Investment Commentary

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Kovitz Investment Group℠

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Market and performance summary

If there was ever a quarter that demonstrated the fickleness of Wall Street, this past quarter was it. It also provided a textbook example of why investors should not try to read too much into each and every economic report (or earnings report, for that matter). Too hot, too cold, or just right? While tough to read even over long time periods, during one short span in May a series of reports on the status of the economy appeared to provide information that confirmed each of the three temperature settings. The market gyrated between elation and desolation as benign inflation readings at the wholesale level and falling oil prices were offset by soft retail sales reports, rising interest rates and increases in consumer inflation. Each new economic report seemingly contradicted the one just before it and judging by the market's violent reactions each was taken as the new trend. But we continually remind ourselves (don't others?) that one data point does not a trend make. Blips happen. (Really, they do).

Alas, perhaps we just lack the gift of prophecy that is so abundant on Wall Street. But, our feeling has always been that if you spend time worrying about 'the economy' and its direct or indirect impact on 'the market', then you can't devote considerable time to what we believe to be a far more productive purpose: the search for good businesses whose stock is available at reasonable or bargain prices. So while most investors were trying to divine the economy's every nuance, we weren't. Instead, we were patiently searching for companies to which to allocate capital towards (or away from). And we did this while logging in another quarter of out performance relative to our benchmark, the S&P 500. For the quarter ended June 30, 2005 the equity portion of the accounts managed by KIG℠, on a composite basis, increased by 4.4% (net of fees) outperforming the S&P 500, which rose 1.4%. For the first six months of the year, the KIG composite is to the *positive* by 3.4% (again, net of fees) while the S&P has *declined* by 0.81%. Year-to-date, the NASDAQ is *down* 5.12%

Do the shuffle

While we seemed to imply above that contradictory economic data was the primary culprit in the market's choppiness last quarter, we are actually highly skeptical that the market, on a daily basis, really reacts to backward-looking government economic data. It seems that investors are more likely taking their cue from what others are doing and sending the market whichever direction the current momentum seems to be. It's a dangerous sort of circular reasoning: Investors sell only because others have sold and buy only because others have bought.

Investor opinion often appears unduly influenced by whatever shares have done recently. A Merrill Lynch survey done in early May (right around the most recent market bottom) showed that U.S. fund managers on balance felt that stocks were slightly overvalued. In early March, when the stock market was much higher (most recent top), the same managers felt that stocks were somewhat undervalued. This bizarre logic (and we use the term loosely) seems to play itself out over and over again on Wall Street; stocks become "more expensive" by falling. The cumulative effect of such thinking becomes a self-fulfilling prophecy.

Can it really be that investors are really just like confused holiday shoppers who, instead of buying a lot of gifts from a store with a 50%-off sale, load up instead on items from the store that has marked everything up by 50%? When the perceived risk in going against the market's apparent pricing model is greater than the reward, the answer appears to be yes; it seems best just to join the market. Prices be damned.

This mindset can be observed directly by examining the current portfolio turnover statistics of professionally managed funds. (Turnover is a measure of a fund's trading activity- the higher the turnover percentage the more trading activity.) The average turnover until the mid-1960s was 15%, implying an average holding period of about seven years. Today, the average holding period in professionally managed funds is less than a year meaning annual portfolio turnover is greater than 100 percent. It would seem that the shorter the holding period, the more the beliefs of others (herd mentality) rather than long-term fundamentals become central to investment decisions.

We believe this finger-on-the-trigger approach to investing is a sure-fire way to self-destruction. While the financial press, particularly the anchors on cable TV, seems to imply that investors should reshuffle their portfolios in response to each new data point, especially those that portend doom, we prefer to make our decisions to buy or sell, and when to do each, based on fundamental company specific issues. The key variables that will make a company successful over a longer timeframe have little or nothing to do with what others are selling at the moment (or why they are selling). Instead, it has everything to do with the company's competitive position, whether it can produce robust free cash flow, management's past success at allocating capital, and, most importantly, whether it achieves a return on capital that is in excess of its cost of that capital. If your goal is to sell before everyone else, chances are you're not thinking about these factors. And if you're not thinking about these factors chances are that you won't be a successful investor over the long haul.

