

Investment Commentary

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Marc S. Brenner, JD, CPA
mbrenner@kig-llc.com
312.334.7302

Mitchell A. Kovitz, CFA, CPA
mkovitz@kig-llc.com
312.334.7301

Jonathan A. Shapiro, CFA, MBA
jshapiro@kig-llc.com
312.334.7324

Bruce A. Weininger, CFP, CPA
bweininger@kig-llc.com
312.334.7334

Skip Gianopulos, JD, LLM, CFP
sgianopulos@kig-llc.com
312.334.7303

Richard Salerno
rsalerno@kig-llc.com
312.334.7304

John Conway
jconway@kig-llc.com
312.334.7343

Edward Edens
eedens@kig-llc.com
312.334.7333

Mark Rosland
mrosland@kig-llc.com
312.334.7322

Ted Rupp
trupp@kig-llc.com
312.334.7317

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Q & A with Kovitz Investment Group

We think it's important every once in a while to take a critical look in the mirror. So we recently sat down with ourselves (we enjoyed the meeting) to discuss issues ranging from our recent performance to long range plans for our business, as well as investing in general. We tried to think about if our positions were reversed, what kinds of questions we would want answered. We'd like to share that discussion with you.

Q. How did your clients' portfolios perform in the quarter just ended (12/31/05)?

KIG. The equity portion of the accounts managed by KIG was up 4.2% in the quarter. This is after all fees.

Q. How did that compare to your benchmark, the S&P 500?

KIG. The S&P, including reinvested dividends, was up 2.1% for the quarter.

Q. How about for the year and versus the S&P 500?

KIG. For the full year 2005 we were up 9.3%, while the S&P was up 4.9%. Our goal, over long periods of time, is to best the S&P by 3-5% per year, but it's rare that in any one year we perform right in that range, which we did this year.

Q. What drove the out-performance?

KIG. While we take a great deal of pride in our historical out-performance, we are especially proud of what we accomplished this year because we did it without any exposure to the hottest sectors of the market like energy, utilities, and natural resources.

Most managers who underweighted these areas had lousy years, so we felt fortunate to have performed as we did. Enthusiasm notwithstanding, we never like to participate in areas where we don't see convincing and sustainable value. Gains in fashionable sectors usually can be traced to self-fulfilling prophecy and not necessarily to basic fundamental value. Historically, when these things break, and they will break, the struggle to be first out the door can lead to violent downdrafts.

But while our decisions are usually 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 losses. The goal is simply to make solid decisions on the basis of justifiable premises, valid logic and hard evidence and not market sentiment, popularity or emotion. And while market commentators can debate about what the next hot sector may be, we will continue to focus on the business itself and the price at which it is selling. These are the two factors we know for certain are going to determine sustainable future value, not the sector a company is or isn't in.

Q. OK, so what drove the out-performance?

KIG. Right, we were getting to that. Not only did we not have the tail-winds from exposure to hot sectors, but we also had the apparent head-winds of significant exposure to some out-of-favor sectors, like financial and consumer stocks. Given this, we guess you'd have to chalk up the year to good old fashion stock picking. We had a significant number of holdings that were up more than 25%. More importantly though, our losers did not hurt us too badly, with none falling more than 16%.

Some of the significant winners for 2005 included, E*Trade (NYSE: ET) (+87%), Abercrombie & Fitch (NYSE: ANF) (+40%), WellPoint (NYSE: WLP) (+39%), Assurant (NYSE: AIZ) (+38%), Medco Health (NYSE: MHS) (+34%),

Barnes & Noble (NYSE: BKS) (+33%), Motorola (NYSE: MOT) (+32%), Accenture (NYSE: ACN) (+29%), and Fossil (NASDAQ: FOSL) (+26%). Some of these weren't even in the portfolio all year as they were purchased during 2005.

The top losers included, Gap (NYSE: GPS) (-16%), Gannett (NYSE: GCI) (-16%), Abbott Labs (NYSE: ABT) (-13%), Walt Disney (NYSE: DIS) (-13%), and Pfizer (NYSE: PFE) (-11%).

Q. How do you define your investment style?

KIG. Before we answer what we are, it may be helpful to first define what we are not. We are not market strategists and certainly not market timers. We don't profess to know what the market is going to do next week, next quarter, or even next year. We don't focus on generating short-term performance, but rather on maximizing our clients' long-term net worth. We don't try to hit home runs with each new idea- consistently pounding out singles and doubles will serve fine. And we are definitely not closet indexers or style box proponents.

