

Investment Commentary

Summer 2006
Volume III, Issue 4



Marc Brenner, JD, CPA
312-334-7302
mbrenner@kig-llc.com

Mitchell Kovitz, CFA, CPA
312-334-7301
mkovitz@kig-llc.com

Jonathan Shapiro, CFA, MBA
312-334-7324
jshapiro@kig-llc.com

Bruce Weininger, CFP®, CPA
312-334-7334
bweininger@kig-llc.com

Skip Gianopulos, JD, LLM, CFP®
312-334-7303
sgianopulos@kig-llc.com

John Conway
312-334-7343
jconway@kig-llc.com

Ed Edens, MBA
312-334-7333
eedens@kig-llc.com

Rich Salerno
312-334-7304
rsalerno@kig-llc.com

Andrea Cohen, CFP®
312-334-7312
acohen@kig-llc.com

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Past performance does not guarantee future returns.

Market and Performance Summary

During the second quarter of 2006, the equity portion of the accounts managed by KIG, in aggregate, was down 2.8% (net of fees), falling more than the S&P 500, which lost 1.4%. For the year to date, through June 30, the S&P 500 has increased 2.7% while KIG is up 1%.

Not a great quarter and we make no excuses. We will always remain accountable for our decisions regardless of the outcome and never be ones who take credit for success while blaming bad luck when we fall short.

That said, our historical performance continues to reflect well versus our benchmark over periods of time much longer than one quarter. KIG's annualized 5-year and since inception (9.5 years) returns are 4.2% and 6.7% ahead of the S&P 500's annualized numbers.

We discuss our thoughts on what may cause our performance to improve in the section "**Flight to Quality**" below.

Saving Grace?

From May 10th through June 13th, a period during the quarter where the market sold off quite severely, the S&P 500 fell 7.3%, while KIG's composite portfolio was down a less terrible 5.5%. Other sectors of the market felt an even harsher reality. The Russell 2000, a small company index, and the emerging market index (as measured by the iShares MSCI Emerging Markets ETF) were down 13.2% and 25.4%, respectively, over the same period. Why our portfolios would go down less when the overall market gets hit exceptionally hard we believe is due to two primary factors: our focus on valuation (margin of safety) and the general high quality nature of the assets we own. To us, going down less than the overall market feels almost as good as going up more than the market (if you were to press us on this, however, we might say the former actually feels better).

Flight to Quality

The phrase used around Wall Street these days to explain the recent downturn is "repricing of risk". What this apparently connotes is that investors decided that they've had enough of risk, which as best as we can tell must mean any asset where its price can fall as well as rally. Often times, especially in periods of complacency, investors chase return without regard to risk. They routinely bid increasingly risky and obscure assets to levels which will result in lower and lower returns, with

consideration of risk at best an afterthought. Complacency must have been rampant not all that long ago, and it sucked in many unsuspecting investors who thought asset classes such as emerging markets, metals and other commodities were one-way tickets to prosperity.

Risk is never an afterthought with us. It can't be. Managing other people's money is too great a responsibility to let the allure of quick profits sidetrack us from our primary goal of compounding wealth over long periods of time in a manner that minimizes the risk of permanent capital loss. Most of the time this requires having the discipline to stick to the opportunities where we have an edge and sit out the ones we don't. We're pretty sure we don't have any advantage in determining the value of a non-cash generating asset class such as commodities, so we just let the pitch go by (remember, there are no called third strikes in investing, you can choose to swing only at the fat pitches down the middle of the plate). Besides, we don't really want to invest in things that could be a coin flip between doubling or going down substantially. We want the downside of every holding to be no more than 15-20% and the upside to be at least 40-50%. The key for us is not to be wrong about the downside.

For some time we have believed that the spread between high quality and low quality assets is too low. As the spread normalizes, our portfolios should be in position to benefit. One of two things will happen; either low quality trends downward toward high quality implying little downside for our portfolios, or high quality trends upward creating decent upside. While the second option is clearly preferable, if the first were to occur, the stagnation in high quality would more than likely not last forever.

Volatility Does Not Equal Risk

As the market swooned in May and June, investors seemed to be bracing for the worst- a bear market onslaught, perhaps? While the selling has not been significant thus far, more of a hiccup than anything else, we thought it may be instructive to discuss how we would act if a more serious decline were to occur.

