In fact, we sometimes pity the big institutional investors. Their bosses, co-workers and clients judge everything they do on a daily basis. Some jabbering squawker on CNBC says it's time to get back into "the semis," and you can bet they will be feeling heat from people who don't understand why they aren't "playing the semis" too. Not having these external influences is also more than a small edge.

We certainly acknowledge that a contrarian's investment returns ultimately depend on what other investors will pay for assets at some point in the uncertain future. And the behavior (and timing of that behavior) of countless others is something that no one can control or reliably predict. So we rely on our judgment of what a good business looks and smells like and that the price we are paying has what we believe to be unreasonably low expectations built in. We don't need to be exactly right on next quarter's earnings or next year's growth forecast, but just roughly right about the company's competitive position and long-term cash generation. To us, contrarian investing really means that while we don't necessarily know what's going to happen in the next chapter, we think we know what the end of the story is going to be like.

Our way or the highway

Interestingly, company price to earnings (P/E) ratios are in one of the narrowest ranges we've ever witnessed. This should make stock picking more relevant than ever. On this score, we believe patience will be well rewarded. We will wait to buy stocks on terms we believe to be attractive; not because of fear of missing a market rally or a rush to bring down cash levels.



An example of buying stocks on our terms can be seen through the evolution of our composite's portfolio holdings over the past several years. With the addition of Citigroup (NYSE: C) and American International Group (NYSE: AIG) to your portfolio holdings last quarter (more on these specific holdings later), we now own 27% (8 of 30) of the companies in the Dow Jones Industrials, an index containing 30 of the largest U.S. companies, with market capitalizations ranging from approximately \$20 billion to \$400 billion. This is something that we would have thought unthinkable three years ago. Prior to 2003, we only owned two Dow stocks and only five others with market capitalizations greater than \$10 billion, or approximately 20% of our total equity holdings. Currently, approximately 60% of our holdings are considered large cap stocks (market caps greater than \$10 billion). What caused this massive shift from predominately smaller (technically mid cap) to larger companies? Did we wake up one morning with the sudden preference for large cap companies or disdain for smaller ones? The motivation, as it is always in matters regarding investment decisions, was driven by valuation. The late 90s bull market drove valuations of many of the preeminent large companies' stocks close to historical highs (comparable to the Nifty Fifty days of the early 1970s), while most (non-tech) medium and small caps languished in the investment equivalent of purgatory. At that point in time, it seemed the only companies to pass muster on our screens were mid caps.

We went back and calculated median P/E ratios for both the Dow and the S&P MidCap 400 Index at the beginning of the years 2000 and 2005. At the beginning of 2000 the median P/E of the Dow 30 was approximately 28, while the S&P MidCap 400 had a P/E of less than 15. Fast forward to 2005 and the Dow multiple dropped to around 20 (30% *drop*) while the S&P 400's increased to 21 (40% *increase*). Directionally, large caps have become relatively cheaper while mid caps more expensive. Today then, many more large company stocks seem to pass our screens.

Paying attention to valuation is our primary tool for risk management in the portfolio construction process. Not being constrained by arbitrary factors such as company size allows us the flexibility to implement this tool in a very effective manner. Our mission is to find undervalued securities. Period. Executing a "go anywhere as long as its cheap" style of investing should enable us to realize this mission.

The long and short of it

Coaxed on by the financial media, the sell-side analyst community and a general lack of patience, many investors eschew the relative security of long-term investing in favor of the high risk/low reward realm of short-term trading. On the subject of shrinking investment horizons we came across a commentary by Bill Nygren, portfolio manager of The Oakmark and Oakmark Select Funds, and somewhat of a kindred spirit (i.e. a fellow follower of the Warren Buffett methodology). While we pride ourselves on the intellectual challenge of coming up with original ideas and insights for this newsletter his words seemed to



capture our feelings and philosophy so well we thought we shouldn't feel too bad about passing them on to you.

(From the "Commentary on The Oakmark and Oakmark Select Funds- 12/31/04"- www.oakmark.com)
"What is less understandable is why so many investors ... often look out only a month or so! The quarterly letters from all of our fund managers continually stress the importance of a long time horizon. This repetition isn't because we forgot we'd already written about looking at the long term or because we think our readers haven't understood! We keep writing about a long-term horizon because it is probably the single most important aspect of the Oakmark (Editor's Note: "and KIG") approach to investing. As we all know, in the short-run, just about anything can happen in the stock market. In the very long-run, however, the laws of economics demand that stock prices reflect fundamental business value. By looking long-term, we can rely on estimates of business value and how that value will change over time. We can search for opportunities to invest at prices below our value estimates and look to benefit from the long-term convergence of price and value. Only by looking at the long-term do stock price movements begin to look rational.

