

Investment Commentary

Summer 2007
Volume IV, Issue 4



In this issue...

Market and Performance Summary ...	1
Performance - Since Inception.....	2
Imagine.....	3
Large Caps Revisited	3
Economic Moats or “How to Protect the Family Jewels”	3
Portfolio Activity	5
Kovitz Investment Group in the News.....	6
Quotes	7

This newsletter has been prepared by Kovitz Investment Group, LLC® (KIG), an investment adviser registered under the Investment Advisers Act of 1940 and is a quarterly newsletter for our clients and other interested persons. Within this newsletter, we express opinions about direction of the market, investment sectors and other trends. The opinions should not be considered predictions of future results. Discussion in this newsletter relating to a particular company is not intended to represent, and should not be interpreted to imply, a past or current specific recommendation to purchase or sell a security, and the companies discussed do not include all the purchases and sales by KIG for clients during the quarter. A list of specific recommendations made by KIG over the past year can be made available upon request. The information contained in this newsletter, which is based on outside sources, is believed to be reliable, but is not guaranteed and not necessarily complete.

Past performance does not guarantee future returns.

Market and Performance Summary

The total return of the equity portion of the accounts managed by KIG was 8.9% (net of fees) for the second quarter of 2007. This compares favorably with the 6.3% return for the S&P 500. For the first six months of the year, the KIG composite has increased by 8.2% (again, net of fees) while the S&P has increased by 7.0%.

The strong quarterly showing in both absolute and relative terms was partly attributable to strong performances by companies impacted by “going-private” transactions, both announced and rumored. In the announced (but not closed) category both **SLM Corp. (SLM)** (“Sallie Mae”) and **CDW Corp. (CDWC)** were up approximately 40% for the quarter as buyouts by private equity consortiums were announced for substantial premiums to preannouncement market prices. Various rumors of a prospective buyout helped push up shares of carpet maker **Mohawk (MHK)** 23% for the quarter. While potentially receptive to a transaction, we would be content for Mohawk to remain a public entity and continue to grow its value intrinsically, something management has been doing quietly for some time now. **Steak n Shake (SNS)** (a new holding detailed below) was up about 11% from our mid-quarter purchase as SEC filings revealed that an investor group acquired a nearly 10% stake (pun intended) in the burger chain. Also performing well in the quarter were **Joy Global (JOYG)** and **Apollo Group (APOL)**, whose shares rose 36% and 33%, respectively, on more “mundane” fundamental news of strong quarterly results.

Significant performance detractors for the quarter included **Bed Bath & Beyond (BBBY)** which announced its first earnings warning in the company’s history and promptly saw its shares fall about 10%. Our response, naturally, was to buy more and then some more. A short-term view on this purveyor of housewares would certainly be cause for concern as the slowdown in housing has taken, and probably will continue to take, its toll on near-term earnings results. However, viewed by the optics we prefer, a telescope as opposed to a magnifying glass, we see a company distinguished from its competitors by its breadth of product offering and superior financial returns. We also see a company possessing a terrific balance sheet with an enormous amount of cash on hand, no corresponding debt and ample square footage growth pos-

Continued on page two

sibilities. When the stock price will reflect these attributes is of course unclear. **US Bancorp (USB)** (down 5%) and **Procter & Gamble (PG)** (down 3%) were the only other holdings down any significant amount and this on no real fundamental news.

As we always say, we have no idea what the stock market will do over the next several quarters (at least we get an A for consistency). There is a reasonable chance, however, that volatility will continue as the market reacts to the fear/euphoria du jour. This does not mean that we should withdraw to the sidelines and wait it out for “normal” time – financial markets will always be subject to these uncertainties. The only certainty is that no one possesses special insight, sustainable for the long run, as to when these uncertainties will arise or retreat. Therefore, trying to time when to be “in” and when to be “out” is a fool’s game at best. However, it does mean that common sense and investing discipline are more important than ever. We can’t eliminate risk, but we can identify, analyze and price it, giving us a better sense about when to take risk and knowing how much of it to take.

We still think it’s generally a fully-priced world. The interesting thing about today’s market compared to historical markets is that it’s not offering many valuation anomalies in which we can confidently invest with a really high expected rate of return. There are very narrow valuation spreads across industries and across the companies within specific industries. That said, we feel very good about the businesses we own and their prospects for growth in value over the next few years.

