

Investment Commentary

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Move and contact information for KIG

KIG is taking the next step in the transition to our new investment advisory firm - getting our own office space. On February 14, we will move to our new location at 222 West Adams (also known as the USG/AT&T Building) in downtown Chicago. We have included with this letter our new contact information. If you're in the neighborhood, please feel free to stop in and check out our new home.

We appreciate your support and loyalty and the confidence you have shown by entrusting us with your capital. We look forward to continuing our relationship for many years to come.

Our new mailing address is 222 West Adams Street, Suite 2160, Chicago, IL 60606.

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This newsletter has been prepared by Kovitz Investment Group, LLC, an investment adviser registered under the Investment Advisers Act of 1940. This Investment Commentary is a quarterly newsletter for our clients and other interested persons. Within this newsletter, we express opinions about the direction of the market, investment sectors and other trends. The opinions should not be considered predictions of future results or recommendations to clients of specific securities for purchase or sale. 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

We ended the year with a quarter of solid compounding. The equity portion of the accounts managed by KIG was up by 12.5%, on average, in the fourth quarter of 2003. For the full year, our equities returned 28.1%. (Results for the quarter and year are measured on an internal rate of return (IRR) basis, net of costs and an assumed 1.25% annual management fee.) For the quarter and year, the S&P 500 was up by 12.2% and 28.7%, respectively.

Normally, you won't see us excited by just matching the return of the overall market. But 2003 was not a normal year. Touched off by worries over the prospective war in Iraq and its impact on corporate profits and deflation fears, the market slumped in the early part of the year. We can recall at that time a general sense of pessimism that stocks, as an asset class, would never again provide returns comparable to their historical averages. (Why this should be the case we often wondered. Did someone repeal the laws of economics?) As we have long witnessed, investors have an uncanny ability to extrapolate recent trends into the foreseeable future. But fear (second only to greed), in particular to matters of money, has a way of warping the perceptions of otherwise rational individuals.

As we moved into Spring, however, these fears largely subsided as substantial monetary and fiscal stimulus kicked into gear. These two forces acted as a kind of economic adrenaline, reflatting the financial system, driving corporate profits higher and pulling stock prices up with them. But the stocks which led the charge in '03 were largely lower quality issues, with heavy debt burdens and uncertain prospects. It seemed that the more sensible the investment idea the more it underperformed. This is exactly why we're not too

unhappy with our recent performance and why we believe that our portfolios are well positioned for whatever lies ahead. We were able to keep pace with minimal exposure to the most speculative industries. This means we achieved market-like returns without taking market-like risk, which is exactly what we strive for- high risk adjusted returns. In other words, we believe that our investment philosophy and portfolio management process provides the best way, over long time periods, to maximize profit potential for a given level of (acceptably low) risk.

Why do we feel good about the future? We believe that these recently strong performing sectors have been fueled, not by fundamentals, but sheer momentum, and it's unlikely to be sustainable. A correction (i.e., a return to more realistic valuations- think of a rubber band stretched to its limit and then suddenly released) could very well be around the corner. We're just not exposed to that scenario and rather like it that way. More importantly, we feel that in such an event fundamentally sound businesses will find favor with investors.

All this should *not* imply that we're focusing on our one-year performance. Our competitive advantage rests in being able to compound wealth over longer periods of time. December '03 saw the return of the Dow Jones Industrial Average to 10000. While heralded as a seminal event, viewed from our perspective it should have been small consolation. After all, the Dow first crossed 10000 in April '99. That's very little progress in over 4 ½ years. Was the recovery from the low in October 2002 such a relief that the lack of progress over the longer term just ignored? To be exact, from April 1, 1999 through December 31, 2003, the Dow

increased by 16.8% (including dividends), or 3.3% on an average annual basis. The S&P 500 fared even worse, losing 7.4% (negative 1.6% per year) over that time period. In comparison, KIG clients have fared much better. *The equity portion of our accounts increased by over 55%, or 9.7% per year, on average, over this period.*

We believe that our continual focus on the downside risk evident in each security we analyze is the most important factor in achieving these results. Purchasing businesses for less than 70% of underlying value minimizes long-term risk while providing substantial profit potential. There is such a strong conviction in our process that all of our portfolio managers and, in fact, most of our employees, have significant personal investments in the same names that we own in your portfolios. When we say we manage your money as if it were our own, we mean it.