"The financial media, with their need to create urgency for viewers and readers, often shifts focus to near-term issues that may affect today's trading but won't even be remembered in a few years. Combined with the fact that bad news sells better than good news, it is no surprise that the media seems to highlight the news items that might cause a market decline. Even though I work on stocks every day, I was somewhat taken aback to see that in late December (2004), the S&P 500 had reached a level that was 50% higher than it was as recently as March 2003. The magnitude of the gain had just snuck up on me. Over

nearly two years when the attention centered on a lingering war, higher oil prices, expectations for higher interest rates, a declining dollar, the likelihood of more terrorist attacks, and a deep political division in the U.S., the stock market quietly marched upward and produced outstanding returns. Seems like the media barely even mentioned the viewpoint that an amazing rebound in corporate earnings combined with the lowest long-term interest rates in a generation *justified* a stock market move of this magnitude. Instead, the commentary on the market increase was usually tempered by a mention that an investor who bought an S&P index fund in early 2000 had still lost money."

Thanks Bill. We're pleased to say that since the March 2003 lows KIG's equity composite has compounded at a 59% clip (through December 2004, the time frame he referenced). As you know, like the folks at Oakmark, we focus on a longer time horizon because of its complete sensibility and also because of its necessity in executing our investment philosophy. Our motivation is on identifying exceptional businesses selling at prices that we believe are substantially below intrinsic business value. Over short time periods such as a quarter or even a year market sentiment may not have sufficient time to close the gap between fundamental value and actual price. But patience and a refusal to get sidetracked by issues that truly don't relate to fundamental value are usually rewarded, we've found, as the pricing gap eventually closes.

We believe that our long-term performance record validates this approach as a way to create wealth over the long term. Our equity composite track record, which now stretches over eight and one-quarter years (1/1/97 - 3/31/05), indicates that KIG clients have experienced an average annualized return of 15%, doubling the 7.5%

Portfolio strategy and modifications

annual return for the S&P 500 over the same time period. This annual return differential becomes even more magnified through time with the help of compounding interest. On a cumulative return basis over that time period, KIG performance results in a 215% increase in portfolio value versus an 81% increase for the S&P. On a 1 million dollar equity portfolio the *difference* between the two ending values after 8.25 years is over \$1.3 million.

We spend our time thinking about a company from a business owner perspective; what it would be like to own the company for 10 or even 20 years. The key variables that will make a company successful over that timeframe have little or nothing to do with what is happening over some short time period, like whether the company is going to beat earnings expectations next quarter. Instead, it has everything to do with the company's competitive position, whether it has strong free cash flow, its past success at investing that cash flow, and whether it achieves a return on its capital that is in excess of its cost of that capital. The answers to these types of questions, in our opinion, will likely determine the future success and value of the company.



We would argue the biggest inefficiency in the market now is that investors' time horizons are too short. Therefore the most effective strategy is to find companies whose futures are being under-priced over a longer time frame.

During the quarter we established six new positions and added to one existing position. On the sell side we eliminated three positions and trimmed our exposure to five others.

While we are finding a reasonable number of new purchase opportunities based on our quantitative and qualitative criteria, truly compelling (read real cheap) prospects have not been as forthcoming. Not wanting to pass up opportunities to own quality (but not genuinely inexpensive) companies, we have been content to take smaller initial positions with the intent to increase our stakes on any further price weakness. The risk inherent in this strategy is if prices do not weaken we will have lost an opportunity to make it a larger position (did we just state the obvious?). We are more concerned, however, about the potential for downside risk than about the risk of missing some upside. Our goal is to position your portfolios for a range of potential outcomes so that we may continue to preserve and grow your capital.

On the buy side, we added several financial institution concerns as the threat of higher interest rates sent the whole sector lower (a falling tide lowers all boats?). While we acknowledge that financial stocks don't necessarily fare well during periods of rising rates, we felt that valuations already discounted much of the rise and that franchise values, competitive positioning and healthy dividend yields mitigated the chance for further downside.

The Bank of New York (NYSE: BK), known for owning the oldest retail bank in the U.S., has steadily diversified itself away from traditional banking and into a global leader of securities servicing. The company is engaged in providing a comprehensive array of services that enable institutions and individuals to move and



manage their financial assets in more than 100 markets worldwide. Because of its depth and breadth of financial service products, we believe BK is uniquely positioned to capture a larger share of the increasingly integrated worldwide financial markets. Similar to another financial services holding, US Bancorp (NYSE: USB), BK generates a substantial portion of its revenues through fee based contracts and therefore its financial results are less sensitive to increases in interest rates and the flattening of the yield curve.

Assurant (NYSE: AIZ) is a provider of specialized insurance products including creditor-placed homeowners insurance, credit insurance, warranties and extended service contracts, small employer group health, dental and disability insurance, and prefunded funeral insurance. AIZ has dominant market positions in practically all of its non-group lines. These are primarily lower risk, niche insurance markets where Assurant's size and scale will enable it to be the low cost provider allowing the company to continue to grow share. The medical group insurance business has been an early proponent of Health Savings Accounts (HSA), an area to which more employers are turning in their cost containment efforts.

