

Investment Commentary

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Market and Performance Summary

During the first quarter of 2006, the equity portion of the accounts managed by KIG, in aggregate, was up 3.9%* (net of fees), slightly below the S&P 500's return of 4.2%. Over the past one-year and three-year periods, KIG's equities increased on a cumulative basis 14.7% and 80.4%, respectively, 3% and 19.4% higher than the S&P 500 over the same time periods. We will focus on a longer, and even more relevant, performance reporting period in the discussion to follow.

Looking Ahead

With the market turning in one of its best first quarter performances in several years, how does the rest of the year shape up? Will the Fed overdo it by raising rates too far? Will the consumer retrench in the face of higher energy prices and a weakened housing market? If so, will business spending pick up the consumer's slack? Will the U.S. dollar resume its decline? Those of you who have been with us for a while, we're sure, can already guess at our answers to these queries. We have no idea. And contrary to what others may say they don't either. But guess what? Your investment performance does not depend on the answers to any of those. Really, it doesn't. Perhaps in the short-run it may, stock prices always react to positive or negative news flow. But in the long-run your performance will be dictated by one factor and one factor only—whether we are buying financially strong and competitively advantaged companies at the right price.

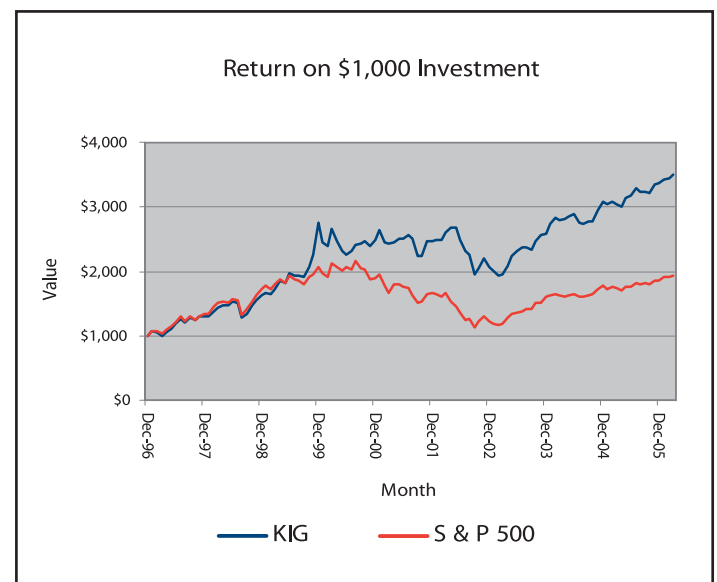
How can we say this with such confidence? The simple answer is that stock prices ultimately depend on a company's ability to generate cash flow and companies with the characteristics mentioned have shown a historical propensity to do so. Another answer, perhaps less obvious, also relies on historical evidence - our performance track record. We have never invested with these types of questions running through our heads and our long-term performance stacks up against our benchmark quite favorably. Instead of focusing on what may go right or wrong with the economy, we instead focus exclusively on what can go right or wrong at the individual company level. In our opinion it's more manageable, and appropriate, to evaluate the sustainability and potential for growth in sales and cash flow of an individual company than it is to determine where interest rates are going or what aggregate spending levels of consumers may be. Weighing factors such as industry growth potential, a company's competitive position within an industry, the likely behavior of competitors, potential for technologi-

cal change, and quality of management, while not necessarily easy, is just a bit more intuitive to us. And since long-term out-performance is highly correlated with avoiding serious errors, and not in making macro economic predictions, we just feel our time is better spent this way.

So here's the supporting evidence: Our audited track record currently spans nine and one-quarter-years and sports an annualized return of 14.9% versus an annualized S&P 500 return of 7.9%. The size differential becomes even more magnified when looked at on a cumulative return basis: KIG +262%, S&P 500 +102%. A triple and a half vs. a double. And these figures are calculated net (after) of fees.

5-Year Highs

There is much talk in the financial press recently about the S&P 500 and NASDAQ trading at 5 year highs, meaning these indexes are just managing to get back to levels that existed prior to when the bear market hit. While that sounds all warm and fuzzy, as you can see from the graph below, KIG clients recovered the bear market losses by approximately December 2003 and have been hitting *all time* highs ever since.



On a related note, we hear gold is now hitting 25 year highs. And that's a good thing? A 25-year holding period and no return. Sheeshh, you could have planted a bar of gold in your backyard and probably have gotten more growth than that.