How do we view the sizeable declines in the market? By and large, we take them in stride comfortable with the understanding that that is what markets do ("markets fluctuate" as J.P. Morgan profoundly stated.) One thing you would not see us do is to sell into the decline. Those that do (sell into declines)

delude themselves into thinking that they are saving money by getting out ahead of the next wave of selling they are sure will be coming. But nobody (regardless of what some say) can consistently time the ups and downs of the market, so while somebody may be proud of their trades that “saved” them the few percent the market fell post their selling, were they back in to capture the 5%, or 10% move up off the bottom? Probably not. Still, most investors will never realize that selling to avoid a temporary loss most likely ends up costing them in the long run, outsmarting even themselves. These types of actions by others are fine by us because it is one of the things that can create opportunities for those willing to keep market drops in perspective. When people are fearful, we believe being constructive is the best course.

It’s just that in our minds it seems absurd to sell something you believe over time will be worth more than its quoted price to avoid some downside in the short-term. This is because we are secure in the belief that any value lost is, most likely, not a permanent impairment but rather a temporary manifestation of negative investor psychology (i.e. not a true reflection of “value” at all). Our conviction on this point stems from the fact that we have confidence that what we own is undervalued and will sell at a higher stock price at some point in the future once intrinsic value is realized. Timing is, as usual with us, uncertain. In other words, the gratification may be delayed, but not denied.

We constantly assess and reassess what we own and why we own it. This way, when the market turns desperate we aren’t caught off guard. Investing typically brings out all sorts of cognitive biases, but they seem to loom even larger in times of stress. Biases like social proof that something is wrong (the assumption that others possess more knowledge about a situation hence they deem the behavior of others as appropriate), overweighting near-term data/trends and just plain falling victim to uncertainty and doubt are heightened in anxious moments. People don’t consciously choose to invest with emotion- they simply can’t help it. To remove the element of emotion we think it’s imperative to just stay focused on the expected values of what you believe something is worth, regardless of what just happened to the price. Fortunately, human wiring serves to limit the size of the population that act in this fashion. We make our own decisions and are willing (and happy) to be held accountable for them rather than seek safety in whatever everyone else is doing.

It’s also important to have a library of ideas on which you’ve already done careful valuation work that you can quickly update and respond to. Doing new research in times of crisis is very difficult. Without the ability to buy in the middle of a crisis you’ll suffer from the volatility of it but won’t be able to take advantage of buying the cheap assets that result from it. In an age where advantages don’t present themselves frequently, they must not be squandered.

How does all this fit in with our risk management mandate? Is this reckless behavior? We take our cue from Carl Icahn who believes risk should be thought of as fundamentally driven by the underlying value of the company, rather than prevailing market conditions. We have seen too many times where market prices, either for individual stocks or market aggregates, just did not justify the fundamentals (both on the too high and too low sides). Most market volatility is unnecessary anyway as underlying fundamentals are far more stable than the market projects: An example of behavioral forces overpowering reason.

Contrary to modern portfolio theory risk is not about short-term swings in portfolio values. Portfolio volatility and risk are not synonymous. Chris Browne of Tweedy, Browne studied the long-term performance of seven of the greatest investors in history and found that they under performed market averages between 28% and 40% of the time when measured over short time periods such as one year. Over longer periods of time, however, these same investors trounced the averages. Were the portfolios more risky just because they were volatile or underperformed for a short time?

Having a longer time frame than the competition is more than a small advantage. In a sense, we can arbitrage their short time frame versus our longer one. Big players, particularly mutual funds and hedge funds, are not willing to expose themselves to possible short-term pain for long-term gain. On the other hand, we are willing to endure some pain (or just stagnation) if we see a worthwhile longer-term reward.

Making money in the stock market is not risk free and never an orderly process. For if it were, the upside would not be any greater than the return on government bonds (an essentially risk free instrument). We firmly believe that in order to make money investing in stocks, you must be prepared to lose money. Counterintuitive? Perhaps, but it’s only by adopting this mindset that an investor can earn excess returns over time.

Little Book, Big Ideas

The Little Book that Beats the Market is a reminder that great things come in small packages. The book, an offering from investor and author Joel Greenblatt, is no bigger than a children's board book but is filled with ideas that are so powerful that it may as well be the size of *War and Peace*. Greenblatt has had tremendous success as an investor; his hedge fund, Gotham Partners, has earned better than 40% annually since 1985. (For this reason alone we figured this was something that we couldn't pass up reading- whenever great investors are willing to talk, we'll listen). But based on the wit and wisdom of this work if he ever decides to hang up his Bloomberg terminal, he definitely has a future as a writer.

The book, which is purposefully written in a way so even his children, ages 6-15, could follow along, describes an investment philosophy that on its face is so simple that an investor with just a little bit of knowledge may dismiss it. But as Leonardo da Vinci so eloquently stated, "simplicity is the ultimate sophistication." And based on Greenblatt's investment record you've got to believe it works.

There's a qualifier though, Greenblatt proclaims, the only way you'll be successful with it is if you believe, truly believe, through thick and thin, that the philosophy makes sense and will work. Which of course is easier said than done because everyone only wants to get rich quickly and Greenblatt's approach does not promise wealth overnight.