“A year ago, the risk was relatively low, and the potential reward substantial. Today, the risks are high and the rewards limited.”

Marc Faber, Managing director, Marc Faber Ltd



What's next? Don't ask us...

We are frequently asked about our thoughts on the market. Recently, the questions center on whether this bull market is a cyclical affair that will run out of steam sometime this year, or whether it's a longer lasting secular state that will continue to push up the averages. To be honest, even though our whole day is consumed by investments, we really have no idea. We certainly have some thoughts on the subject (it would be impossible not to), but we try as hard as possible not to let those thoughts cloud our thinking in any way and not to let them influence our purchase/sell decisions.

For the record, however, our *gut* tells us that, in the short term, the market will trend higher. It seems all too silly, but investors like stocks more once they've gotten more expensive. Our *head*, however, is telling us to be wary. The conditions in the general market seem to have a great deal of similarity with those that existed at the height of the bubble. In order to cope with this dichotomy, all we can do is stick to our discipline of ignoring the overall trends of the market and attempt to identify those businesses meeting our stringent qualitative and quantitative criteria, the most important being that our assessment of business value is significantly higher than where its stock trades in the open market, and to sell those stocks where the price to value ratio is no longer firmly in our favor.

“How many efficient market theorists does it take to change a light bulb? None. The market will take care of it.”

Martin Whitman, Third Avenue Management



Whether or not a bubble is brewing, it is comforting to have equity investments in well-financed, well-managed companies which we believe are selling at substantial discounts to the market and our estimate of private market value. We believe this combination of factors provides reasonable odds that we can generate attractive investment returns over the next few years, the time frame on which we are always focused.

Dividends schmividends

One of the more significant changes to the tax law in 2003 reduced the taxes paid on most dividends from the taxpayer's highest marginal rate (as high as 35%) to a maximum 15%. While this doesn't eliminate completely double taxation (earnings are already taxed once at the corporate level), it certainly is a step in the right direction. From an investor's standpoint, the change makes dividends a more palatable way to receive the benefit of company cash profits. As far as companies are concerned, the change in taxation makes the dividend payment a more viable method for returning cash to shareholders. We believe, however, that this has skewed investor perceptions as to the importance of the dividend, in particular, as the mere presence of a dividend, or an announcement of an increase in the payout, is now viewed as an important investment criterion.

Let's take a step back. A company that generates excess cash has three choices as to what it can do with it: reinvest in the business by expanding productive assets, reduce liabilities, or make distributions to shareholders. Let's leave the first two choices aside for

now (covered in prior newsletters). Distributions can take two forms—dividend payments or share buybacks. While the effect of dividends is much easier to measure (the cash is right there for you to see) and some may derive satisfaction from seeing the quarterly dividend checks hit their account statement, we prefer that our companies, which are typically in stable or growing industries, utilize their excess cash by buying back shares (assuming, of course, that its valuation is reasonable). The change in the tax code has not altered our view; on a long-term basis, we believe share buybacks enhance stockholder value more so than paying a dividend.

As money managers, our goal is the creation of wealth, not the creation of income (i.e. dividends). Income brings current tax liabilities, which deplete resources (dollars) that could otherwise be compounding at favorable rates. Therefore, creating wealth in the most tax-advantaged manner means striving for realized and unrealized appreciation. To be sure, a tax liability is created on sale (currently at the same 15% rate for long-term capital gains), but you will be better off paying once at disposition than each and every year along the way (you lose the compounding effect).

Conceptually, the thing we like most about share buybacks is that it shrinks the capital base of the company and increases the ownership percentages for remaining shareholders. If we are positive on a company, then owning a larger piece of the pie can only be a good thing.

We believe dividends are gaining prominence for another reason: most investors don't really understand what they own, so as a hedge, they'd like to get some dollars placed in their pockets today. We just don't fall in that camp. We are intimately aware of what we own and why we own it. Because of this level of surety on the business (sometimes misguided, most of the time

not), we can forgo current payments in order to earn bigger dollars in the form of capital appreciation down the road.