“Growth Trap” Revisited

In our Fall 2005 newsletter, we conjectured as to why investors weren’t warned more fully or forcefully about falling into “growth traps”: “Value traps”; it seems, get all the attention. Well a new book by Jeremy Siegel (Wharton Business School) recently hit the shelves titled “*The Future for Investors*”, and the first part of the book is devoted to “Uncovering the Growth Trap”.

To refresh, the growth trap is what we define as the proclivity of investors to be seduced into overpaying for the industries and firms that appear to offer the highest growth potential. We are of the belief, and apparently we have at least one ally in Mr. Siegel, that this relentless pursuit of growth, through buying hot stocks, seeking exciting new technologies, or investing in the fastest-growing countries, dooms investors to poor returns. Why? We believe that investors invariably pay too high a price for a piece of the action. The concept of growth is so avidly sought after that it lures investors into overpriced stocks in fast-changing and overly competitive industries, where the few big winners cannot begin to compensate for the myriad losers. (Ironically, Siegel’s 1994 book, “*Stocks for the Long Run*”, is widely considered as one of the classic texts of growth-stock investing, and was continually cited by stock bulls in the late 90s in support for high valuations.)

“Growth is not the problem, it’s what people are paying for growth,” Siegel explained in a Business Week interview. He believes investors would do better buying out-of-favor industries, reinvesting often-high dividends so as to accumulate more shares in weak periods, and waiting until those companies return to favor. Exhibit No. 1: Siegel found that anyone who had bought and held the original 500 stocks in the Standard & Poor’s 500-stock index when it was created in 1957 would have made more money than someone who owned the updated index over that time. (The S&P 500 is reformulated by committee periodically to make sure it encompasses the 500 “leading” companies.) When he started his research, Siegel admits he thought that rejuvenating the list with the fastest growers was one reason it performed so well. Not so, it turns out. You would have done better sticking with the laggards. Siegel argues investing in the stocks of the fastest-growing companies may be a bad idea. The simple reason is that investors too often overpay for growth. In a subsequent interview, Siegel exclaims, “[if] you claim that there is no growth trap... why have “value” stocks trounced “growth” stocks in virtually all long-term studies? Why are small-capitalization growth stocks

the worst-performing sector of the market? Why have IPOs, whose value depends almost entirely on future growth, badly underperformed the market? And why has the fastest-growing country over the last decade, China, given investors the worst returns?” You go, Jeremy!

To make his point, Siegel uses an interesting analogy, which for anyone who is familiar with point-spread sports betting will undoubtedly appreciate. “Anyone who wagers on sports knows that automatically betting on the “best” team is not necessarily a winning strategy. Team A may be the best team, but if everyone else agrees and sends the odds (the spread) to too high a level, you should bet on the worse team.”

He, and we, believe the same principle applies to stocks. Those that have the brightest prospects and are expected to grow the fastest do not necessarily make the best investment. *It all depends on the price you pay for the value you are getting.* Betting on the “best” team without knowing the odds is the same as buying the fastest-growing stock without looking at the price.

Growth. Value. Something in between. It doesn’t matter. Successful investing requires predicting not only how fast a company will grow but also recognizing the price you are paying for that growth. Everything you buy must be evaluated against its price. We contend, and in fact have incorporated as part of our investment process, that the return to investors depends not on how fast earnings grow but on how fast earnings grow relative to what investors expected. (Remember, the consensus forecasts embedded in security prices mean that those prices will not change if the expected happens). We wrote about this concept in the last newsletter (PARG- Price At a Reasonable Growth) and will look to expound on the topic in future issues. The pricing mechanism for buying stocks should really be no different than for buying bonds. Buyers of investment grade bonds understand that returns increase as the price of the bond falls in relationship to coupons and to par. And because the maturity dates are all contractually fixed, bond investors know that the *only* way to get an increased return is to buy the bond at a larger discount.

For some reason, investors treat common stock investing differently, but the same return calculations and mathematics should apply. While it is true that the inputs on stocks are more amorphous than those for bonds - company earnings (coupons) and intrinsic value are variable and the maturity is longer (infinite) - very often, stock buyers forget the para-

mount importance of *price* to the return calculation.

If this strikes a chord, it's because this reasoning forms the basis of one of our primary investment principles - "margin of safety", or paying the right price for businesses in order to provide a cushion against the unexpected. And if there is anything we know for certain in the investment business it's that you need to expect the unexpected.

