Investment Commentary

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Kovitz Investment Group

Mitchell A. Kovitz, CFA, CPA
mkovitz@kovitzinvestment.com
312.334.7301

Jonathan A. Shapiro, CFA, MBA
jshapiro@kovitzinvestment.com
312.334.7324

Marc S. Brenner, JD, CPA
mbrenner@kovitzinvestment.com
312.334.7302

Bruce A. Weininger, CFP, CPA
bweininger@kovitzinvestment.com
312.334.7334

Robert C. Piton, CFA
rpiton@kovitzinvestment.com
312.334.7321

Richard Salerno
rsalerno@kovitzinvestment.com
312.334.7304

John Conway
jconway@kovitzinvestment.com
312.334.7343

Mark Rosland
mrosland@kovitzinvestment.com
312.334.7322

Christopher Recker
crecker@kovitzinvestment.com
312.334.7307

Ted Rupp
trupp@kovitzinvestment.com
312.334.7317

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Market and performance summary

During the fourth quarter of 2004, the financial storm clouds of the third quarter parted. The market, which seems to demonstrate no memory from day to day, let alone quarter to quarter, appeared to put behind its fears of the election, terrorism, Iraq, rising oil prices, a falling dollar and potentially higher interest rates, and ended the year on a powerful note that turned a ho-hum year into something a little more exhilarating.

The S&P 500 rose by 9.2% in the fourth quarter to finish the year with a gain of 10.9%, including reinvested dividends, about equal to its long-term average annual return. Also, for the year the Dow Jones Industrials and the NASDAQ were up 3.5% and 9.1%, respectively. Not to be outdone, the equity portion of the accounts managed by KIG, in aggregate, increased in value by 11.1% in the quarter, bringing the gain for the full year to 18.7% (net of fees and transaction costs).

While we are certainly happy with both the absolute and relative performance for the year, you may be surprised to hear that 2004 actually left something of a bad taste in our mouths. We look back over the year and see many instances where we could have made better decisions. Of course, with the benefit of hindsight, any investor could make these observations. But we want to look backward with the intent to improve going forward. Albert Einstein is credited with saying, "…success comes from curiosity, concentration, perseverance and <u>self-criticism</u>." We want to understand better the steps that led to a sub par decision in order to make sure we learn something from it.

For self-criticism to be its most effective, Einstein stressed the need to embrace the concept of destroying your own best-loved ideas. Indeed, most of the successful investors that we follow seem to leave their minds open to change. Whether it was Warren Buffett shifting his focus away from the strict quantitative measures of Benjamin Graham towards more qualitative characteristics, such as the business quality and sustainable competitive advantages, or Bill Miller of Legg Mason who used his value principles to evaluate internet-type companies, they had to do away with or modify their own long-held beliefs. We believe fervently that with the basic building blocks of our investment philosophy set, making incremental enhancements to our process through self-critical analysis and "blowing up" our best-held beliefs will produce huge strides.

Long-term focus

Now even though a calendar year seems nice and precise, it is still a rather arbitrary (and short) time period in which to judge the returns and the skill of an investment manager. It is necessary to look over much longer periods of time to appropriately gauge investment skill. There is a great deal of noise in short-run returns and luck can play a significant part as well. Another reason why we believe you need to focus on longer term results is self-serving—we fully expect there to be a period of time where we will underperform. This may be over a calendar quarter, a year or even slightly longer. We consider these to be relatively short time periods and would not be concerned if that in fact happened. We are singularly focused on generating and accumulating wealth for our clients over a relationship lasting many years in order to help our clients meet their financial goals. It is only over these longer periods of time where the compounding effect of performance returns is all-powerful, and even slight outperformance on an annualized basis provides large differences in future portfolio values.

Consider our track record over the last eight years (1/1/97 – 12/31/04), a period encompassing a time of significant market volatility. KIG equity portfolios have increased 220% over that time period. On an annualized basis this equates to a growth rate of 15.6% (net of fees and costs). For the same time period, the S&P 500 has increased 85% (8% annualized). This means that, at these performance returns, $100,000 invested in the S&P 500 would have become $185,000, while a similar amount invested with KIG at the beginning of this period would have grown to $320,000, an amount 73% higher.