So what is the philosophy and why are we touting someone else's investment strategies? Because it is exactly the same as ours. Invest in good companies when they are cheap.

Our mantra has always been to buy good companies at cheap (or even fair) prices and have the patience and discipline to wait, regardless of the market environment, for the gap between market price and intrinsic value to close. It sounds simple and it is, except for the patience part. That's where most investors fall flat. It requires faith that you are right when the market is saying you're wrong. No doubt, a tough standard to meet.

So why is Greenblatt (and us) willing to tell his secrets to the world and lose his competitive advantage? Because he knows that most everyone who reads it does not have the capacity, emotionally and intellectually, to embrace it and let it work for them. Why? Because there are times when the strategy does

not always work- there may be stretches of 1-3 years where the formula underperforms or loses money. Most people cannot stick with a strategy that fails to do well even for a short period of time.

Greenblatt sums it up best. "Traditional value investing strategies have worked for years and everyone's known about them. They continue to work because it's hard for people to do, for two main reasons. First, the companies that show up on the screens are scary and may not be doing so well, so people find them difficult to buy. Second, there can be one-, two- or three-year periods when a strategy like this doesn't work. Most people aren't capable of sticking it out through that."

Let's hope this continues to be the case.

Quarterly Activity

During the quarter, we established four new positions and eliminated three. In addition, we added to an existing position and trimmed two others.

The mini market swoon did not create as many new buy opportunities as we would have hoped, but we found four that met our criteria of good and cheap. We followed last quarter's addition of Dell with another large cap technology company that has fallen out of favor with investors. **Microsoft's (MSFT: NASDAQ)** share price has been battered over concerns about new product delays and increased investment in certain internet initiatives. At current levels, however, we see Microsoft not as an overpriced technology company anymore but one of the world's great businesses that has become attractively valued.

The perfect business earns very high returns on capital that it can continue to reinvest at the same levels without requiring significant amounts of additional invested capital. A close second is a business earning a high return but can't redeploy it at the same levels and has a management intellectually honest enough to know that. Instead of plowing it back into low return projects they just return that capital back to shareholders through share repurchases or dividends. Right now Microsoft is a hybrid of these two ideals. They earn exceptionally high returns on existing businesses, have some promising new ventures, but are also beginning to return excess cash flow back to its owners.

Buying into companies like Microsoft, which are suffering what we call "a period of unpopularity", often means signing up for

short-term frustration as the stock continues to languish. But, the best opportunities carry more perceived risks and we are cognizant of the fact that the market's recognition of hidden or ignored value often takes time to arrive and the road toward that recognition can be quite bumpy. But if we are correct about the underlying economics of the business and only roughly right about future cash flow, we will do just fine.

Another new purchase made during the quarter was **CarMax (KMX: NYSE)**, known primarily for their used car superstores. Conceptually, the way they have set up this company just resonates with us. The idea, from the very beginning in 1993, was to create a model that is the antithesis of the way the used car market typically operates. (We know, you get the chills just thinking about it.) CarMax posts no-haggle prices and guarantees an offer for a trade-in whether you buy from them or not. Financing terms are clearly disclosed and salespeople are compensated based on a flat dollar amount per sale and not a percentage based on sale price. All these things tend to improve the car buying experience which engenders repeat business and word of mouth advertising.

CarMax's competitive position is extremely attractive; currently no other company is doing things the way they are. Their competitive advantages are many. Each CarMax store has roughly 4-5 times the inventory of a typical used car dealer and if you don't find what you want at the store you're at, you can access their 20,000 cars nationwide on Carmax.com and they'll ship between locations. Technologically they are also way out in front with sophisticated inventory and pricing systems.



While not necessarily cheap based on current earnings we believe we are paying a fair price for the value received. But we also consider the upside to be ample given where the company is in its growth trajectory (currently 70 stores with potential for several hundred, or more) and opportunity for margin improvement as they fill in markets. One thing we are certain of, however, is that the stock price will be volatile (notice we did not say risky) so we have scaled our initial position size accordingly with the full intention of buying more at some point in the future.

The two other new positions added this quarter were **Mercury General (MCY: NYSE)** whose operations are primarily in auto insurance, and human resources consulting firm **Hewitt Associates (HEW: NYSE)**.

During the quarter we also increased our position in **Royal Caribbean (RCL: NYSE)** after the share price retreated on news that its largest competitor, Carnival, was seeing a slow-down in its Caribbean cruise bookings which would penalize near-term earnings. We've never professed to be able to gaze into the future and accurately predict what each quarter's earnings will be. Nor do we think that kind of predictive capability is necessary to be a successful investor. You don't have to predict the future if you know the company has the assets, competitive advantage and management to do well. At the end of the day we're focused on these characteristics and a company's ability to generate cash flow and its ability to either reinvest it successfully, or pay it out. Given the duopoly structure of the cruise industry and the pricing discipline that it engenders along with other fundamental virtues (particularly valuation), we feel Royal Caribbean will reward those who are in it for the long haul.