Q. So how do you attempt to earn excess returns for your clients?

KIG. By buying good companies at cheap prices and having 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. Everybody wants to get rich quickly, almost assuring that they won't.

It comes down to how you measure what's good and what's cheap. We've found the best way is to think of, and analyze, stocks as businesses. Simply put, a stock represents an ownership interest in an actual business, with an underlying value that does not depend on and is not necessarily represented by its share price. Conceptually, this frames the decision process to be more about underlying value than current market sentiment.

Possessing this business-owner mentality is a trait that we have found is shared by all the best investors we have studied.

Most importantly, in our mind anyway, is that our decisions are never 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 other equity investment alternatives.

Q. Has it been successful?

KIG. We think so. We have an audited track record that now spans nine years. Over that time period, our average annual return has been 14.9% compared to the S&P 500's annual return of 7.6%. On a cumulative basis, the comparable numbers are KIG +249% vs. the S&P +94%. This means that a million dollar investment nine years ago with us would have grown to \$3.49 million while a comparable investment in an S&P 500 index fund would be worth \$1.94 million. Nothing exhibits the power of compounding returns more than the difference between these two ending figures.

Q. How do you think you were able to achieve those results?

KIG. Probably the biggest factor is that we have what we believe to be a sound intellectual framework for making decisions and, this is the most important part, the ability to keep emotions from corroding that framework. The market is really just a pendulum that forever swings between unsustainable optimism, which makes stocks too expensive, and unjustified pessimism, which makes them too cheap. So we just try to keep a level head and sell to optimists and buy from pessimists. Honestly though, we find it's never really as good or as bad as what the conventional wisdom depicts. Just look at 1999 (really good) and 2002 (really bad) as recent examples.

As we said before, we want to invest our clients' capital, and ours too of course, in companies we believe are trading at substantial discounts to what we consider their true business worth. But it's dangerous to try to predict how long it will take the market to correct the valuation gap we think exists. Of course we'd like it to happen overnight but we know that this is not generally how these things work. That's why patience and emotional detachment, as much as any other qualities we know, are prime determinants to generating excess returns over the long-term. We believe that not getting sidetracked by issues or events that don't truly relate to business value is more than a small advantage for us.

We take our cue on this from Warren Buffett, who wrote in the 1994 Berkshire Hathaway shareholder letter, "We try to price, rather than time, purchases. In our view it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?"

Our process for constructing portfolios, admittedly conservative, focuses squarely on minimizing risk in each investment decision, primarily by making sure we invest in quality businesses we can understand and that sell at reasonable prices. This is the Benjamin Graham "margin of safety" principal we have discussed so much over the years. We apply this investment discipline confidently and consistently, regardless of short-term market events. While it may seem counterintuitive to associate conservatism with out-performance, our historical results, as well as those of the most successful investors throughout time, suggest otherwise.

Buying undervalued securities often means you're making decisions that go against the conventional market wisdom. A particular stock, or even entire industries, may be undervalued because of a lack of interest or because of unjustified popular prejudice.

As long as we see value, we believe neither of these issues should preclude us from action. We have confidence in our abilities to see through to the fundamentals while ignoring the fact that everyone else will think we're goofy.

Q. So you buy companies with problems?

KIG. We just don't prescribe to the Wall Street maxim that stocks should be bought because they have gone up and sold because they have gone down. This may be pretty simple-minded, but by our calculations stocks should provide higher returns when they are purchased at lower prices, and correspondingly, they should provide lower returns when they are purchased at higher prices.

Again, it was Buffett who said something like "it's not that we like pessimism, it's that we like the prices it produces." This has been a powerful (and profitable) concept for us to grasp. Short-term issues will soon fade and the basic value propositions will eventually shine through. Just don't ask us when. "When" may be important for individual securities, but it isn't for portfolios; and we build and manage portfolios.

But to even be considered for purchase, a company must be in an industry that we believe has good economics and possess some type of sustainable competitive advantage, exhibited by stable margins and high returns on invested capital. The business must also generate a relatively high free cash flow yield and have a management team that will invest this cash flow in ways to improve shareholder value.