Citigroup (NYSE: C) is one of the largest diversified financial service companies in the world. It conducts activities in consumer, corporate and investment banking, investment management and brokerage, among others. While it has many moving parts, its financial strength and global footprint is unmatched and nearly impossible to duplicate. A historically low valuation and hefty dividend yield limit further downside, in our opinion.

American International Group (NYSE: AIG), an insurance and financial services organization, has recently received a fair, no, make that an inordinate, amount of

publicity not for its dominating presence as an international insurance company, but instead for the resignation and dismissal of several high ranking executives, including former CEO and Chairman Maurice "Hank" Greenberg and other negative headlines revolving around its accounting. Greenberg who is (was?) widely considered one of the most influential, visionary, and ruthless titans in the insurance industry ended his four decade tenure with the company amid speculation that he may have manipulated the company's financial position to look slightly stronger than it was. While we have always viewed insurance industry accounting as somewhat opaque, some of the revelations coming out of the AIG investigation were rather unanticipated. As unemotional and pragmatic investors, however, we are forced to put these disclosures in perspective. We believe that those transactions that were improper, or at the very least pushed the accounting envelope, amount to a small portion of the company's total net worth and obscure the reality that AIG is still a unique global franchise with a solid financial position and strong cash flow. Most importantly, we feel the company's earnings power has been diminished only slightly. While the short term price pressures on AIG will be felt, we remain encouraged by the long-term franchise

Our two recent non-financial institution purchases can easily be discussed in tandem for, even though they sell vastly different products, they mirror each other in practically every way. CDW Corporation (NASDAQ: CDWC), which we have owned in the past, is a direct marketer of computers and related technology products and services, while Bed Bath & Beyond (NASDAQ: BBBY) operates specialty retail stores that sell domestic merchandise. Both companies have experienced consistent records of sales,

“The frozen orange juice syndrome”

earnings growth and margin expansion, hallmarks of businesses capturing market share. Each company has generated extremely high (in excess of 20%) returns on invested capital and neither company has ever had to take on debt to finance growth; it has all been done with internally generated cash flow. Both companies' valuations have come down to ranges we think do not give enough credit to the enduring franchise each has built and the potential for future growth.

We increased our position in Gap (NYSE: GPS), one of the few stocks we believe to be extremely undervalued at current levels. Gap has two of the most important attributes we look for; the capacity to generate substantial excess cash flow, and management that demonstrates an ability to deploy the cash wisely and in the shareholders' best interest. Even with recent sales trends tracking below expectations, the company still generates prodigious free cash flow which gives management a tremendous amount of financial flexibility to continue to pay down debt, buy back stock and increase dividend payments.

We sold our entire positions in Outback Steakhouse (NYSE: OSI) and Smithfield Foods (NYSE: SFD) for reasons solely based on valuation. We also eliminated our position in BJs Wholesale (NYSE: BJ), which despite a nice increase from its lows was, in hindsight, a mistake.

In addition, we trimmed positions in Abercrombie & Fitch (NYSE: ANF), AmerisourceBergen (NYSE: ABC), Cardinal Health (NYSE: CAH), Quest Diagnostics (NYSE: DGX), and Laboratory Corporation of America (NYSE: LH). We felt it prudent to pare exposure to Abercrombie as it grew into an outsize position due to the run-up in its stock price. We also reduced our positions in the lab companies, Quest and Lab Corp, which also saw decent price appreciation. On the other hand, we reduced Amerisource and Cardinal, not because of big price explosions (both are relatively flat since purchase), but because weakening fundamentals in the drug distribution sector has seen us turn slightly more cautious on their risk/reward scenarios.

We typically end each quarter with quotes that we find either interesting or relevant to the topics just discussed. But we couldn't find any this quarter. Instead, we thought we'd finish with this somewhat unorthodox theory from Barbara Bernstein, the wife of Peter L. Bernstein, someone we've quoted a few times over the years.

“A generation that has grown up drinking only frozen orange juice believes that orange juice exists only in the frozen format. Never having indulged in the real thing, they have no concept of what they are missing.”

To put this in its original context, it was offered as an explanation to why modern day investors don't demand companies to pay out more of their earnings in dividends. The point being that since the 1950s, investors, feasting primarily on capital gains, have forgotten that dividends have provided a healthy chunk of stocks' historical total returns. (In fact, up until the 1950s, dividend yields on stocks were almost always higher than yields on bonds. The reasoning? Stocks were inherently more risky than bonds so investors should receive more money in the form of fat dividends.)

Current topics that came to our mind were things like how our children will assume that there have always been 200+ channels available on television. Or could they ever envision life without remote controls or microwaveable meals? ■







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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