Investment Commentary

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Market and performance summary

During the second quarter of 2004, the equity portion of the accounts managed by KIG, in aggregate, was up 3.1% while our benchmark index, the S&P 500, rose 1.7%. Year-to date, through June 30, the KIG equity composite has increased 11.4% (net of fees and transaction costs), outpacing the S&P 500's increase of 3.4%.

The strength in the quarter was driven primarily by the fact that just a few of our positions were down for the quarter, and only two by over 10% (**Kohls (NYSE: KSS)** (-13%) and **Brinker (NYSE: EAT)** (-10%)). Nine of our portfolio holdings were up over 10%, with **Safeway (NYSE: SWY)** (+23%), **CVS (NYSE: CVS)** (+19%), **Jack-in-the-Box (NYSE: JBX)** (+19%), **Abercrombie & Fitch (NYSE: ANF)** (+15%), and **Schering-Plough (NYSE: SGP)** (+14%) among the strongest. Interestingly (for us, anyway), Safeway and Schering-Plough were on last quarter's biggest decliners list. It just goes to show that it's foolhardy to even think that stock prices are predictable in the short-run. Instead, it reminds us to remain patient and continue to adopt a longer-term focus with emphasis on company fundamentals and valuation.

In order to evaluate our equity selection performance, however, you need to look at a period of time longer than just six months. Over the five year period since June 30, 1999, a period encompassing both bull and bear markets, KIG equity portfolios have *increased* 52%, or an annualized growth rate of 8.7% per year (net of fees and costs). For the same time period, the S&P 500 has *declined* in excess of 10% (negative 2.2% per year). We believe this performance is the direct result of our investment discipline, which we apply confidently and consistently, regardless of short-term market events, which focuses squarely on minimizing risk in each investment decision. Also contributing to our results is our willingness to take contrarian stands while generally ignoring market trends and the temptation to play "hot" sectors.

While pleased with our out-performance so far this year and historically, we are far from satisfied. Our culture is one which craves constant improvement and we continually try to identify areas in our investment process where we think we can do an even better job. Whether it's developing a deeper understanding of specific industries, improving our analysis of balance sheets, upgrading our trading capabilities, getting better at managing risk, or continuing to improve the information flow among members of our investment committee, we are committed to incremental development and improvement.

Recent portfolio activity

The second quarter was one that resulted in relatively little activity. We added one new stock idea, sold another and increased our position in a current holding. Not exactly non-stop action, though that's not to imply we punched in, had lunch and went home early. In this case, as will always be the case for us, the "ends" (long term growth in your capital we manage) is where we focus, not on the "means" (transactions).

It's human nature to feel a strong impulse toward action. That impulse, though, does not mean that there's an opportunity to do something productive. For some (most?) investors holding cash while waiting for the emergence of investment opportunities is emotionally difficult. This compulsion to invest is even more difficult in the current interest rate environment where you earn next to nothing on your cash holdings. However, as custodians of your assets, we have a mandate to show first a return *of* capital, and then, a return *on* capital.

When opportunities risk not only the latter, but the former too, we feel it's incumbent to squelch the impulse for action for action's sake.

We can't create attractive opportunities, but what we can do is recognize them when the market presents them to us. We just aren't seeing many opportunities that we believe would make for productive long term investments. In situations like these, we believe it's better to do nothing than to do something dumb. Ultimately, we don't get paid for activity, we get paid for being right.

To be clear, our lack of activity is not stemming from a top-down asset allocation decision to hold some cash. Cash is only a default option because our bottom-up search for value has not turned up any better alternatives (on a risk-adjusted basis). And, of course, our inactivity does not mean that we're trying to time the market. We will buy a stock anywhere, anytime regardless of what's happening in the market as long as we believe we're receiving more value than we're paying and the risk is tolerable. The relative inactivity is solely due to one simple fact—in our experience, if you can't find stocks to buy at the **right price**, then it's not worth it to buy them at all.