Performance – Since Inception

We provide the introductory paragraph on quarterly and year-to-date performance results in an effort to provide timely information and complete transparency for our clients. However, as far as relevance as an insight to our process (and future success), it’s a fairly lousy indicator. There’s far too much noise in financial markets to place any meaningful value on short-term performance. Luck, both good and bad, can have significant impact on these results. Performance over longer time spans is thus a much preferable benchmark to gauge the skill of an investment manager. We offer this:

- Since inception (January 1, 1997), a period now encompassing 10½ years, \$10,000 invested in equities with KIG grew

to approximately \$42,800 while a similar amount invested in the S&P 500 Index with dividends reinvested grew to approximately \$24,000.

- Converting to annual average terms, the KIG composite has appreciated 14.9% per year after all expenses compared to a gain of 8.7% per annum for the S&P before any expenses.

We have achieved this record and will strive to maintain it by ignoring short-term market fluctuations and focusing on one thing: company fundamentals. As it has been, our investment philosophy is to make commitments of capital in a fairly limited number of understandable companies that have superior long-term economics, strong finances and reasonably good management, and that sell at what we believe are attractive prices.

Our investment process can be summed up in three primary steps. First, analyze the business to discern if the company possesses a moat. The best businesses have a competitive advantage or economic moat (more on this important topic later) that enable them to create wealth over time for shareholders. Second, value the business. We view stocks as ownership stakes in businesses and therefore need to know what they are worth (the intrinsic value) to determine how that value compares to the one being placed on it by the market (the stock price). Third, and possibly most important, wait for a margin of safety. We will only buy those stocks trading at significant discounts to our intrinsic value estimate. Encompassing each of these steps is a mandate to think independently. Not following the crowd, but instead rationally analyzing each opportunity based only on logic and hard evidence, has been more than a small advantage for us.

Expanding on point two above, we try to make a clear distinction between business value, what we refer to as intrinsic value, and market value of a business’s common equity. We define intrinsic value as the discounted value of the cash that can be taken out of a business during its remaining life. While proponents of the efficient market theory would undoubtedly disagree, we believe market value to be an unreliable indicator of intrinsic value as market value can be subject to psychological quirks, momentum, and other vagaries. We would admit, however, that anyone calculating intrinsic value necessarily

comes up with a subjective figure that will depend on cash flow and discount rate estimates. Despite this fuzziness, however, intrinsic value is the only logical way to evaluate the relative attractiveness of various businesses. More importantly, the only way we know of to be confident that we're not overpaying is to have a well-grounded sense of what the underlying business is worth.

Imagine

...with apologies to John Lennon

*Imagine there's no market/ It may be tough to comprehend
No Dow Jones Industrials to guide us/ No discernible trend
Imagine all investors living without quotes...*

*Imagine no quarterly numbers/ Is it that hard to do?
Nothing for management to spin/ And nothing to trade
on too*

Imagine all investors relying on fundamentals...

*You may say it's not realistic/ But this desire will not wane
We hope someday you'll join us/ And the investing world will
be more sane*

*Imagine a world of patience/ We're sure it may be tough
No need for charts or estimates/ Sound thinking will
be enough
Imagine all investors relying on logic and common sense...*

*You may say we're dreamers / But we refuse to be undone
We hope someday you'll join us / And all investors can live
as one*

To be continued...

Large Caps Revisited

Avid readers of these newsletters (yes, both of you) know that we're not style boxers and as such don't argue that invest-

ment strategy should include broad asset classes just for the sake of exposure to various segments of the market. Rather, we've argued (some might say ad nauseam) that investment decisions should be made solely on a company by company basis, regardless of the size of the company or its categorization (growth vs. value). However, many of our current portfolio companies happen to be large capitalization stocks and we see value in this sector. We're especially bullish on holdings of ours that previously were considered large cap growth companies such as **Home Depot (HD)**, **Wal*Mart (WMT)**, **Johnson & Johnson (JNJ)**, Procter & Gamble and **American International Group (AIG)**. To be clear, the current emphasis on such companies did not arise from a decision to focus on this specific segment of the market but is rather the result of our typical bottom up, company by company approach; these just happened to fall out. In our view, no other part of the market offers as convincing an argument for a low risk, high reward investment proposition. We first wrote about this last fall ("Big is Beautiful") believing that these stocks exhibit very narrow quality spreads meaning that some of the best run companies appear to be trading at little to no premium, and in some cases at a discount, to the average public company. Buying average companies for well below average prices is one way to extract value from the market. We've always favored higher quality businesses and today it appears that you may be able to extract similar value by buying quality businesses for the price of an average one, essentially getting a quality premium for free.