One thing that we learned early on in our investing careers, but of which we still have to constantly remind ourselves, is that it's important to start with the premise that there is something wrong with every potential investment. Now, there also must be plenty of pluses; after all, something attracted us to the investment in the first place.

The trick is to weigh the positives against the negatives, giving particular emphasis to those negatives that may be temporary or even illusory. We know that if we want to buy a stock at a discount, things can't be all rosy. Even we would have to admit that markets are efficient enough that we wouldn't be able to get high quality assets at a discount without the trade-off of the near term outlook not being great. But if we are correct in our assessment of the business, then the price will eventually take care of itself.

Q. What is the right price to pay for an investment?

KIG. There's no single answer to this question as each situation has a different fact pattern, and we really don't want to bore you with the details of our mathematical models. (After all, you've read this far and we'd like you to continue.) But suffice it to say, the primary factor is that the expected return must justify the risk accepted. In other words, the stock must be trading at a significant discount to what we believe is its intrinsic value. This provides for our projected upside, while creating a sufficient cushion on the downside.

Constantly reminding ourselves to relate what is being paid to what is being offered is an invaluable trait in the investment business. Ben Graham used to implore investors to buy your stocks as you buy groceries, not as you buy perfume. Speculators may base their standards of value upon the market price. But as investors, we judge the market price by established standards of value.

We have somewhat modified the popular investment style called "Growth at a Reasonable Price", or GARP, to fit the parameters of how we define value. Our style can more aptly be labeled PARG, or "Price at a Reasonable Growth". We just think that GARP doesn't really force you to instill a lot of discipline in the investment process, as an investor can give himself or herself a fair amount of leeway in determining what a reasonable price is.

Under PARG, however, the price we're willing to pay is pretty much set because we define it as a percentage of intrinsic value. We can play around with the growth rates, certainly, but we just make sure whatever assumptions we use, we're comfortable that they are conservative.

Q. You seem to stress that discipline is a key theme in your investment process- can you elaborate?

KIG. You should want to buy something when it's cheaper and constrain the impulse to buy after it's rallied and prices are higher. Both of those acts take an extreme amount of discipline because it's the opposite of what most people tend to do. It sounds simple to want to buy something after it's gotten cheaper- after all it's what you do at department store sales. But with stocks, people view it differently. We don't know why, most just seem to think that if something has gone up it will probably continue to do so. Similarly, if it's fallen in price, it probably will continue to fall further. We call this the "extrapolation effect", which seems to be a hard-wired tendency in most human brains.

Prices should only inform investors not influence them. And we know in our hearts that the best time to invest is when things you love are going lower. It's just not a natural act so you need to develop the discipline to do it. *We refuse to let other people's moods and lack of discipline govern our destiny.*

Q. As you screen for investment ideas, do you focus on earnings growth?

KIG. We have a tendency to focus less on the income statement and more on the cash flow statement and, of course, the balance sheet. Earnings growth can lead you astray as it did to many investors during the technology bubble.

In a sense companies can make earnings growth whatever they want, but if they are not at least covering their cost of capital, earnings growth is essentially meaningless. Shareholder value increases only if a company earns a rate of return on its new investments that is greater than the cost of capital used to fund those investments. Earnings, however, can increase not only when a company is investing at a rate above its cost of capital but also when it's investing at a rate that is below its cost of capital. Here's a simple thought experiment to take this point further:

Assume that you know of an unlimited source of capital that would be willing to invest its money to anyone that wants it to fund a new business or project. Further assume that the cost of this money, or the return that can be achieved in an alternative investment, is 10%. Now, let's say you can go out and reinvest the money borrowed at an 8% return. Here's the question. What is your earnings per share growth going to be for this venture? The answer is it's going to be *anything you want it to be*. All you have to do is keep going back for more money, reinvest it, and you will generate earnings growth at whatever rate you choose. And the kicker is, the more rapidly you grow earnings, the worse off you are, because you are investing below the required rate of return.

An understanding of this has led us to an important investment maxim: moderately growing companies that generate excess cash flow can be better investments than rapidly growing companies. It all comes down to return on capital and valuation.

In actuality, we see no end to the fascination with growth. But obvious prospects for physical growth in a business or industry do not translate into obvious profits for investors. History gives you many examples including the airline industry and more recently the internet. While both of these industries grew spectacularly, most of the benefits accrued to the consumer, through lower prices, rather than to the companies supplying the services and the investors who backed them.