Having a mandate to be fully invested at all times strikes us as a bit of lunacy. (Quite frankly, after experiencing a grueling bear market, you'd think other investors would develop an appreciation for capital preservation.) We will not commit client capital just for the sake of appearing "fully invested." We conduct our own research using independent, unbiased, conservative and, hopefully, logical analysis. If this process doesn't turn up any values then we will keep our "powder dry" for another day.

But while it may be disappointing that we're not finding good values today we can never be sure of what tomorrow will bring. Along these lines, Seth Klarman, a money manager at Baupost Limited Partnership, had this to say. "One of the biggest challenges in investing is that the opportunity set available today is not the complete opportunity set that should be considered. Indeed, for almost any time horizon, the opportunity set of tomorrow is a legitimate competitor for today's investment dollars. It is hard, perhaps impossible, to accurately predict the volume and attractiveness of future opportunities; but it would be foolish to ignore them as if they did not exist." Having cash available to take advantage of future opportunities is a cost that we feel should not be ignored.

But while it's been hard this year to find new stocks selling significantly below our estimates of intrinsic values, we believe our existing holdings continue to sell at a discount and we continue to see growth in their value.

But, while not extensive, we did make some portfolio moves. We dipped our toe in the technology waters once again this quarter with our purchase of **Nokia (NYSE: NOK)**, the Finland-based cellular phone manufacturer. Recent results have been poor as the company has seen its leading market share in the mobile handset industry slip. But in typical fashion, investors, intently focused on the negatives, sold off the stock to levels that incorporated all the bad news (and then some), and conveniently forgot about the positives. So while we too have concerns short-term about potential margin erosion from pricing cuts necessary to stem market share losses, longer-term we see a company with a strong consumer franchise that has consistently generated high returns on capital and possesses vast R&D resources and management talent. Nokia also has a cash horde of almost $15 billion, practically no debt, and dividend yield of 3%. Coupling these attributes with a valuation that appears to have limited downside, we were willing to step into a controversial situation.

Stepping into unpopular situations seems to have worked fairly well for us over time.

We also increased our position in St. Paul, now named **St. Paul Travelers (NYSE: STA)** as a result of its recent merger with Travelers Insurance. While risks exist near-term, particularly related to reserving levels and integration issues, we are optimistic when we take a step back and view the combined company on a longer-term basis. The combination creates the second largest property/casualty insurer in the U.S. with annual premiums written in excess of $20 billion and a total capital base of $27 billion. This is no small advantage in a business where scale is so important. Also, the cost savings due to the merger are potentially large, creating opportunities for margin expansion. Because we prefer to purchase securities at a substantial discount to our estimate of private market value (what a financial or strategic buyer would pay to acquire the entire company) we're only going to be able to achieve that if the near-term outlook is cloudy, not sunny.

We sold our position in **PNC Financial Services (NYSE: PNC)** as its stock price approached our fair value estimate. Our return on this investment was approximately 40% (including dividends) over a holding period of roughly 18 months.

Across the Universe

Many investors focus on the market and less on the companies within it. We're of the opinion, however, that the movements of the market on a day to day, or month to month (and quite possibly even the year to year) basis are unpredictable and, more importantly, unanalyzable. Our perspective, therefore, is always and completely focused on specific companies within the market because what *is* analyzable is the value of the underlying businesses relative to the market prices of their securities. So we don't try to forecast the market and place bets accordingly; it's too hard and we don't think we'd add significant value doing it. What's easier, for us anyway, is to buy out-of-favor stocks whose futures are being under priced and to hold them until the market's perception changes and the gap between share price and underlying business value narrows.

But with the number of publicly traded companies in the U.S. now in the many thousands, the potential investment opportunities appear to be overwhelmingly endless. So how do we sift through this morass to ultimately wind up with the 25 to 30 companies in your portfolios at any one time? In an effort to not only create a more manageable and efficient system for analysis, but also to assure that we are following only high quality companies, we have developed the concept of our "Universe". Our Universe is comprised of what we believe to be the finest companies that trade on U.S exchanges in industries that we feel have solid economics. Basically, it's filled with businesses we would love to own in their entirety (if we had the capital required to do it).