The passage of time has only served to reinforce our optimistic stance. The spread has narrowed to the point where the implied growth in earnings is well below what can be reasonably expected. Timing, as usual, remains uncertain. With the private equity boom showing signs of strain, it's possible that investors may begin to turn an eye toward these high quality behemoths. But if not, we've got as much patience as private equity funds have cash.

Economic Moats or "How to Protect the Family Jewels"

"In business, I look for economic castles protected by unbreachable moats."

While the preceding quote was from the 1995 Berkshire Hathaway Annual Report, in actuality Warren Buffett has been

preaching the virtues of economic moats and competitive advantages for decades. In his mind, the possession of a moat is the single most important criterion for a successful investment. Ours too. But while we have given lip service to the moat concept over the years we've never really spelled it out in detail and made clear its importance to our investment process. We aim to rectify that transgression.

One of the basic tenets of modern economics is that, over time, competition will erode the profits of all industry players. We know that if Company A is producing excess profits, competitors (Companies B, C and maybe even D) will soon take note and attempt to enter the industry and do the same. As capital flows into the industry, the new competition will shrink Company A's profits unless it has advantages over its competitors.

An economic moat refers to a business's ability to maintain competitive advantages over its competitors in order to protect its market share and long-term profits. The wider the moat, the larger and more sustainable the competitive advantage. We credit *Investopedia* for conjuring up the perfect imagery with their definition: "Just like a typical medieval castle, the moat serves to protect those inside the fortress (and their riches) from outsiders (potential competitors). Without a wide economic moat, there is little to prevent competitors from stealing market share (and thus profits)."

So why is this so important for investment purposes? If a company with a wide moat possesses characteristics that act as barriers to entry for would-be competitors and less competition generally supports a company's ability to sustain higher pricing, then a moat allows a company to generate returns on capital above the cost of capital – possibly for many years. This potential window into the future is a great advantage for an investor. It means that cash flows are more predictable and less volatile which makes the valuation process somewhat more trustworthy and less capricious.

Potentially the textbook example of a sustainable competitive advantage can be seen in the case of Wal*Mart. Wal*Mart's historic rise to its status as the world's largest retailer from very modest beginnings was largely a result of its aggressive cost-controls and subsequent low-price advantage over competing retail outlets. Once Wal*Mart grew to be a mega company, it

enjoyed further cost advantages afforded by its buying power and distribution network. Retailers who have attempted to go head-to-head with Wal*Mart on a price basis have not fared well. Furthermore, competition cannot easily recreate the brand recognition, economies of scale or the logistical, technical and informational capabilities of its distribution network and inventory management systems. For these reasons Wal*Mart has a wide economic moat.

The following, while not exhaustive, are five of the most common types of attributes which can lead to economic moats:

1. As exemplified by Wal*Mart's prolonged success, a *cost advantage* which competitors cannot replicate can be a very effective economic moat. Companies with significant cost advantages can undercut the prices of any competitor who attempts to move into their industry, either forcing the competitor to leave the industry or at least slow or stop their growth, or make the effort less profitable. Companies with sustainable cost advantages can maintain a very large market share of their industry by squeezing out any new competitors who try to move in.
2. Being big can sometimes in itself lead to an economic moat. At a certain size a firm achieves *economies of scale* (when an increase in output leads to a decrease in the long run average cost of each unit) which reduces per unit overhead costs in areas such as financing, advertising, production, etc. For this reason, large companies which compete in a given industry tend to dominate the core market share of that industry, while smaller players are forced to either leave the industry or occupy smaller "niche" roles. **Nokia (NOK)** exhibits its large economies of scale by spreading production costs over an increasing volume of cell phone handsets.
3. Related to economies of scale is when a company is able to establish itself in an industry to the point where suppliers and customers can be subject to *high switching costs* should they choose to do business with a new competitor. Because of the one-time expenses or inconveniences a buyer incurs to change over from one product or service to another, competitors have a very difficult time taking market share away from the industry leader. One example of such a switching cost would be changing your cable or satellite provider.