Watch the Wedge

As avid readers of *Barron's*, we faithfully await each Saturday to see what investment morsels we may be able to harvest from its pages. Always on the prowl for potential ideas, *Barron's* has proven to be a reliable source of, if not necessarily actionable ideas, diverse and usually respectable viewpoints. That is not to say that we find everything in its pages to be worthwhile. For instance, a recent issue contained the following investment nugget:

"The less important decennial cycle reflects some interesting patterns. The years ending in 5 and 8 tend to be the strongest with an average gain of 30% and 18.5%, respectively. The years ending in 7 and 0 have been sub-performing years. What about 2006? Years ending in 6 have produced average gains of 6% since 1881. However, since the 1970s, the gains have been outstanding: 1976 was up 17.9%, 1986 advanced 22.6%, and in 1996 the market rose 26%."

Hmmhh? So, let's get this straight 2006 good, 2007 not so good. Note to self: leverage up portfolios now through the end of the year, begin unwinding New Year's Eve. Not exactly a fundamental approach to buying securities.

How about another sampling?

"The S&P 500 rallied Monday, Feb. 27, to a new cyclical high, but there was no follow-through, which has been typical of market action so far in 2006. That Friday [March 3] - the key harmonic day we were tracking as a likely turning point - the SPX approached its Monday high, missed by 0.24 of a point, and faded."

[Despite some possible] short-term weakness, net volume readings remain in gear with the uptrend. Still, we think the backdrop calls for caution. Peak net volume readings have declined with each rally since the April

2005 low; it wouldn't take much selling to overbalance.

Longer-term, the SPX looks to be in a wedge-shaped pattern from the October 2004 low. If the SPX reverses and breaks from here, these patterns are typically followed by rapid A-B-C declines to the start of the wedge pattern. If our bias is confirmed, the good news is that any decline following this pattern would most likely mark a correction, and not the start of a more serious bear market."

Whew! That is good news. We had been brought up, instilled through countless lectures by our parents, that wedge patterns always implied pending doom. So much for parental guidance.

Just like there are many ways to skin a cat, we're sure there are many successful ways in which to invest. We're pretty sure though that these aren't them. These are extreme examples for sure, but we see so much of this type of gobbledygook (technical term) strewn around in the investment world that's supposed to pass for constructive advice. Because it is conveyed by so called experts and because it is said with such self-importance, people assume it is important. But they're really just making it tougher than it needs to be. Just think like business owners and you'll most likely do better than most.

Our approach is difficult though, too. But not because it is hard to understand or is filled with gobbledygook, but because it requires patience and faith that you are right when the "market" is saying you're wrong. The skill set to value companies along with patience, discipline, analytical ability and a long-term horizon are our competitive strengths and we have a feeling that they will become even more advantageous (as Mason Hawkins of Southeastern Asset Management aptly points out) "in a world where hedge funds must report results every 30 days."

We thought we'd leave you with one more for fun; an absolute scrumptious tidbit by way of Henry Weingarten, managing director of the Astrologers Fund and, apparently, financial astrologer extraordinaire.

"Weingarten is predicting that the Dow Jones Industrial Average, now over 11,000, will dip below 10,000, and the Nasdaq Composite Index will fall below 2000 from its level of 2262 sometime between March 1 and June 30, a period encompassing the March 29 solar eclipse."

"The truth is it's more than that," Weingarten says. The

eclipse, he points out, will be accompanied by Pluto being in essentially the same sensitive spot in the cosmos as Saturn was around the market crash of 1929. Some of the planetary activity also mirrors that of the 1989 real-estate recession.

Though Weingarten is more than 90% sure that "something" will happen around these astrological events - and probably a major event - he adds that "it's not necessarily bad."

Thanks Mr. Weingarten, duly noted. Keep up the good work.

Quarterly Activity

During the quarter, we established five new positions and eliminated five (six for tax-deferred accounts). In addition, we added to four existing positions and trimmed three others (four for tax-deferreds). Even though we were pretty active on the buy-side during the quarter it still seems like we are having a tough time finding a multitude of attractively priced securities. Everywhere we turn, we see companies that seem pretty reasonably valued (i.e. no significant upside), but very few, if any, of the "no brainers" (i.e. huge potential upside) that we like to see. The environment just doesn't seem all that conducive right now for our type of fundamental, margin-of-safety-based investing style. The fact that we were so active on the sell side may be additional evidence. There has been an extreme compression in the price to earnings spreads and depressed valuations are rare. Arnie Schneider from Schneider Capital Management summed it up perfectly- "It's the Lake Wobegon market: Every company is above-average."

However, any negativity perceived above is only related to finding new opportunities and doesn't extend to what we currently own. We like, no we love, what we own. We think that it includes a lot of "no brainers".

We also feel very good about the companies added this quarter. The investees are mostly unique leaders in their industry, enjoy franchise strength with high returns on capital and we believe were purchased at requisite margins of safety of value over price. We also believe that as a group, they generate high free cash flow yields and possess management teams that are allocating that cash wisely.