Q. Do you focus on a specific sector of the market- large cap, small cap, growth, value?

KIG. We feel that in order to carry out our mandate to generate superior investment results we need to have the flexibility to put our clients' money in anything we think fulfills our criteria for undervaluation; what we call our "go anywhere as long as its cheap" philosophy. We think we understand what a good business looks and smells like so why should we be constrained by arbitrary factors such as company size or how someone else classifies a certain company as growth or value?

What we find interesting is that what sells cheaply year to year is always changing. For example, regarding company size, we looked at the median market cap of our composite portfolio over the period 2000 through 2005. What we found was that it has steadily increased- from a low of \$5 billion in 2001 to a current \$20 billion. The implication being that we liked a lot of mid cap stocks back then and a lot of large cap ones now. But the evolution wasn't preordained, it just kind of happened as a function of what looked attractive to us at the time. We now own 33% (10 of 30) of the companies in the Dow Jones Industrials. This is something that we would have thought unthinkable even just a few years ago as most large cap companies, like those in the Dow, were not priced at levels we would have considered to be undervalued. But one by one, they just kind of fell into our portfolios.

We also don't feel we have to be fully invested at all times for fear of falling behind our benchmark for a quarter or two. We can choose to buy stocks we feel are undervalued or not to buy them if they aren't. Our mandate is to grow our clients' long term wealth in a sensible and responsible manner and beat our benchmark over periods measured in years, not months or quarters.

Q. Does company management's guidance impact your thinking?

KIG. Generally, no. Realistically, how can it? Management, almost by definition, is not objective when it comes to their own company. We're not implying that they are dishonest, but just think about it- while we're sure they have confidence in their abilities to do great things for their companies, the incentives are such that how can they not want to hype their own stock? At the least, they know how to put a positive spin on things.

But think about it logically as well. There are very few managements who don't guide for future double digit earnings growth. In fact, it's considered a sin on Wall Street to project anything less. Now consider the historical record- the past 75 years or so, the realized earnings growth for the S&P 500 has been less than 2% above inflation. So you can't really put history on their side.

Obviously, there will be companies that can grow that quickly, but we don't think we're necessarily smart enough to know in advance which those might be. This is why we use very conservative assumptions in our value estimates and demand that most of the return we garner comes from the expansion of the price-to-earnings multiple and not only from earnings growth in itself.

We care a lot more about what management is doing, which is very well documented, than what they are saying. We can learn almost everything we need to know about management by looking at the numbers. Through experience, some painful, we have realized that face-to-face conversations are not necessary and can actually be counter-productive. We have yet to hear management warn of an existing problem that, if not resolved, would result in a dramatic drop in share price. But that's what we care about.

Q. How about Wall Street analysts?

KIG. Our view about analysts is very similar to that of management. Their incentive structure is just not aligned with ours. In the most basic sense, they are really just salespeople who want us to buy their product (with commission dollars). Some have detailed industry knowledge that can be helpful to us in a general sense, but as earnings predictors and stock pickers we believe they fall flat- just look at the historical record.

Q. Are you finding any value in the market today?

KIG. Certainly not on any large scale. The cupboard of new purchase opportunities remains largely bare. Since we are in the business of making investments, it's not a situation we are all that excited about. But overpaying for investments isn't a satisfactory answer to the problem.

We spend the majority of our time thinking about what companies are worth, looking at the economics of the business and determining what an intelligent private owner would pay to buy that business and hold it forever. On that basis, there just aren't that many attractive prospects.

If this process doesn't turn up any values then we will keep our "powder dry" for another day. Usually, we've found it's better to do nothing than to do something for the sake of doing something. The latter usually doesn't work out well. Ultimately, we don't get paid for activity; we get paid for being right. We can't create attractive opportunities, but what we can do is recognize them when the market presents them to us, and to be prepared to act upon them.

Q. Does that mean you didn't put any new ideas in your client accounts this quarter?

KIG. No, the cupboard wasn't completely empty. We established initial positions in 5 companies that met our valuation criteria. However, none of these were so persuasively cheap that caused us to act in a big way. In other words, we were content to take a small position now and would be prepared to make it more meaningful on further price weakness.