This is not to say we ignore dividends in our analysis. It's just that we seek to maximize *total* returns rather than to maximize income from dividends and interest. In other words, we manage for a total return (dividends plus capital appreciation) and don't care how we get there. A company paying a 5% dividend with 5% earnings growth has total return potential of 10% (assuming a constant price to earnings multiple). A company paying no dividend but growing its earnings by 12% should yield a total return of 12% and would therefore be a more attractive investment opportunity to us.

Certainly, dividends can be an attractive (maybe necessary) enhancement to income for those needing current liquidity from their portfolios. But for those whose goal is long term growth, and own companies that can compound capital at high rates, buybacks are more apt to create larger values over the long run.

“Some of the speculative momentum tactics that again are evident... are reminiscent of the silly years, for sure. But things can go on that way for quite a while before reaching the point of maximum, untenable silliness.”



Michael Santoli, Barron's columnist

Recent portfolio activity

The downside to a rising market is that it is difficult to find good ideas for capital commitment. During the quarter, we established three positions and eliminated two. This relative inactivity (1 net new position) does not bother us. While we will always prefer to own equities in the long-term, we are patient in the short-run as we look for qualifying investments.

Sometimes doing nothing (or close to nothing in this case) is the best course for generating superior long-term investment results. On this, we take a cue (by way of Warren Buffet) from the late Ted Williams, arguably Baseball's best hitter and the last man to bat over .400 for an entire season. Undoubtedly, one must have natural ability to hit (or invest), but Williams said the most important aspect to being a good hitter is to wait for the pitch in the sweet spot. In his book, *The Science of Hitting*, he wrote, “My first rule of hitting was to get a good ball to hit. I learned down to percentage points where those good balls were.” Williams broke down the strike zone into many sections and knew, based on his own strengths and weaknesses, where he would have the most, or least, success in making good contact. Williams' discerning eye told him whether a pitch was in his “happy zone” where he could hit .400 or better, or the low outside corner where the most he could hope to bat was .230.

We have a pretty good idea of our “happy zone” when it comes to evaluating businesses and, like Williams, are content to wait for the fat pitches that we are certain will one day come our way. The temporary lower yield obtained from staying liquid in the short term will more than be offset by above-average longer term performance. We will not be driven by pressures to have a better number for some short term arbitrary period (i.e. quarter end of 12/31). Besides, there are no called third strikes in investing.



As you know, we are not theme investors, but our three new purchases do share a similar trait. Each could be classified as having a near term outlook that is mixed, but a long term outlook that is promising. “Buy when the fear is palpable!” has always been one of our investment battle cries. We look for mispriced securities, targeting companies that have fallen out of favor despite having strong fundamentals and where prices don’t necessarily reflect the particular company’s actual earnings strength. Anything that disrupts investors’ ability to objectively look at the business for even short periods of time- a temporary cloud- is ideal for creating profitable investment opportunities. An understanding that stock prices are just way more volatile than the underlying fundamentals of the business has been more than a small advantage for us.

We initiated a position in **Anthem, Inc. (ATH)**, a managed care provider serving almost 12 million members in nine states. Anthem markets its products and services using the exclusive Blue Cross Blue Shield (BCBS) names that are practically synonymous with health care. Over the past several years, Anthem has been a consolidator of BCBS plans. This has been an attractive business model as Anthem has been able to lift the profit margins of the less efficient BCBS providers by rationalizing costs and implementing sophisticated information and management systems. Anthem’s shares fell hard (about 15%), however, when it announced its intention to merge with WellPoint Health Networks (WLP), the California BCBS franchise, for more than \$16 billion in stock and cash. The decline in the stock price was largely based on concerns of the merger being dilutive to its ’04 earnings outlook. In our view, which apparently is 180 degrees from that of Wall Street’s, near-term earnings dilution is, by definition, a short term

issue and one on which we typically don’t focus our attention. (By the way, based on our calculations assuming very conservative cost savings opportunities and few other synergies, the deal shaves approximately a nickel off of ’04 earnings.) When the acquisition closes by the middle of this year it will forge the country’s largest managed health care provider with 26 million members. Scale is an extremely important factor in the health care industry, and we believe the outlook for the combined entity is robust, regardless of what happens to earnings in the near-term. To us it represented a growth company selling at a value price. While we didn’t anticipate a quick rise in the stock price (we never do, as discussed below), Anthem shares have appreciated 20% since our initial purchase, as investors have, in our opinion, refocused their attention on the fundamentals of the business.