We took an initial position in **Dell (NASDAQ: DELL)**, the

ubiquitous PC maker. Dell utilizes a direct business model (no middle-men) combined with a made to order assembly process. This model, along with their logistical expertise (buying processes/inventory management), has enabled the company to become the low cost provider of PCs and related equipment. In an industry marked by falling prices, this is an enormous competitive advantage. One of the stellar growth stocks of the 90s, investors have begun to shun the company as its sales and earnings growth rates have slowed from the 25-30% rate it showed during the halcyon bubble days to a more recent (and more sustainable) low teens rate.

While Dell certainly has some kinks to work out on the business side to jump-start its growth, at its current valuation we believe it represents a solid risk/reward even if this doesn't happen. Dell's executional prowess along with its non-capital intensive model enables it to generate significant free cash flow. At purchase, we estimated its free cash flow yield to be about 6.5%. What this means to us is that if we had bought the entire company our cash on cash return would be 6.5% in year one; a respectable return which we would expect to grow over time. The company also had \$8.5 billion in net cash (cash on hand less debt)- roughly 12% of its \$70 billion market capitalization.

More importantly though is what management is doing with that cash flow. It is buying back stock. In 2004, Dell bought back over \$4 billion in stock and in 2005 the company accelerated its buyback efforts spending \$7.2 billion to repurchase 204 million shares. In the fourth quarter of '05 alone, the company bought in 66 million shares for \$2 billion. As you know, we love companies we own to buy back their own stock and much prefer it to explicit dividend payments of similar amounts. If we like a company, it should follow that we would want to own as big a percentage of it as possible. One way for us to accomplish this without having to put out more of our (your) own capital is for the company to do it with theirs. Consequently, our returns should increase more rapidly as a result of their buying in shares at a substantial discount to intrinsic value.

We also purchased shares in **Sprint Nextel (NYSE: S)**, the merged wireless provider entity which brought together a consumer-centric company (Sprint) and an enterprise-focused company (Nextel). The consolidation of the U.S. wireless service industry has taken seven, roughly equal competitors just a few years ago to the current state where three enterprises (Sprint Nextel, Verizon and Cingular) control approximately

70% of the market. Until recently, one of the primary concerns we had regarding the industry was that competition would eventually drive down pricing and erode margins. However, consolidating industries change the economic incentives to cut price and we believe that the big three will continue to act rationally in that regard.

Later this spring, Sprint is expected to spin-off to shareholders its no-growth local-phone division. While the division is somewhat of a cash-cow (which we will likely keep in the spin-off), we expect that as a pure-play wireless company the new (new) Sprint Nextel will garner a higher multiple from investors. Post spin-off, free cash flow will still be strong with an estimated cash yield of about 8%, which management could deploy towards paying down debt and/or aggressively repurchasing stock. Like with Dell, we expect free cash flow to grow over time.

Another purchase during the quarter was **Dow Chemical (NYSE: DOW)**, the nation's largest chemical company (number two globally). We have typically shied away from cyclical-type companies with our thinking being that because of the potential for volatile earnings streams it takes two good calls to have a successful investment - one on the way in (before earnings peak) and one on the way out (before they crash). By and large, we believe it's a heck of a lot easier to focus on less volatile industries where your success is primarily determined by just the price you pay on the way in and have thus focused our energies in this area (determining when a margin of safety exists based on market price vis-a-vis our estimate of intrinsic value). Nevertheless, in the case of Dow we felt the valuation risk/reward was extremely favorable. We don't believe that a cyclical downturn in their earnings is imminent, and even if earnings were to fall from current levels we don't believe it will be severe.

In addition, we purchased shares of **Tyco (NYSE: TYC)** and **Apollo Group (NASDAQ: APOL)**. Tyco, which has been more famous for its former management's largess than its business acumen, is currently in the process of un-conglomerating, splitting its business into three constituent parts (health care, electronics and fire and security). Apollo is the largest for-profit education company in the U.S. where its University of Phoenix unit has pioneered the online education industry. Both companies have high free cash flow yields and are aggressively repurchasing their shares. Maybe we are theme investors after all.

We also used price weakness to increase the position sizes of several of our favorite names including, **Home Depot (NYSE:**

HD), **Berkshire Hathaway (NYSE: BRKB)**, **Johnson & Johnson (NYSE: JNJ)** and **Bed Bath & Beyond (NASDAQ: BBBY)**.