Of course, excessive reshuffling might add value if investors were able to shift money consistently out of investments that were overpriced and due for a fall, and into undervalued assets with significant upside potential. Unfortunately, most investors do the exact opposite: their emotional responses to market movements as well as their pre-wired tendencies to find meaningful patterns in random short-term events cause them to invest heavily in assets that have delivered exceptionally strong recent performance and are set to deliver lower returns going forward. Likewise, they avoid or sell those investments that have underperformed in the short term but are now on track to produce increasingly greater future returns.

Since when was investing about avoiding the bumps anyway? If you're investing with a time frame longer than next quarter, we believe you can safely ignore them and more importantly, use them to your advantage. The mindset employed at KIG is to always be fearful of losing money but never to be afraid to put ourselves in a position to make money. Our long-term performance investing in equities would seem to support this type of thinking. KIG's equity track record (eight and one-half years- 1/1/97 through 6/30/05, audited through 12/31/04), indicates that our clients have experienced an average net of fees annualized return of 15.1%, more than doubling the 7.4% annual return for the S&P 500 over the same time period. This annual return differential becomes even more magnified over time thanks to the eighth wonder of the world, compound interest. On a cumulative return basis, KIG performance results in a 230% increase in portfolio value versus an 83% increase for the S&P. On a million dollar equity portfolio the difference between the two ending values after 8.5 years is over $1.45 million.

To buyback or not to buyback?

We intend to own companies that produce excessive amounts of free cash flow (i.e. cash that a company is able to generate after it has reinvested in the company's continuing operations). A question that each company naturally faces is what to do with the cash that it accumulates on the balance sheet. In our opinion, what separates good management teams from bad ones is their ability to allocate capital to its best use (i.e. the project or activity that yields the highest return for shareholders). The short list of alternatives for the utilization of the cash is paying dividends, reducing debt, making acquisitions, undertaking capital expenditures, or buying back stock. All things equal, our preference has and will continue to be for buying back shares.

Our penchant for buybacks is quite simple; since we will not be selling our shares back to the company (we own it for long-term reasons), our percentage ownership in the company will increase. Increasing ownership in an entity you feel good about cannot be a bad thing. Buybacks also have the not so insignificant consequence of being accretive to earnings per share (EPS). While achieving growth this way is less preferable than growing net income organically, remaining shareholders will still experience growth in their profit take through their higher ownership stake.

Management's decision to buy back its shares should be based on the same rationale we use to decide to purchase the stock: shares should be bought if, at current prices, it appears to provide for a long-term profit opportunity. Should our's and management's assessment that shares are undervalued prove correct, then we gain at the expense of shareholders who voluntarily tender their shares.

Why are we not as excited about companies which use their excess cash to fund an acquisition or invest in new capacity through capital expenditures (new factories, stores, equipment, etc.)? While these activities may offer a decent return on investment, that return is uncertain at the time of capital outlay. Returns on buybacks, however, are highly certain. Consider a situation where a company's stock is trading at 12 times earnings (P/E = 12). Buying back shares at this price ensures the company of at least an 8.5% return (the capitalization rate, or inverse of the PE), and possibly higher if earnings (or the P/E multiple) rise. Of course, the company could earn less, but the decision for the buyback itself most likely means that management is somewhat confident in the current state of the business.

An alternative option that seems to have generated investor excitement recently is for companies to pay out a one-time, or special, dividend. Most notably, **Microsoft (NASDAQ: MSFT)** paid out roughly $30 billion ($3 per share) of idle cash last November as a special payment to shareholders. But as shareholders, this would leave us flat, literally. As an owner of Microsoft examining your November 2004 statement you would have seen your cash account increase by $3 per share for each share of Microsoft owned and your equity holdings decrease by $3 per share for a net gain of?. . .zilch, zip, nada (less if you take into account the tax impact of the dividend). One-time payments are just that, one-time events that do not create long-term value. Buybacks, on the other hand, are always present due to their lasting impact on EPS.