The selection criteria for inclusion are rigorous. Some of the crucial attributes we look for include (there are many others);

- An identifiable and sustainable competitive advantage (i.e. a moat around its business);
- Generation of high returns on capital employed,
- Low degree of financial risk; and
- Strong cash flow that exhibits a high correlation to reported earnings.

Currently, our Universe is populated with approximately 250 names. It is not a static list however; we will add and subtract companies as factors change. Some of the more recognizable names (that we don't own already) are **Coca-Cola (NYSE: KO)**, **Procter & Gamble (NYSE: PG)**, **Wal-Mart (NYSE: WMT)**, **Starbucks (NASDAQ: SBUX)**, and **Dell (NASDAQ: DELL)**. It also includes many lesser known companies (other than those we own already) that have fabulous track records such as **Fastenal (NASDAQ: FAST)**, **MBNA (NYSE: KRB)**, **Emerson Electric (NYSE: EMR)** and **Ross Stores (NASDAQ: ROST)**.

So if we would love to own every company in the Universe how come we don't? One word—price. A company will only be moved from the Universe into your portfolios if its stock is trading at the right price. We've discussed at length in these newsletters what the right price means, but suffice it to say, the primary factor is that the expected return must justify the risk accepted. In other words, the stock must be trading at a significant discount to what we believe is its intrinsic value. This provides for our projected upside, while creating a sufficient margin of safety on the downside.

Most of the time, however, the companies in our Universe trade at or above what we believe to be fair value, thus not meeting our margin of safety criteria. By keeping track of so many stocks, which we do through proprietary models and a passion for this stuff that allows us to cram our limited mental capacity with it, the day occasionally comes when one or more will fall to a price low enough where we are faced with a purchase decision. Good investors put themselves in the position to act quickly when bargains emerge because, as every shopper knows, a good bargain doesn't last long. We believe the Universe system puts us in that position.

A note on portfolio construction

Other than price, there's another reason we don't own every company in the Universe. As you've no doubt noticed, your portfolios rarely contain more than 30 companies. Why do we limit our portfolios to roughly 30 companies? We seek to control risk through prudent, but not excessive, diversification, but most importantly, we want the capital we manage to be concentrated in only our very best ideas. We see no advantage to having our 100th or even our 50th, best idea at some insignificant percentage of a portfolio (like most mutual funds and many other private managers), where it will have little impact on the performance of the overall portfolio. In our opinion, over-diversification will only lead to mediocre results. We have confidence in our analysis so it only makes sense to position your portfolios in a way where it will make a difference in growing your net worth.

Growth, value and the NBA draft

With the recent completion of the NBA draft, it got us thinking about its similarities with investing. The draft is about the future. It's somewhat irrelevant what a player has accomplished in his collegiate career (if he even went to college these days) if he can't help your team win more games. Some of the best college players (Danny Manning, Steve Alford, Christian Laettner, and Marcus Fizer- for a close to home example) have had precious little impact at the next level. Likewise, the

valuation of stocks is forward looking. A stock is only worth as much as the present value of its company's future cash streams. What a company has earned in the past does not necessarily have any bearing on the current value of a stock Also, a stock will only be a good addition to your portfolio (i.e. help you win) if you can reasonably see upside potential in its share price relative to the downside risk.

But what got us really thinking was how the recent phenomenon of drafting players directly from high school versus the more traditional route of selecting seasoned college players was similar to the growth vs. value debate. Drafting a coveted high schooler is all about potential. And just like this potential will kindle the fascination of anxious general managers, growth stocks, typically in exciting industries and thus easier to tout in terms of analyst reports and media coverage, captivate the imagination of hyper-active investors.

Because growth companies (high school kids) typically have rosy futures, there is no shortage of money managers (general managers) who are willing to hold them. In contrast, many money managers may feel vulnerable holding a portfolio of companies that are tainted by lackluster past performance or an uncertain future (the typical fodder of fundamental-based managers). The result of these considerations is that prices of growth stocks get bid up and become overpriced while value stocks, from lack of attention, become under priced.

