Investment Commentary

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Market and Performance Summary

The equity portion of the accounts managed by KIG® finished the fourth quarter up 6% bringing our calendar year return for 2006 to 13.5%. This compares to the performance for the S&P 500 of 6.7% for the quarter and 15.8% for 2006.

Why the slight underperformance for the year? Investment commentators would likely say that 2006 was not the year to settle on a portfolio strategy, stick with it and beat the market. They would say that you needed to be nimble, moving in and out of sectors at just the right time. Given that a relatively small percentage (less than 20%) of active managers outperformed their benchmarks in 2006, many managers may have attempted to do this but were just unsuccessful. Or, if they were like us, they stuck to their strategy and accepted the fate that they may underperform for a short and arbitrary time period such as a calendar year. (We don't think you can really call something a strategy unless you stick to it.) To think that one could be a successful long-term investor with a series of short-term bets is madness in our view. It would be akin to a marathon runner planning his 26 mile journey as a series of sprints followed by slow jogs- he may lead the race for a while, but there's no way he's finishing first. In fact, he may not even finish at all.

True investing, to us anyway, is about participating in the success of the business over time as a partial owner, as opposed to speculating on short-term movements of its stock price. These are two very different notions- one dictated by the fundamentals of the business and its ability to generate cash flow, the other by the constant tug and flow of the market as sentiment continuously shifts along the spectrum of exhilaration and despair. We try to step in at the despair threshold, buying ownership stakes in fundamentally excellent businesses when the gap between its market price and our assessment of intrinsic value is wide. We don't know when or how fast the gap will close, but historically, patience in letting it do so has proved rewarding for our clients.

By the way, the reason for our underperformance is straightforward. Some of our largest holdings, primarily Motorola (MOT) and Home Depot (HD), had sub-par years. At the same time buy-out activity helped spur out performance in stocks deemed "take-outable" relative to large caps (in which a preponderance of our holdings currently exist), despite a meaningful decoupling between fundamentals and valuation among the respective groups. Besides, going up more than our benchmark has not necessarily been the primary source of our long-term out performance. Rather, preserving capital in down markets- going down less- has been where much value was added. We view 2006 as another mile, and look forward to continuing our trek in building long-term out performance.

Ten Years and Counting...

Purchasing undervalued assets from sellers who can't or won't tolerate short-term volatility has enabled us to consistently generate above average returns over long time frames. As of December 31, 2006, KIG now has an audited track record spanning ten years. Over that time period, our clients have experienced an almost fourfold (4x) increase in their assets, or 14.8% compounded annual growth, net of fees. The S&P 500 over the same time period has compounded about 2.25 times its original amount or 8.4% on an average annual basis. $1 million invested in each would be worth $3,960,000 and $2,245,000 for KIG and the S&P, respectively.

The Private Equity Bonanza

With torrential floods of money flowing into private equity funds over this past year, take private transactions have been more than common occurrences. Total merger and acquisition spending in the U.S. for 2006 is likely to eclipse the prior record of $1.5 trillion set in 2000. All this activity has lent strong support for the publicly traded equity markets. Besides the actual announcements of acquisitions, it seemed that on a daily basis analysts touted their pick as the next likely buyout candidate giving traders fodder for buying while at the same time squeezing short sellers to cover their bearish positions.

While we're appreciative of the technical support M&A has provided, our excitement is actually for an unintended consequence. The private equity binge has prompted management to refocus on capital structure, i.e. the mix of equity and debt they employ. Even in situations where a company is not an ultimate buyout target, investor activism emboldened by the threat of private equity is arbing out sub-optimal capital structures. Companies who have too little debt are being forced to take on more. Companies with cash in excess of investment opportunities are actively buying back shares. Such actions bode well for equity holders of companies who fit our prototype whether an actual buyout takes place or not.

The genius of private equity transactions, or leveraged buyouts in general, is the use of debt to create value for the equity holders. Certain companies, those that generate consistently high levels of cash and have low debt-to-capital ratios, can (and should) add debt to their balance sheet without impairing long-term financial flexibility. Today's low interest rate environment provides the added benefit of cheap financing. In a take private transaction, the new debt incurred is used to pay off all existing stockholders (except for those who may be part of the buyout group), at typically higher than market prices. Such action removes the company from the public realm. Even the feasibility of this type of transaction sends a wake-up call to management, who of course, can preempt acquisitive buy-out funds by taking on the debt themselves and buying back stock with the proceeds. While current shareholders don't get as much of a short-term pop in the stock price they do receive a longer-term benefit: an increase in the earnings power on a per share basis and a significantly higher stock price.