But all buybacks are not created equal. One thing we don't condone is when companies put in buyback programs that are meant only to offset the EPS dilution from employee stock option programs. This is a blatant transfer of wealth from shareholders to employees. We have typically shied away from companies that have highly dilutive stock option plans in place.

Quarterly activity and portfolio strategy

As you might have guessed from our diatribe above, while we may gripe about the market's schizophrenia, and for most investors it may present an uncomfortable proposition, we actually welcome, and are even desirous of it. How else can you find the opportunities to buy in at bargain prices and sell at dear ones?

Summarizing our current sentiment we take our cue from the Federal Reserve, who lately seems to churn out the same statement after each interest rate meeting, and we repeat the same thing this quarter we stated last quarter: "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 been few and far between. 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 price weakness. The risk to this strategy is if prices do not weaken we will have lost an opportunity to make it a larger position. 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."

While we remain agnostic on the aggregate level of the market, valuations at the individual company level aren't all that attractive; an aging bull market that's becoming less generous perhaps? This statement doesn't necessarily imply that we see many instances of overvaluation either. In general, companies seem to be fairly valued. (Note: we cannot say the same for the other major asset classes as bonds, real estate and commodities appear to us to be generously overvalued.) Other investors may justify current valuations by comparing to something more expensive or by using overly optimistic assumptions. Buying expensive stuff and justifying it with talk of everything else being expensive, too, can work for a while. When it stops working, though, it's a tough place to be. Perhaps we are underestimating corporate profits or overestimating potential increases in interest rates, but these aren't really bets we're willing to make. We long for obvious discrepancies in valuation and just aren't seeing it as often as we would like. In other words there's not much value in value right now.

During the quarter we established three new positions and added to three existing positions. On the sell-side we eliminated two positions and trimmed our exposure to six others. The quarter began for us with a flurry of purchases. You may have thought we had gotten our finger stuck on the buy button as in one week-long stretch (April 15-22) we purchased five stocks for most of our portfolios. Coincidentally (or not?), this torrent of activity coincided with the recent market lows. But as the quarter progressed (and the market moved upward), buying made way for selling.

The three stocks purchased this quarter make for a fairly eclectic mix: **La-Z-Boy (NYSE: LZB)-** furniture, **Accenture (NYSE: ACN)-** management consulting and **E*Trade (NYSE: ET)**- on-line brokerage/banking. But while toiling in disparate businesses they share many of the characteristics for which we hunt. Most importantly, each has dominant market position and the ability to generate excess cash flow. As is the norm, all of these buys were precipitated by share price weakness driven by what we believed to be Wall Street shortsightedness (i.e., no fundamental issues). ***** This just in: Research shows that stocks provide high returns when they are purchased at low levels of valuation. Similarly, they will provide low returns when they are purchased at high levels of valuation. ***** In our opinion, this shortsightedness produced a low level of valuation for each.

We actually were able to do something that we haven't been able to do for quite sometime; take advantage of (temporary?) price weakness in an existing name to add to our initial positions. And we were able to even do it twice this quarter. Both **CDW Corporation's (NASDAQ: CDWC)** and **Clear Channel's (NYSE: CCU)** stock price fell for what we considered to be non-fundamental reasons, and we used the opportunity to increase our positions in each. We were also able to initiate a position in Berkshire Hathaway for newer clients, but did not add to what was a relatively large position already for longer-term clients.

We sold our entire positions in **CVS Corp. (NYSE: CVS)** and **Jones Apparel Group (NYSE: JNY)** because we saw limited upside in each name from current levels, but for very different reasons. In the case of CVS, after a temporary stumble in 2002, the company executed on its business plan flawlessly as it joined Walgreen Co. as the dominant players in the pharmacy industry. Over our holding period, the stock price benefited from the blissful combination of earnings multiple expansion on a growing earnings base. Even though we remain optimistic on the business, at over 20 times current year's earnings, we felt the stock was fully valued.

Our reasoning for the limited upside in Jones stemmed from our perception of the competition in the women's apparel industry (fierce) and its organic growth opportunities (limited).