Additionally, investors tend to have exaggerated hopes about growth stocks (high school prospects) and end up being disappointed when future performance falls short of their expectations. Similarly, investors are often unduly pessimistic about the prospect for value stocks and wind up being pleasantly surprised when results are not as bad as was thought. We've found things are usually neither as good, nor as bad, as the crowd thinks.

But because the price paid is what will ultimately determine the success of the investment (think buy low/sell high), to us then, investing needs to be value based. Naively assuming that since the business is good, the stock must be too is a sure fire way to the investment equivalent of a car wreck. A classic example of this type of thinking occurred in the early 70s when the "Nifty Fifty" dominated investors' thoughts (and purchase orders). These blue chip growth companies had such bright futures that their stocks were bid up to ridiculous levels (similar to the late 90s run on tech stocks). The poster child for this group, Coca-Cola, ran up so much in price in 1971 and 1972 that even though it doubled its earnings between 1973 and 1982, its stock price was still down by half over that time period. A more recent example is Wal-Mart. Since 1999, the company has grown its earnings in excess of 75%, yet the stock is 25% lower today than where it was then. These examples illustrate that, in effect, investors can discount many years of future growth into current prices. By overpaying, you can sit for years waiting for the value to catch up with the price paid.

Recall our "Rubber Band" theory we discussed in these pages a couple of quarters ago. We wrote then, *"It's not that we don't think growth stocks are good companies, it's that we have an aversion to paying unreasonably high price/earnings multiples even when we are sufficiently persuaded of the growth prospects. Unless we realistically expect the price/earnings multiple to expand, the inherent downside risk outweighs upside potential. We call this our "Rubber Band" theory of valuation: the further a stock's valuation is stretched the harder the snapback (i.e. multiple contraction) can be. But, if we find a company whose valuation is similar to a rubber band lying on the*

table (i.e. slackened and unstretched) then there is a very low potential for snapback and perhaps a significant probability for stretching (i.e. multiple expansion)." The correct application of this theory, more often than not, should keep us from overpaying.

And just to beat this point to death, in the 1992 Berkshire Hathaway annual report, Warren Buffet wrote that "the term value investing is redundant…" for *"What is investing if it is not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value- in the hope that it can be sold at a still higher price- should be labeled speculation (which is neither illegal, immoral nor, in our view, financially fattening)."*

Inadvertently or not, it's been our observation that most investors focus their efforts on speculation under the guise of investing. They mistakenly (foolishly) believe their mission is to find the next Microsoft. Besides the lack of intellectual honesty in this act, if they do find what they think they're looking for they tend to ignore what glorified expectations are already priced into the stock (i.e. the rubber band is really stretched).

Even with the nasty consequences of the technology bubble still being felt (the NASDAQ is still down 60% from its early 2000 high), we see no end to the fascination with growth. Investors still tend to extrapolate from the past and become excessively excited about promising new technologies. They do this while letting prices of boring, slower growing businesses languish and drop below their value based on more fundamental measures. Because these behavioral traits will likely persist, a disciplined, patient investment style grounded in fundamentals (and not hype) will remain a rewarding long-term strategy. ■

"Any individual, when alone, can be a cultivated person. However, put him in a crowd and he immediately becomes a blockhead."

Guastave LeBon, from "The Crowd: A Study of the Popular Mind" (1895)

"Regarding learning from your own mistakes, the best thing to do is to learn from the other guys' mistakes … our approach is to try and learn vicariously. As Patton used to say, 'It's an honor to die for your country, but make sure the other guy gets the honor.'"

Charlie Munger,
Vice Chairman of Berkshire Hathaway

"There is absolutely no substitute for paying the right price. In the Bible, it says that love covers a multitude of sins. Well, in the investment field, price covers a multitude of mistakes."

Arnold Van Den Berg,
Century Management

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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