We sold several long-held positions and some not so long-held during the quarter. All were sold for valuation reasons and all were profitable. Included were **Barnes & Noble (NYSE: BKS)**, **Brinker International (NYSE: EAT)**, **Cardinal Health (NYSE: CAH)**, and **Laboratory Corp. (NYSE: LH)**. We also sold our two furniture companies, **Furniture Brands (NYSE: FBN)** and **La-Z-Boy (NYSE: LZB)**, for tax deferred accounts and taxable accounts where the holding period was over one year. While we made decent returns in each, our outlook of the sector deteriorated slightly from our initial, perhaps too optimistic, view.

As is our custom when positions become over-sized relative to our comfort level (due to price appreciation vs. margin of safety considerations), we sold down our holdings in **Assurant (NYSE: AIZ)**, **Medco Health (NYSE: MHS)**, and **WellPoint (NYSE: WLP)**. Where position size allowed, we also trimmed **E*Trade (NYSE: ET)** in tax deferred accounts only, as our holding period is still within the one-year time frame and downside from current levels does not appear steep.

Although perhaps obvious, another reason we sell or trim positions is to clear out room for new or potentially new purchases. Capital allocation with a finite amount of capital is one of our most important functions.

Final Thoughts (Not from Us)

We thought we'd wrap up with some passages we came across in the recent addition of "*Outstanding Investor Digest*," one of our favorite investment publications. The first, on the subject of John Maynard Keynes and contrarian investing, is from Bill Miller of Legg Mason Value Trust fame. The rest come from some other guy named Warren something-or-other.

Miller: It reminds me of the line that Keynes used. Keynes was a great investor, but he had to put his ideas through the King's College endowment committee. And he recommended some Argentine bonds in the early or mid-1940s. And they said, "Well, you can't buy those - because the outlook isn't that good for them."

So he sent 'em a memo saying, "I want to again explain my investment philosophy. It's called contrarianism. And what that means is that the stuff I like is stuff that the average person, when they look at it, *won't* like, and indeed will think

is imprudent. So the fact the committee doesn't like it is the best evidence for it being a good investment." But they still rejected it again...

It doesn't pay to worry. There are *always* reasons to worry.

Buffett: But we're not good at forecasting markets. We know, in a very general way, that we were getting enormous bargains in the mid-'70s - and we knew that the market went crazy to some extent in the late '90s. But Charlie [Munger] and I spend *no* time thinking or talking about what the stock market is going to do. And that's because we don't know.

Sometimes we *do* know we're getting very good value for our money when we buy some stocks (or some bonds, as the case may be.) But we are not operating on the basis of any kind of macro forecasts about stocks.

There is *always* a list why the country will have problems tomorrow. But there's always a list of opportunities, which don't get mentioned quite as often.

So we don't sit down and make a list of the bad things that are happening in the economy and the good things that are happening - and, therefore, forecast the stock market. Such forecasts will often fail, even if you correctly forecast some of the bad things or good things.

The U.S. is the most remarkable success story in history..

Buffett: Overall, I'm an enormous bull on the country. This is the most remarkable success story in the history of the world, if you think about it. In 1790, we had less than 4 million people in this country - and there were 290 million people in China. There were 100 million people in Europe. And they all had the same intellect we had, they were in the same general climate, and they had lots of natural resources. And here we are 215 years later, and the country that had those 4 million people has 30% or so of the world's GDP.

So it does not make sense to bet against America. That doesn't mean all our policies are smart or anything.

Buffett: But I wouldn't get pessimistic on the country. The big

worry is what can be done by either terrorists or governments that have access to nuclear, chemical or biological weapons. But in terms of the basic economics of the country, your children are going to live better than you live - and your grandchildren are going to live better than your children live.

It's crazy to let macro concerns drive your decisions.

Buffett: I've seen so many people pass up opportunities because they get focused on a single economic variable or a single problem that the country faces and they forget about the good things. If you can buy very good businesses at attractive prices, then it's *crazy* to say, "I think I'll sit this one out because it might get a little cheaper next year," or "because the world's going to hell."

We've never operated that way. We've never decided not to buy a business we like because of a macro view.

Buffett: We get paid not for jumping over 7-foot bars, but for stepping over 1-foot bars. And the biggest thing that we have to do is decide which ones are the 1-foot bars and which ones are the 7-foot bars, so when we go to step, we don't bump into that bar. And that's something I think we're reasonably good at.

Maybe we case out too many things as being too hard, and thereby overly narrow our universe. But I'd rather have the universe be interpreted as being a little smaller than it really is, than being interpreted as larger than it is.

* 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 is reported gross of fees and costs, and assumes dividends are reinvested in the index.



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