Media seems to be one area that we have been able to mine for some ideas. Talk about an unpopular segment right now. Media companies, primarily those involved in newspaper publishing, radio and broadcasting have had a tough time showing the type of growth that gets investors excited. Given what we discussed earlier regarding extrapolation tendencies, most investors have left this area for dead. Part of it is also the "Google Effect"; the fascination this company has garnered has made almost every other media company pale in comparison. And while the Googles of the world have certainly altered some of the dynamics of the industry, it would be foolish to believe that "old" media is rendering itself obsolete and unable to generate significant free cash flow. While the growth in cash flow has slowed, it has not turned negative, which the current valuation of many media companies imply. In fact, as "old" media adapts to a potentially new environment, it's probable that future capital expenditures may decrease, fueling growth in free cash flow (cash flow after capex). We will always trade off significant earnings growth for sustainable free cash flow if the valuation warrants it.

So during the quarter we increased our exposure to the newspaper sector by establishing a new position in **Tribune (NYSE: TRB)** and adding to our **Gannett (NYSE: GCI)** position. Just to be clear, we don't envision either of these companies returning to their historical growth rates, but they seem to be priced as no growth or declining growth companies.

If they can do better than that, and we believe they will, the upside is significant. We also added a position in **Time Warner (NYSE: TWX)**, the grand-daddy of all "old" media companies.

Another area that we continue to add to is what we call the fallen large cap growth names. Many good companies that had been priced at a premium just a few years ago now seem under-priced. Over the past several quarters, we have added names like **Wal*Mart (NYSE: WMT)**, **Procter & Gamble (NYSE: PG)**, **Citigroup (NYSE: C)**, and **American International Group (NYSE: AIG)**. We believe that these better than average businesses are selling at average prices and now incorporate a margin of safety that had been lacking before. **Coca Cola (NYSE: KO)** was a company we added this quarter that we think fits this description.

We also took new positions in **Royal Caribbean Cruises (NYSE: RCL)** and **Fossil**, a maker of casual watches. One thing Google can't offer, at least not yet, is a substitute for telling the time by looking at your wrist.

Q. Did you sell anything?

KIG. While there are a few holdings that have crept closer to completely closing the valuation gap, nothing quite got there this quarter. The fact that volatility has been relatively subdued has been a factor. We tend to sell, and buy, more things when volatility is high. We did exit our position in **IAC/InterActive (NASDAQ: IACI)**, but this had less to do with valuation and more to do with the fact that we could not get comfortable with some of the aspects of their accounting.

Q. What are your current favorite ideas?

KIG. Our top three ideas, in order, would probably be **Home Depot (NYSE: HD)**, **Disney** and **Gap**. And when we call some-

thing a “favorite” idea, we mean that, in our opinion, the risk/reward is extremely favorable or considerably tilted to the reward side.

The Home Depot situation is one we love- the stock price has stagnated while its earnings have continued to grow. The main concern seems to be that as the housing market cools HD’s results will cool as well. We have no disagreement with that view; it’s just that, in our opinion, the current valuation discounts much more than that. We think margin expansion in its core business due to continued efficiency gains is still only in the early phases. Also, the company has really made an effort to diversify into other areas outside of home improvement, such as professional supply and installation services. These areas are getting close to reaching critical mass and will likely stop being a drag on margins. The company has in place a platform for future growth that is being under-appreciated right now.

Disney is another company whose competitive advantages, we believe, are just not reflected in the current valuation. With the exception of the studio business, all of Disney’s segments have been performing well but the stock price has not kept pace. Most of the concern is centered on what a slowing economy will do to its theme park operations and of course there’s also some of the negative media sentiment overhang we discussed earlier. Again, this is why we price and not time our investment considerations. There’s an intrinsic value to the theme park business that is not as volatile as its short-term earnings prospects.

We also don’t feel Disney is as vulnerable to the havoc being wreaked in the media industry because of the quantity and quality of their content. Companies like Apple and Google do not create the content that they distribute- it needs to be created somewhere and creative content has been a hallmark of Disney since the company was founded.

We continue to like Gap- even more so at its current price

level- as we believe that the market embeds such low expectations and that the upside from getting the product right continues to be greater than the downside from continuing to get it wrong.

Gap has two of the most important attributes we look for- the capacity to generate substantial excess cash flow, and management that demonstrates an ability to deploy the cash wisely and in the shareholders’ best interest. Even with recent sales trends tracking below expectations, the company still generates impressive free cash flow which gives management a tremendous amount of financial flexibility to continue to pay down debt, which they’ve done, buy back stock, and increase dividend payments, both of which they’ve done and we believe will continue to do.