We believe our performance is the direct result of our investment discipline, which we apply confidently and consistently, regardless of short-term market events. Most importantly, decisions are not made with the hopes of goosing returns over the next quarter or two, but to provide rates of return that when compounded over several years or more, substantially beat your other equity investment alternatives. Being true long-term investors we can shut our eyes to short-term fluctuations and have comfort that what (we have identified as good, but undervalued, businesses) goes down will come back up. Keeping this perspective when others don't (or can't) represents opportunity rather than risk.

Sectors, stocks or businesses?

In year-end reviews, many market commentators, instead of using the hackneyed adage about being a stock-picker's market, have pegged 2004 as a sector-picker's market. With energy, materials, industrials and real estate posting hefty gains, the assumption is that it would be nearly impossible to outperform the market in 2004 without significant representation in one or more of these sectors. Other than a small position in a cement company (**Lafarge North America (NYSE: LAF)**), which we exited halfway through the year, we had no holdings in any of these "hot" sectors. Additionally, what should have served as an additional handicap was that we had an overweighting in one of the worst performing sectors of '04- health care (up 3.2% based on the Dow Jones Industry Group data). This overweighting, however, actually proved to be a boon as our health care holdings increased approximately 20% (on an equal weighted basis) and outperformed the rest of our portfolio.

We have always taken issue with the notion that it is necessary to play the market trends in order to achieve superior results. While we may miss out on some upside in the short-term that others capture, it has not impaired our ability to make money in less conventional ways. Besides, we have always been fretful about running with the crowd for fear of being trampled. Our performance this year only serves to reinforce our notion that investing is not best played as a group sport. But while our decisions may be at odds with the conventional wisdom of the market, they will always be consistent with our longer term goal of achieving the highest possible returns while attempting to minimize the permanent loss of capital.

And while market commentators can debate whether sectors or stocks are more important, our vote will always be that the business itself and the price at which it is selling are what matters most.

For the year

Our out-performance for the year was largely driven by the fact that relatively few of our positions were underwater. This is as it should be when our decisions are sound. We will never bat one thousand, however. Excluding holdings purchased in the fourth quarter (too recent to focus on), only five (out of roughly 30) of our holdings posted negative results for the year, with only three falling by over 10%. On the other hand, of the 25 or so positive gainers, 17 were up more than 20%. Far and away, our largest gainer was **Abercrombie & Fitch (NYSE: ANF)**, which soared over 90%

as investors became more comfortable that weak sales trends were beginning to reverse. **WellPoint (NYSE: WLP)** (nee Anthem) increased over 50% for the year as the company consummated a significant merger that appeared to be in jeopardy earlier in the year. Rising pork prices lifted shares of **Smithfield Foods (NYSE: SFD)** over 40%, while our two lab (medical testing) companies, **Laboratory Corp (NYSE: LH)** and **Quest Diagnostics (NYSE: DGX)** were up 35% and 32%, respectively, basically on no real significant news (perhaps it was just the fact that the naysayers had it wrong and the fundamentals were strong). Investors must have finally convinced themselves that the turnaround at **McDonalds (NYSE: MCD)** that began in early 2003 was not an illusion, causing the shares to rise over 30%. Mickey D's was the best performer of the Dow 30.

As for the laggards in 2004, leading the list was **Marsh & McLennan (NYSE: MMC)**, which fell over 35% late in the year as New York Attorney General, Elliot Spitzer, accused the insurance brokerage firm of manipulating market prices, conflicts of interest, and bid rigging. While not necessarily a death knell for the company, in our mind the allegations called into question the ethics of a management team that could foster that type of culture, and we subsequently sold our entire position. Though it has recovered over 20% from its lows, **Merck (NYSE: MRK)** was still down 28% for the year with its well-documented issues stemming from its voluntary removal from the market of its arthritis and pain medication Vioxx (please see our Fall 2004 newsletter for our thoughts on this matter and why we continue to hold it). The recently completed holiday season proved to be somewhat unkind to children's educational toy maker **LeapFrog Enterprises (NYSE: LF)** resulting in a 17% decline for year.

While these types of losses are never enjoyable, keeping them to a minimum, on a relative basis to the winners, is the key. Managing risk includes managing position size. Significant unforeseeable negative headlines (whether resulting from fraud, criminal behavior, or just unexpected events) are inevitable. Limiting the impact of those negative surprises on our portfolios' long term growth is our responsibility.