A recent example of how this played out in one of our portfolio companies is with Home Depot. In early December, as rumors swirled about private equity interest in the home improvement retailer, the company announced a shotgun $5 billion debt placement and virtually overnight bought back $3 billion worth of stock. Because of Home Depot's low valuation and the favorable rates at which it was able to obtain financing, we expect this act alone will add roughly $0.10 to next year's per share earnings.

This may be only the beginning of such transactions. Other portfolio companies which have similar characteristics to Home Depot (modest debt, high recurring cash flows, low capital expenditure requirements) and therefore a reasonable chance exists that their managements will act similarly include **Coca Cola (KO)**, **Procter & Gamble (PG)**, **McDonald's (MCD)**, **Bed Bath & Beyond (BBBY)**, **Costco (COST)** and **Gap (GPS)**.

With institutions and other investors forking over trucks full of money to private equity funds, there may ultimately be too much money chasing too few legitimate LBO candidates potentially dampening future returns. This could adversely affect sub par businesses with a buy-out-premium fully reflected in their valuation, but could meaningfully benefit shareholders of fundamentally sound businesses possessing the untapped potential of an under levered balance sheet.

What Did What in 2006?

While we try to eschew the "what have you done for me lately" mentality that tends to sweep through our industry, we nonetheless will recap how our holdings fared over the course of 2006. All figures are from December 31, 2005 or date of purchase, if later, and include dividends paid during the year.

Of our 47 current holdings in client accounts (more on this later), 36 (77%) were up for the year, 1 was flat and 11 (23%) declined in value. 15 holdings were up more than 20%, while only one fell by more than that amount. Of the positions exited completely in 2006, nine (75%) were done so profitably while we booked losses on three.

The top performers came from varied industry sectors. Shares of **CarMax (KMX)** were far and away the leading gainer rising a CarMaxian 68% since our May purchase as the company continued to beat earnings expectations by a wide margin. Two of our newer "old media" stocks did well as investors appeared to wake up to the fact that their business models were not irrelevant in the Google media age. Shares of **Walt Disney (DIS)** and **Time Warner (TWX)** rose 44% and 26%, respectively.

Finance holdings did well despite concern over the inverted yield curve. The **Bank of New York (BK)** rose 26% as two events spurred its shares. First, in April the company effectively exited retail banking by engineering an asset swap with J.P. Morgan, getting J.P.'s corporate trust business in return for BK's New York retail branch network. Then in November, the company agreed to merge with Mellon Bank creating the world's largest securities servicing company and one of the biggest asset managers. **Berkshire Hathaway (BRKA, BRKB)** (70% insurance) finally started to close some of the huge gap we believe exists between its trading price and its underlying value. An uneventful hurricane season coupled with higher premium revenues were probably the initial catalysts that began to move the shares, but we suspect that it just highlighted the true earnings power of the company. Berkshire rose 25%. Also **U.S. Bancorp (USB)** was up 26% with no real news other than continuing to reward shareholders with share buybacks and increased dividends. **Even Citigroup (C)** awoke from its long slumber rising 18% for the year. Much of that increase came in just the last couple weeks of December as rumors mounted that restless investors may begin agitating for a management change or possibly a break up of the company.

Computer related stocks, **Microsoft (MSFT)** (software) and **CDW (CDWC)** (hardware) did nicely, up 28% (since purchase) and 23%, respectively. And our first foray into energy proved profitable with **ConocoPhillips (COP)** rising 24% since our September 30 purchase.

No sooner had we decried our **Dell (DELL)** investment in last quarter's newsletter than it began a turnaround rising 10% in the fourth quarter. The market seemed to come around to our view that its business model was still sound and cash flow generation high. We will now make a standard practice of disparaging at least one holding each newsletter, two if possible.

For this newsletter let's focus on **Apollo Group (APOL)**, the for-profit education concern. The stock turned south after its 3rd quarter revenue came in well below expectations. Current noise aside, we believe this is an inherently sound business. The company's financial metrics are strong with no debt and sound cash flow generation in spite of the lower revenue. Low capital requirements and solid, if not spectacular, growth potential further support our view and we have increased our position at these lower levels.

Motorola had a disappointing 2006, dropping 8% for the year, but over 20% from its peak reached in October. So far things haven't gotten much better in 2007. The company recently surprised us with an earnings warning as its revenue mix slanted too far towards its lower end phones which it sells primarily in emerging market economies. At current levels, Motorola's valuation, after stripping out net cash of roughly $4 per share, is priced for practically no growth. Regardless of the recent shortfall, we believe the market's expectations are going to prove to be too low.