There’s a commonality among these ideas which is that the reason that they are trading at what we consider low valuation levels is because most investors’ time horizons are just too darn short. Short-termism can lead to certain inefficiencies in the pricing of assets. Therefore the most effective strategy is to find companies whose futures are being under-priced over a longer time frame.

Q. Why is it do you think that the focus on the short term has become so powerful?

KIG. The short answer is that most people are greedy and want success quickly. Today, the average holding period in professionally managed funds is less than a year. This is a really short time in which to own a company. Not much is likely to change fundamentally over a time period this short. But one thing that can change is the perception of how a company might do over the next quarter or two. So the shorter the holding period, the more the beliefs of others rather than long-term fundamentals become central to investment decisions. Also, the recent popularity of absolute return strategies may be causing some managers to make shorter-term bets than what makes ideal economic sense.

Whether purposefully or not, the financial media encourages the short-term focus. Imagine if CNBC had its Wall Street gurus come on its airwaves and say that stocks should do fine over the long haul, but frankly, we, and everyone else, have no idea what will happen in the next few weeks or months or even years. Now this is what they should say, but boy would that make for bad TV- and low ratings. Instead, they trot out those that profess to have a definite opinion on which way the market is going to move and what factors will make it so. The implication is then that investors should reshuffle their portfolios in response to these factors. Then they bring on someone else, who most likely has a conflicting view and the reshuffling starts anew.

Of course, excessive reshuffling might add value if investors were able to consistently shift money out of investments that were overpriced and due for a fall, and into undervalued assets with significant upside potential. Unfortunately, as we've pointed out already, most investors do the exact opposite.

As we all know, in the short-run, just about anything can happen in the stock market. In the very long-run, however, the laws of economics demand that stock prices reflect fundamental business value. If only investors could compel themselves to take a longer term view, it would cut down on most of this short-term nonsense.

Q. What is your outlook for the market in 2006?

KIG. If you've really been listening you would know that we wouldn't even pretend to know the answer to that. So, we'll take a pass, not only to remain true to our principles, but to spare ourselves the embarrassment of being wrong, because we know we will be.

Seriously though, we just don't feel we add any value by speculating what the market may or may not do over a short time period, and we define short as anything less

than 3 years. In our experience, it's best to just focus on each opportunity as it presents itself without regard to what we think may or may not happen in the near future. If we're right on the business, the stock price will eventually take care of itself regardless of short-term market pressures.

We will say that it's a very different environment today than what we're used to. There's been a tremendous tightening in the range of price-to-earnings ratios making stock picking an even more important determinant of future performance.

Q. Who have been your greatest investment influences?

KIG. It's obvious just by the sheer number of times we quote him that Warren Buffett has had an enormous amount of influence on our investment style. We also would give a lot of credit to his partner, Charlie Munger, whose insights into the folly of human behavior and the importance of building mental models adapted from diverse disciplines have had a profound impact as well. But most of Buffett's basic building blocks originated with his teacher Benjamin Graham. Graham's precepts were revolutionary and will likely never be improved upon. His idea of a margin of safety will never be obsolete. The idea of making the market your servant will never be obsolete. The idea of being objective and dispassionate will never be obsolete. Graham was really the first to bring all of these concepts together.

Q. Switching gears a little, KIG seems to have added quite a few new employees, why is KIG hiring so many new people?

KIG. Our recent growth in assets, customer interest and demand, and business opportunities required us to seek out quality professionals to help us achieve our goals and our clients' goals.

So the need was there and we have been very fortunate to have been able to attract very high quality additions to our KIG team. In some respects, we have followed the philosophy of hiring the “best athlete” if they are available. We believe that these new additions are among the best at what they do (analysis, client service, compliance), as borne out by their success, our prior personal experience with them, by what others think of them and their skill sets. And we are proud that they have chosen to leave the very successful positions they were at in order to join us and what we have built.

Q. How has your business grown in terms of assets? How much assets are you currently managing?

KIG. Although we will always consider our investment performance to be our most important measure of success, we have grown quite a bit over the last two years. We more than doubled our assets under management over that time period, going from \$375 million of assets to more than \$750 million. Approximately \$425 million of which is in our core equity portfolios.