Historically, we've found good opportunities in situations where something has gotten cheaper after we've bought and because we've done all the upfront work have the confidence to buy more as prices come down. Some of our most successful investments have been small positions that did poorly at first, but we added more at lower prices because we thought we understood the companies better than others. And because the stocks had gotten cheaper, we had more downside protection and could take full positions. If you can understand what the person selling you the stock is fearful of and that fear is either irrational or overdone then it tends to be an opportunity. Also, focusing on the validation of the market over the short-term will not only tend to disappoint but will lead to poor decision-making and lost opportunity.

On the sell side, we eliminated our positions in **Estee Lauder (EL: NYSE)**, **Merck (MRK: NYSE)** and **Quest Diagnostics (DGX: NYSE)**. In the normal course of company reassessment we began to get less comfortable with our decision to purchase Estee Lauder. Competition seemed to be getting even more intense and while Estee Lauder may be able to defend its market share it would likely come at the cost of reduced profitability due to increased spending on advertising and marketing. With the upside in the shares compressed from our original target we thought it better to allocate the Estee Lauder capital into other higher return possibilities. The takeaway though is that we didn't ignore new, conflicting information because of some formerly conceived notions or because we just wanted to continue believing in our original thesis. If we conclude we were wrong, or that fundamentals have changed, correct the



mistake and move on. In this case, the position proved to be marginally profitable but we would have acted similarly if we were in a loss position.

“What a long strange trip it’s been,” was running through our heads as we decided to extricate ourselves from our position in Merck. Though, to be fair, we should probably insert the word “unprofitable” somewhere in the Grateful Dead’s memorable lyric. Why sell now? We were loath to sell as the stock bottomed in the mid \$20s late last year, but after an approximately 30% move from there the upside seemed somewhat limited as it trades at a valuation towards the high end of its large pharma peers, even with the legal overhang from Vioxx and pending patent expirations.

We also trimmed back our exposure to **E*Trade (ET: NYSE)** and **McDonald’s (MCD: NYSE)**. While we still see further upside for both of these companies’ shares, we decided to take some money off the table to be able to provide some purchasing power for current or future ideas.

Quotes

"The excitement and enthusiasm surrounding commodities, and the belief that they will continue to rise, is not surprising. People want to buy today what they should have bought 5 or 6 years ago; call it the 5 year psychological cycle.

"Today people want commodities, emerging market, non US assets, and small and mid-cap stocks. Those were all cheap 5 years ago and had you bought them then you would be sitting on enormous gains. But 5 or 6 years ago, everyone wanted tech and internet and telecom stocks, and venture capital and US mega caps. The time to buy them was in 1994 or 1995, when they were cheap. But in 1994 or 1995, people wanted banks and small and mid-caps, which should have been bought in 1990, and well, you get the picture." — Bill Miller, Legg Mason Value Trust letter to shareholders, April 24, 2006

"We look for three things [in our managers]: intelligence, energy, and integrity. If they don't have the latter, then you should hope they don't have the first two either. If someone doesn't have integrity, then you want them to be dumb and lazy." — Warren Buffett

"Chris Davis [of Davis Advisors] has a temple of shame for mistakes. [A wall in his office on which he hangs stock certificates of the worst stocks he's ever bought.] But that is inadequate. You need a temple of shame squared, to include great things you almost bought and would have, had you been a little more rational. You'll be a lot better investor if you remember boners of both kinds. Reality doesn't distinguish – either way, in 10 years, you're poorer." — Charlie Munger

"Choosing individual stocks without any idea what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot." — Joel Greenblatt, from *The Little Book that Beats the Market*



Ted Rupp

312-334-7317
trupp@kig-llc.com

Mark Rosland

312-334-7322
mrosland@kig-llc.com

Patrick Wiese

312-334-7305
pwiese@kig-llc.com

Jason Petite

312-334-7311
jpetitte@kig-llc.com

Steve Hengst

312-334-7337
shengst@kig-llc.com

Vy Tieu

312-334-7344
vtieu@kig-llc.com

Chris Czachor

312-334-7313
cczachor@kig-llc.com

Joel Hirsh

312-334-7307
jhirsh@kig-llc.com

Kovitz Investment Group, LLC

222 West Adams Street, Suite 2160

Chicago, IL 60606

Phone: 312-334-7300

Fax: 312-334-7308

Email: Info@Kig-llc.com