Top 10

To keep you up to date on the companies that will most likely impact your portfolio as we move into 2005, we've included below our top 10 holdings as of December 31, 2004. This is based on the KIG composite portfolio, an aggregation of all our fully discretionary fee-generating equity portfolios with a minimum of $100,000 in equity investments. Keep in mind that, due to available cash, account size, timing of when the account was opened and the like, this list may not comport to your portfolio exactly.

Company	**Ticker**	**%**
WellPoint	WLP	6.7%
Home Depot	HD	5.9%
Motorola	MOT	5.1%
McDonalds	MCD	4.8%
Alliance Capital	AC	4.4%
Berkshire Hathaway	BRKA/BRKB	4.2%
US Bancorp	USB	3.5%
Abercrombie & Fitch	ANF	3.4%
Walt Disney	DIS	3.2%
Medco Health Solutions	MHS	3.1%

Importantly, having 44% of the portfolio in our top 10 ideas goes a long way in explaining our historical returns.

You have to take meaningful positions in your best ideas in order to outperform over time. We see no advantage to having our 100th or even our 50th, best idea at some insignificant percentage of a portfolio, where it will have little impact on the performance of the overall portfolio. In our opinion, over-diversification will only lead to mediocre results.

Bold predictions

Oh, I'm sorry, were you expecting this section to be about our predictions on the year to come? Hardly. And here's why. We recently took the opportunity to review a year's worth of *Barron's* articles, focusing particularly on the beginning of the year roundtable—the annual forum of Wall Street's best and brightest. These pundits ventured their predictions on everything from overall economic growth and stock market returns to the price of oil and the direction of interest rates and the dollar. The results of their macro predictions were startlingly poor; actually worse than startlingly poor. Their individual stock picks didn't seem to fare much better.

In another example of predictions gone awry, economists who prognosticate on the monthly employment report, something Wall Street seems to pay an inordinate amount of attention to, also appear to be less than stellar in their predictions. Over the past year, reports Lehman Brothers, the forecast for the monthly change in nonfarm payrolls has missed the reported change by an average of 110,000. This is no small miss considering the average monthly change over that time period was less than 200,000.

Why are we mentioning this?—to point out that we believe that most investors spend far too much time making, or relying on others to make, predictions about unpredictable events. We just don't think this is necessary to be a successful investor. We believe that investing is about probabilities, not predictions (more on this later), business fundamentals, not hype, and rational decision making, not specious conclusions. In our opinion, not only does this approach produce a more reliable stream of investment returns, it is also so much darn easier. As Yogi Berra said (or is said to have said), "It's tough to make predictions, especially when it involves the future."

The value premium

(Much of the following discussion is attributed to the work done by Doukas, Kim and Pantzalis and their paper titled, "Divergent Opinions and the Performance of Value Stocks")

Although perhaps not universally accepted, strong evidence exists that so-called value stocks have produced higher historical returns than that of so-called growth (or glamour) stocks. For instance, the Ibbotson's Annual Yearbook, which tracks investment returns of numerous indices, indicates that from 1927 through 2004 growth stocks have returned 9% per year whereas value stocks produced an annual return of 12.5%. While this is a bigger advantage than even we would have imagined, and even if you assume that other similar data would show smaller annual differences, most likely a positive spread of value over growth would be revealed. Why a "value premium" exists, however, remains a puzzle to economists who focus their study on asset pricing. It's also of great interest in the debate between those who advocate rational asset pricing (efficient market theorists) and proponents of behavioral finance.

Devotees of the rational school point to the seminal study by Eugene Fama and Kenneth French (1993) in which they argue that the value premium is compensation for bearing risk. They argue that value stocks are fundamentally riskier than growth stocks and therefore the higher average returns reflect compensation for that risk. (We have discussed our feelings on this topic at length over the years. In a nutshell, we refuse to believe that as a general matter an asset (i.e. stock) whose price has gotten cheaper or whose valuation is low implies higher risk. Assuming the company does not go to zero (i.e. bankruptcy, which by the way we have yet to get caught in) by definition, its downside is more limited.)

On the other hand, adherents of the behavioral model, encouraged primarily by a study by Lakonishok, Shleifer and Vishny (1994), claim that value stocks produce superior returns because investors consistently overestimate the future earnings of growth stocks. As for value stocks, investors do the opposite; anchoring their expectations of future growth in earnings to past bad earnings they become excessively pessimistic. That is investors make systematic errors in predicting future growth in earnings of growth (value) stocks and their optimism (pessimism) about the future is the cause of the superior performance of value relative to growth. (Now you're talking. As Warren Buffett said, "It's not that we like pessimism, it's that we like the prices it produces.")