Q. How come you have focused primarily on the individual market versus the institutional market?

KIG. We wish we had a philosophical answer to this question. But the fact is we have simply had more success in the affluent and high-net worth markets than we have had in the institutional market and therefore, that’s where we’ve focused our limited marketing resources. As to why we have had more success in the affluent/high net worth market, our frank assessment is that we have noticed a difference between what’s important to individuals who are investing their own money versus institutions and consultants who are investing other people’s money. Individuals are most interested in performance and client service. The consultants/institutions are more focused on fitting managers into their “style-box matrix”.

We are strictly “bottom up” investors looking for companies that are trading at a discount to their private market value regardless of what label somebody wants to slap on the company. If we were to limit our possibilities to one subset of the market, what happens when that one “style-box” becomes overvalued (think Large-Cap Growth/Tech in 1999). A large cap growth manager in 1999 would have been forced to buy the “cheapest” large cap growth stock even if it was trading at 40 times earnings. We will let others play that game and if that means that we never have success in the institutional market, we’ll continue to sleep just fine. In the meantime, we just hope our individual clients keep focusing on performance and client service and that we continue to merit top marks in both areas. If we can do that, we’ll have no regrets.

Q. What are KIG’s long term plans?

KIG. We intend to continue providing the high level of customer service and performance in the management of our clients’ equity and fixed income portfolios as we have from our beginning. Our growth will continue to come primarily by “word of mouth”, which might not be the fastest way to grow, but is certainly the most rewarding and most sustainable. We will always entertain ways to reach more clients (including referrals from other professional service providers, such as lawyers, bankers, accountants, and wealth planners wanting to bring value to their clients), and to better serve those clients such as by offering alternative investment opportunities, like hedge fund offerings. However, we believe that growth for the sake of growth is not an approach worth pursuing. Alternatively, we prefer to offer a great service at a fair price, and attract the right type of client, namely one that understands what we are trying to do and how we will go about doing it, and one who could truly benefit from what we have to offer.

Q. Why doesn't KIG turn itself into a one stop shop for all my financial needs?

KIG. We love to invest, and we think we're pretty good at it. On the other hand, we recognize that we aren't experts at everything. We believe that our clients should identify expert, trustworthy service providers to specifically address their needs, and pay a fair price for that service, with no conflicts of interest or hidden agendas which can sometimes result from a service provider selling a product, earning a load or commission off that product, and then "giving away" the underlying service for free. We believe that if you offer everything, you're more often than not mediocre at everything. We also believe that a solid investment strategy (and of course performance results) is the engine that makes the rest of your personal financial decisions more meaningful. In short, we would rather recommend a reputable fee for service expert (estate planner, attorney, accountant, insurance expert, 401(k) administrator, etc.) to meet your current needs, rather than claim to do it all for you. We aren't afraid to introduce you to other professionals. That way we can stick to doing what we do best- invest your hard earned assets for long term growth.

Q. It seems that the financial services and securities industries have undergone a barrage of new rules and regulations. How has this impacted KIG?

KIG. It is true that as a result of recent high profile scandals in the securities industry (such as mutual fund late trading and market timing, investment bank research conflict of interests, and the multitude of one-off frauds - i.e., converting investor money for personal use, sending out false statements, etc.), as well as in the financial services area in general (false accounting, etc.), the SEC and other regulatory bodies have come down hard with an onslaught of new rules impacting broker-dealers, investment advisors and hedge funds. Unfortunately, the approach has generally been one size fits all, and there is a break-in period going on right now, as the regulators try to figure out how to actually implement all of the new

rules. Until that all shakes out, we all have to comply with all of the new rules. Fortunately, KIG, from the beginning, has put an emphasis on having the right set of internal controls in place to protect our clients, their assets and our reputation. While we have tried to be one step ahead of the seemingly never-ending introduction of new rules, we appreciate that our clients have from time to time been asked to confirm personal information, provide us with additional documents, or re-execute revised paperwork. We at KIG remain committed to complying fully with all of the new and existing rules and to this end have committed significant resources to compliance matters. In this regard, we feel fortunate to have been able to recently hire Steve Hengst, who comes to us with 6 years of experience at the SEC. And we are equally committed to continuing to protect our clients' assets and interests, without interruption of the service and performance you have a right to expect from us.