Whether it's Comcast (CMSCA) or DirecTV (DTV) providing your service, once you have that company's system in place, the switching costs can be a big deterrent to changing providers.

4. Another type of economic moat can be created by a firm's so-called *intangible assets* which include items such as patents, brand recognition and government licenses. Strong brand name recognition, enjoyed by companies like **Coca-Cola (KO)**, Gillette (owned by Procter & Gamble), and Nike (NKE), allows these types of companies to charge a premium for their products over competitor's goods thus boosting their profits.

5. The *network effect* occurs when the value of a particular good or service increases for both new and existing users as more people use that good or service. eBay (EBAY) is the quintessential example here. As the website with the most sellers, it had the widest selection of products. This attracted the most buyers which in turn attracted more sellers – kind of an infinite loop which feeds on itself. **Microsoft's (MSFT)** operating system business is also a good example of this type of advantage.

Buffett sums it up in the December 1999 issue of *Fortune Magazine*: "The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors." No matter how complex investors (or their wannabe advisors) want to make it, it all comes back to one thing: company-specific fundamentals.

In the next quarterly commentary, we will detail our portfolio companies which we believe have the widest and deepest moats.

Portfolio Activity

We had an unusually active quarter. Market volatility continued and we embraced it. As long as we are prepared, bouts of volatility are needed for success as they afford us the opportunity to buy and sell advantageously. Our preparation enabled us to add four new positions to our portfolios while increasing

stakes in three current holdings. To make room we eliminated three positions and trimmed a number of others. Of the positions sold or trimmed, in each case it was primarily to make room for ideas we liked better. Our goal as analysts is to find those companies with the most attractive risk-reward characteristics. As portfolio managers our goal is to continually challenge each allocation of (your) capital to find its best use. Sometimes that means swapping what we consider a good investment into the prospect of an even better one.

We are pleased to report that we made a number of new investments in high quality businesses this quarter. Even better, we think we paid prices that afford meaningful upside with limited downside.

Steak n Shake falls into our favorite category of under-priced securities – one where not a lot needs to go right for us to realize our upside, but where things just need to stop going wrong. Declining same-store sales over the past seven quarters has soured sentiment so badly that expectations for any turnaround are largely unreflected in the stock price. We like that management is not reacting hastily to appease Wall Street. They have decided the best course is to take a step back and invest the time and money necessary to improve the future health of the franchise. Recently, they have simultaneously slowed down new store openings while closing under-performing units. Management is also focusing on service, menu offerings and store remodeling to drive traffic back into the restaurants. Only when they are satisfied with the results will they put Steak n Shake back on a growth trajectory. Given the brand loyalty currently engendered and its niche product profile, we are optimistic that there is value to be realized.

While more may have to go right for **Robert Half (RHI)** to realize our estimate of upside, we believe the odds of that happening are tilted in our favor. While the company disappointed investors with its first quarterly earnings miss in years, looking at the business over a longer stretch there is little not to like about this high quality enterprise that specializes in financial staffing services. Robert Half enjoys a wide moat built around its brand recognition in its niche area of expertise ("Are you going to call Bob from Accountemps?"). It operates with a lean cost structure and does not require large amounts of capital investment, giving it the opportunity to generate

returns well above its cost of capital. Management also has the “unpulled lever” of excess cash on its balance sheet waiting to be deployed.

The buyout of Sallie Mae had a deleterious impact on the share price of **First Marblehead Corp (FMD)** as two of its largest customers, Bank of America (BAC) and JP Morgan Chase (JPM), are minority investors in the proposed deal. The perceived fear on Wall Street is that these two large customers will turn to Sallie Mae for services they now receive from First Marblehead. Sensing opportunity, but only after a full-blown analysis, we stepped in and purchased shares of this provider of outsourcing services for private education lending. Our assessment, not surprisingly, is that the market is too focused on short-term concerns. FMD as a whole helps banks underwrite and securitize (bundle into securities to be bought by investors) student loans. While Wall Street looked at the company’s near-term income statement impact while determining its downside, it should have looked at FMD as two distinct companies. The first is a mature business servicing its two largest customers, Bank of America and JP Morgan Chase. The second is a rapidly growing company servicing numerous regional banks. From our vantage point, the upside lies in the second and the potential for a pleasant surprise in the first. When looking at FMD’s business to regional banks, we see a business whose scale and proprietary database provide high barriers to entry, pricing power, and low financial risk. Coupled with dramatic growth currently underway in the nascent private student loan market, FMD seems poised for a future of high earnings growth and higher returns. Furthermore, our estimate of intrinsic value ascribes no value to the earnings currently derived from the “Big Two” – an assumption that could prove conservative as there are a number of reasons for FMD to maintain at least some (possibly more) of this business.