This makes intuitive sense to us. Most human beings would rather feel optimistic than pessimistic. Who wants to be considered a pessimist or be around others who are? Optimism is a much easier emotion to embrace. Likewise, pessimism is easier to avoid. But when it comes to investing, we would argue that this represents suboptimal behavior. We've seen countless examples where investors attempt to discern long-run trends and their outcomes from the flow of (recent) short-run developments. They gravitate to the stocks which have done well recently and shun those that have performed poorly. By overweighting recent evidence you tend to lose sight of the long term.

One thing that we learned early on in our investing careers, but of which we still have to constantly remind ourselves, is that its important to start with the premise that there is something wrong with every investment. The trick is to figure out what is right and compare that to the negatives. Even we would have to admit that markets are efficient enough to think that we would be able to get high quality assets at a discount without the trade-off of the near term outlook not being great. We just assume that if we want to buy a stock at a discount, things can't be all rosy.

In a more recent study, Doukas, Kim and Pantzalis (2002) think there may be a different mechanism at work that explains the value premium. They suggest that disagreement among investors about future payoffs could be such a mechanism. In other words, stocks exposed to greater disagreement represent a source of risk for which investors need to be compensated.

It stands to reason that if future payoffs are in doubt then the primary source of disagreement must center on future earnings. The authors theorize that the dispersion of analysts' earnings estimates can serve as a proxy as to the degree of disagreement (the wider the dispersion, the more divergent opinions are). They then demonstrate that value stocks historically have had wider dispersions in analysts' estimates than growth stocks and therefore value stocks are exposed to greater disagreement than growth stocks. The return advantage in value strategies then must be a reward for the greater disagreement.

Simply stated, risk is exposure to a proposition of which one is uncertain. Investors, who tend to exhibit disdain towards uncertainty, will demand high rates of return in order to invest, which leads to the value premium.

While certainly interesting (to us, anyway), we will leave the debate to academicians. All we know is that being contrarian and focusing on value has worked for us so far.

Recent market activity

As we sit here today, the buy side continues to cause consternation as we are having a hard time trying to find any bargains. But while you might see little in the way of buy tickets coming your way, understand that it does not mean that we are doing less work on the research side; it's that we are passing on more ideas, choosing instead to wait until prices come in line with our value criteria before making a commitment. It's not that we're betting, or even fearful of, a market decline, it's that at current prices, most stocks in our "universe" do not offer much in the way of margin of safety (for a complete discussion on "margin of safety", see our newsletters from Fall 2004, Winter 2003, Fall 2002, etc., etc, etc.). While our long time clients have seen these cycles over and over, we appreciate that our newer clients may be wondering what we are doing all day. But we know that if we are patient and disciplined good things will come to us. As Charlie Munger, Vice Chairman of **Berkshire Hathaway (NYSE: BRK)**, is want to say, "Things show up."

Because our measure of the market is how easy it is for us to find new ideas, unless there are some unexpected pleasant surprises in store, the odds seem to be in favor of more modest returns than what we have experienced the last couple of years. In fact, we could be witnessing a time period where all the major asset classes- stocks, bonds and real estate- are broadly overpriced. This is rare in financial markets as typically strength in one area is offset by weakness in others. But we are trained to not act for actions sake and will commit capital only in situations where we feel the reward outweighs the risk. We know that investing can, at times, be a watching paint dry-type game.

With that said, we managed to have a relatively active quarter adding four new names, increasing position sizes in two current holdings and selling out three others.

During the quarter, we initiated a position in **Pfizer (NYSE: PFE)**. Many may question the wisdom of the timing of such a move, given the controversy surrounding one of its largest drugs, Celebrex. You may be asking, "After the horrific experience we just encountered with Merck, why would you wade into a potentially similar incident with Pfizer?" Admittedly, we haven't had tremendous success with all of our forays into large pharma to date. However, our experience tells us that money is made by taking a stand no one else wants to take, not by running with the crowd.