We used the market strength in the second half of the quarter to trim other current holdings (**Medco Health (NYSE: MHS)**, **AmerisourceBergen (NYSE: ABC)**, **Barnes & Noble (NYSE: BKS)**, **Abercrombie & Fitch (NYSE: ANF)**, **Quest Diagnostics (NYSE: DGX)**, **and Brinker International (NYSE: EAT)**). Each of these companies is trading relatively close to our target price and we felt it prudent from a portfolio management standpoint to pare back exposure either through partial sales or covered call writing. The latter was utilized when the current holding period was less than one year or we felt able to exploit the premium in the option market.

Welcome

KIG is proud to announce three additions to our firm, bringing us to a total of 16 fulltime employees. Harold (Skip) Gianopulos, Jr. has joined our firm as Managing Director – Client Services and Portfolio Manager. In his most recent position at Harris he was the Managing Director of the Wealth Management Group in Barrington. Skip graduated from Taylor University with a Bachelor of Science in Business Administration and Computer Information Systems Analysis. He received his Law Degree (J.D.) and Masters of Law in Taxation (LLM) from The John Marshall Law School in Chicago. Prior to joining KIG, Skip was a Senior Vice President of Harris Trust & Savings Bank in Chicago. Prior to joining Harris, Skip co-founded a successful fee-based investment advisory firm. Skip has been featured in Worth Magazine as one of the Top Financial Advisors in the country (giving KIG the distinction as the only firm in Illinois with two people on that list) and has spent his entire career counseling high net worth individuals in all areas of wealth management.
He is a published author and speaker on various wealth management strategies. Skip is a Certified Financial Planner (CFP). Skip's vast experience as a wealth planner in diverse areas such as investments, retirement planning, taxation, and estate planning will further Kovitz Investment Group's ability to provide comprehensive investment advisory services to our clients. Skip's primary responsi-

bilities with Kovitz Investment Group will include the construction and management of client portfolios as well as the oversight of the firm's financial advisory and client service areas.

Vy Tieu, a recent graduate of the University of Illinois at Chicago (UIC), has joined KIG as an equity research associate. A finance major, she will focus on applying her strong technical background to KIG's equity research and portfolio management efforts.

Chris Czachor has also joined us as a full-time employee after serving as an intern for two years while attending DePaul University. Also a finance major, Chris will assist in many areas of our organization, including the bond desk, client service and IT systems.

Miscellany

We are also pleased to announce that we have finally staked our claim in cyberspace by launching a Web site (we figured this internet thing just may be here to stay). By visiting www.kig-llc.com you will be catapulted into a world where nothing is at it appears. No, not really. It's just a functional site that summarizes our approach to managing money and details our investment philosophy. It also has information on our past performance, top equity holdings and various portfolio statistics. Most importantly, we have also made available past issues of these very newsletters in the off chance you have not kept your files up-to-date. Coming soon, you will be able to access our ADV disclosure document which we have relentlessly offered you quarterly. We would also appreciate that if you know someone who would benefit from our services that you tell them about the site.

If you're a glutton for punishment, log on now.

Quotes

"Don't do something, just stand there… emotions are the investor's greatest enemy."-
John Bogle*, *Vanguard Group Founder

"People think because growth stocks are good companies, their stock returns will be high. But in fact, their prices are pegged so high by the market that their returns actually tend to be low."
Eugene Fama*, *"father" of the efficient markets theory

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 and Law (Juris doctorate), 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 seeks long-term capital appreciation of client assets through high risk-adjusted returns. To accomplish this objective, the investment style emphasizes the preservation of capital and minimization of risk primarily by investing in mid to large cap companies believed to be significantly under-valued. We believe equities purchased at prices significantly below their intrinsic worth should protect capital from significant loss and should also appreciate substantially when the market ultimately recognizes business value.

KIG strives to achieve superior long-term performance through the purchase of equity securities of competitively advantaged and financially strong companies at prices substantially less than our assessment of their business value. We consider investments in common stocks as units of ownership in a business. We don't, therefore, regard ourselves as traders of stocks, but rather as part owners of tangible businesses. As such, we look to allocate investment capital on the basis of justifiable premises, valid logic, and hard evidence, not popularity or emotion. Our critical research and buy discipline gives us confidence to establish concentrated portfolios where our best ideas can have meaningful impact on performance.

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