We often say the best investment ideas are obvious decisions. We feel our purchase of **American Eagle Outfitters (AEO)** was one such decision. We believe American Eagle is an exceptionally well run specialty apparel retailer that, while susceptible to short-term earnings pressure, should over the long run sustain returns well in excess of its cost of capital. Trading at a depressed valuation on near term consumer spending concerns, the Eagle seems priced for little, if any, downside.

In addition to Bed Bath & Beyond, we increased our position sizes in **E*Trade (ETFC)** and **Bank of New York Mellon (BK)** (as of July 1, The Bank of New York finalized its merger with Mellon Bank).

We realized substantial gains on the disposal of **Accenture (ACN)** and **WellPoint (WLP)** and sold our shares of **Sprint Nextel (S)** for about what we paid. Based on what we saw after living with Sprint for about a year we decided that its competitive position (its moat) was shrinking vis á vis its stronger competitors, Verizon Wireless and AT&T Wireless (Cingular). While downside from current prices still seems limited, the upside is a little less well defined to us. As such, we used proceeds from the sale to put in the names mentioned above. Similar reasoning provided the impetus to sell or trim holdings of **Dow Chemical (DOW)**, **Pfizer (PFE)**, **Citigroup (C)**, and **Dell (DELL)**. We also used the strength in the stock prices of Sallie Mae and CDW on the takeover news to pare back our positions. While we see nothing that should derail these deals from closing, prudent portfolio management provided motivation to take some money off the table at slight discounts to the announced takeover prices. We also trimmed our exposure to Nokia, **Walt Disney (DIS)** and **McDonalds (MCD)**, as continued strong fundamentals pushed each stock to highs not seen in years.

Kovitz Investment Group in the News

As most of you surely know, the vast majority of our new clients come from referrals from you – our existing clients. And for that we remain appreciative. We’ve also been fortunate to receive some positive press recently. Specifically, Dave Roeder of The Chicago Sun-Times was very complimentary of us in an article on Sunday, May 13, 2007 (the article is available on our website www.kovitzinvestment.com, click on “KIG in the News”). Mitch was also featured in Crains Chicago Business in April and was interviewed on Bloomberg TV in early July.




Quotes

“Your eyes believe what they see. Your ears believe others.”

- Paul Orfalea, founder, Kinko's Inc.

“Within the population of stock and bond investors, the percentage of people who could change their minds tomorrow is at an all-time high.”

- Warren Buffett, 2007 Berkshire Hathaway annual shareholders meeting

As always, we thank you for entrusting us with your assets and welcome your questions and comments.



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

Mitchell Kovitz, CFA, CPA

312-334-7301

mkovitz@kig-llc.com

Marc Brenner, JD, CPA

312-334-7302

mbrenner@kig-llc.com

Skip Gianopulos, JD, LL.M., CFP®

312-334-7303

sgianopulos@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

Mary Anderson, MBA

312-334-7355

manderson@kig-llc.com

Andrea Cohen, CFP®

312-334-7312

acohen@kig-llc.com

John Conway

312-334-7343

jconway@kig-llc.com

Ed Edens, MBA

312-334-7333

eedens@kig-llc.com

Kenneth W. Fink, CFA, MBA

312-334-7330

kfink@kig-llc.com

Mark Rosland

312-334-7322

mrosland@kig-llc.com

Ted Rupp

312-334-7317

trupp@kig-llc.com

Rich Salerno

312-334-7304

rsalerno@kig-llc.com

Jenny Simmons, CPA

312-334-7316

jsimmons@kig-llc.com

Patrick Wiese

312-334-7305

pwiese@kig-llc.com