So how did we go about thinking about this investment? We were certainly not blind to the risks, we knew them intimately (the supposition that something is wrong with every investment is especially apropos). The two primary risks in the Pfizer story are the safety issues surrounding Celebrex and the number of drugs coming off patent over the next few years. But most of our thinking regarding investments focuses on determining business values. Part of the process involves assessing the probability distribution of stock return payoffs by assigning probabilities to various potential outcomes. We don't pretend to know the fate of Celebrex (we don't make predictions), but we can determine cash flows and intrinsic values based on certain events and place probabilities on the likelihood each event occurs. In the case of Pfizer, some of the scenarios we considered were, 1) Celebrex remains on the market, at slightly reduced revenues, 2) Celebrex remains on market at drastically reduced revenues, 3) Celebrex is pulled from the market and resulting legal liabilities are low, and 4) Celebrex is pulled, and legal liabilities are high. Based on the probabilities assigned and the resulting payoff distribution, we felt that at the current market price, the downside was relatively limited. Said slightly differently, we believed that the market was already pricing in a Celebrex recall and we felt we were being adequately compensated for the risk regarding the potential range of liability and the pipeline.

But it's never a static process. We will continue to gather and process all relevant information, and our opinion could change.

Other new, and less controversial, positions we took were in **Barnes & Noble (NYSE: BKS)**, **Gap (NYSE: GPS)** and **Clear Channel Communications (NYSE: CCU)**. Barnes & Noble (books) and Gap (apparel) are two specialty retailers that we believe are extremely well managed, have dominant franchises that are competitively entrenched, produce prodigious amounts of free cash flow and appeared to be selling at discounts to our estimates of private market value.

Clear Channel is a diversified media company with three primary business segments: radio broadcasting (owns approximately 1,200 domestic radio stations), outdoor advertising (owns or operates almost 800,000 billboards- domestically and internationally), and live entertainment (promotes, produces and operates live entertainment venues here and abroad). A combination of stagnating advertising revenues and fears over the competitive encroachment of satellite radio, conspired to bring Clear Channel's valuation to levels we deemed attractive when compared to the amount of cash flow the company generates. As important, management has proven itself to be wise allocators of the company's excess cash flow, swearing off further acquisitions, buying in stock and increasing the dividend payout.

During the quarter, we also increased our positions in both **Motorola (NYSE: MOT)** and **Nokia (NYSE: NOK)**, the two dominant players in the wireless communications field. We believe that the valuations of both companies continue to be reasonable and felt an increase to our exposure was prudent.

As mentioned above, we sold our stake in Marsh & McLennan as well as **Payless Shoesource (NYSE: PSS)** and **Kraft Foods (NYSE: KFT)**. Regarding the latter two, based on competitive pressures we felt compelled to lower our growth assumptions and/or increase our cap rates which resulted in fair values that were very close to current market prices. ■

“Making forecasts about future market levels is much more in the realm of abnormal psychology than finance.”
Marty Whitman, founder, Third Avenue Funds

“We are not prisoners of an inevitable future. Uncertainty makes us free.”
Peter L. Bernstein, economist and author

“Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.”
Sir John Templeton

About KIG

Kovitz Investment Group, LLC is comprised of a diverse group of investment professionals who combine experience in asset management with a thorough understanding of financial markets. The KIG team consists of portfolio managers, equity analysts, bond specialists, and financial advisers. The portfolio managers/analysts possess vast and varied educational and professional backgrounds. As a group they hold advanced degrees in Business Administration (MBA), Taxation, Law (Juris doctorate) and Public Policy (MPP), and professional designations, including Chartered Financial Analyst (CFA), Certified Public Accountant (CPA), and Certified Financial Planner (CFP). Each portfolio manager is responsible for equity research, strategy and implementation.

KIG's approach to investing in equities is based on the methodology pioneered by Benjamin Graham, and as further developed and modified by Warren Buffett and Charlie Munger of Berkshire Hathaway. We consider investments in common stocks as units of ownership in a business. We don't, therefore, regard ourselves as just traders of stocks, but rather as part-owners of a tangible business. Our primary interest lies in acquiring and holding securities of exceptional businesses at suitable prices. As such, we seek to allocate investment capital on the basis of justifiable premises, valid logic and hard evidence, not popularity or emotion.

While we strive to maximize return, we believe that the primary and overriding investment criterion should be safety of principal with a focus on minimizing permanent loss of capital. Our approach is focused on maximizing long-term net worth and not necessarily on generating short-term performance.

Kovitz Investment Group
222 West Adams Street
Suite 2160
Chicago, IL 60606