We finally got (and took) our opportunity to establish a position in **Brinker International, Inc. (EAT)** as the stock fell 20% in one day on fears over its December quarter’s earnings prospects falling short of analysts’ estimates. But as anyone who observes and evaluates businesses can attest, the natural ebbs and flows of business cycles just does not fit neatly into the quarterly earnings ritual to which Wall Street blindly adheres. Brinker, a restaurant operator primarily known for its flagship Chili’s Grill & Bar, has a total of 1,400 company-operated and franchised restaurants located in 49 states. (Those of you in Chicago will also be familiar with Brinker’s two newest portfolio additions to hopefully be rolled out on a national scale, Maggiano’s and Corner Bakery, both purchased from Rich Melman’s Lettuce Entertain You Enterprises.) We believe Brinker to be a quality restaurant company run by a veteran

management team, with decent growth potential primarily due to its solid core brands and promising new concepts.

Coupling these strong fundamentals with a valuation that didn't seem to take them into account, we felt the risk-reward trade-off was firmly tilted in our favor, making Brinker a natural purchase for us. How could one not want to own a quality company at a discounted price? But here's how many on Wall Street viewed Brinker's earnings miss (from an excerpt of a leading Wall Street analyst's report). *"The shares are cheap, especially given that same-store sales are reasonably good... But whether they are cheap is not really the question today. The question is, when will the shares start to move up?"* Excuse me? The shares are cheap but that's not really the question. To us, that is the only question. Whether or not the shares may begin to appreciate for a couple of quarters is not of any significance to us whatsoever. If we believe there exists a wide gap between our valuation and current price then it must be purchased, plain and simple. We don't expect our stocks to appreciate the minute we put them in the portfolio. Patience is a virtue we have in abundance (but the real thanks goes to you, our partners, for allowing us to exercise it) and, historically, our best investment returns have come from situations where we waited, and waited, until the market's perception came around to our view. If there's some disappointment or confusion, most investors are not so willing to be patient. The "I need my returns to come immediately" mentality is what has given us and will continue to give us a huge edge. If it truly is cheap, we can wait. (By the way, since our purchase at the end of October, EAT is up over 20%.

Wonder if the Wall Street analyst's clients are thanking him for keeping them out of a cheap stock?)

Abercrombie & Fitch Co. (ANF) was our third portfolio addition last quarter. Sales trends have been weak for some time, most likely reflecting a weaker economy and a more competitive landscape. We were attracted to this retailer, however, because of its brand equity in the casual apparel market, a bullet-proof balance sheet with no debt and almost \$400 million in cash, and what we believe to be a rock-bottom valuation. We don't believe Abercrombie's earnings power has been diminished to the degree that is implied by the current valuation, and our expectations for the company's cash flow growth remain intact. ANF's two newer store concepts, abercrombie and Hollister, are being well received and should provide a modicum of growth opportunities with minimal cannibalization to the core brand. With what we view as limited downside to current levels, we can be patient to see if sales trends reverse as the economy continues its recovery and ANF reasserts its relevance as a core lifestyle brand for young men and women.

We sold our stakes in **Comcast Corporation (CMCSK)** and **Tommy Hilfiger (TOM)** based on our valuation discipline after each appreciated to a level where we no longer felt the upside potential outweighed the downside risks. We had a satisfactory return on each, with Comcast and Tommy's shares appreciating approximately, 39% and 54%, respectively, from our average cost basis. ■

About KIG

Kovitz Investment Group, LLC is comprised of five portfolio manager/analysts, two bond specialists, two financial advisers, and two associates. The portfolio managers/analysts possess vast and diverse educational and professional backgrounds. As a group they hold advanced degrees in Business Administration (MBA), Taxation, Law (Juris Doctorate), and Public Policy (MPP). Also, as a group they hold five professional designations—three Chartered Financial Analysts (CFA) and two Certified Public Accountants (CPA). 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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