Royal Caribbean (RCL) (down 7%) and **Dow Chemical (DOW)** (down 4%), whose businesses have both been impacted by higher energy prices, fell for the year. Absent further outsized increases in oil and natural gas, we remain optimistic.

You Call This Concentrated?

As we've often times repeated, one of the cornerstones of our investment philosophy is to run a rather lean portfolio of between 25 and 35 names. This way your money is invested in only our top ideas, concentrating the capital into the names with which we have the highest conviction. As we've said before, do you really want money invested in our 100th best idea? That said, our portfolios are running a little stout these days. What gives? Well, we haven't abandoned our beliefs. The past couple of years have just been rather unique regarding how the market has unfolded vis-á-vis our portfolio holdings and conspired against hewing to our normal M.O. While most of our holdings were up over this time period, they weren't up quite so much that very many actually reached our fair value estimates. At the same time, our research efforts uncovered a fair amount of new opportunities which met our quality and risk/reward criteria and we felt compelled to add them to our portfolios. We also haven't found too many "no-brainers" that we would want to make outsized positions. Typically when we do, we will force out smaller positions to make room for these high conviction ideas. The combination of these factors has caused our holdings to swell to the current 47 names (though most client accounts own 40, or fewer).
It is our hope that we will be able to thin the ranks over this coming year. A New Year's resolution to lose weight, if you will.

Portfolio Activity

During the quarter we added three new positions to most client portfolios and eliminated two. Additionally, we selectively increased the exposure to two existing holdings and trimmed our exposure to one other.

While we assess many companies for portfolio inclusion, most fall short (sometimes justly so) of our strict criteria for business excellence coupled with a valuation that confers a margin of safety. While this rigorous evaluation process can cause us to miss out on some short-term "moves", the advantage is that companies that do make it into our portfolio represent exceptional value and should produce outsized returns as the market recognizes the gap in trading value and intrinsic value.

Along these lines, we added three meaningful positions: **Mohawk Industries (MHK)**, **Cinram International Income Trust (CRW.UN)**, and **SLM Corp. (SLM)**. In trying to provide as much transparency as possible, we'd like to provide some insight into why we believe these three stocks represent excellent opportunities.

Before we get to company specifics it's notable that the first two are in industry sectors which have what we believe to be very favorable oligopoly-like structures. An oligopoly is a market form in which a market or industry is dominated by a small number of players, typically three or four. Because there are few participants in this type of market, each oligopolist is aware of the actions of the others. The decisions of one firm influence, and are influenced by, the decisions of other firms. While firms in an oligopoly can't dictate price and availability like monopolists can, they often turn into friendly competitors since it is in all the members' interest to maintain a stable market and profitable prices. Oligopolies also create strong barriers to entry which means returns on capital can remain high for prolonged periods of time. Coca-Cola and Pepsi in soft drinks and Boeing and Airbus in airplane manufacturing are two of the more famous examples of oligopolistic markets. However, the oligopoly structure does not guarantee success for the participants. A current example where the structure is not benefiting the players is in the microprocessor sector of the semiconductor industry where a fierce battle for market share between Intel and AMD has resulted in pricing declines reducing margins and returns for both companies. We don't believe this dynamic will play out in either of the two sectors profiled below.

We purchased shares of Mohawk, the largest manufacturer of flooring products (carpets & rugs, tile, and laminate) in the U.S. with a 24% market share. Mohawk and competitor Shaw Carpets (subsidiary of Berkshire Hathaway) represent 46% of industry sales. The next closest competitor holds 7% market share. The share price has trended lower over the past year on fears that its earnings are unsustainable in the face of a deteriorating housing market. Undoubtedly there is risk surrounding current earnings estimates, but at current levels the market is pricing in a prolonged decline in free cash flow generation. This seems unreasonable given an oligopolistic industry structure, low cost position, clearly identifiable long-term growth opportunities, below average housing related exposure (15% of sales), above average exposure to commercial construction (18% of sales), and minimal big-box exposure. Additionally, the company is integrating a recent acquisition and is aggressively paying down debt. While the market has sold off the stock on housing bubble fears, the company's inherent competitive advantages and valuation suggest significant long-term upside is obtainable regardless of near-term housing industry results.

Cinram is the world's largest provider of pre-recorded multimedia products and related logistics services. With facilities in North America and Europe, Cinram International manufactures and distributes pre-recorded DVDs, audio CDs, and CD-ROMs for motion picture studios, music labels, and computer software companies around the world. DVD production and related logistic support is the largest revenue contributor- about 80% of sales. CRW's largest customers are Warner Bros., Fox, MGM, and Lions Gate. It's a little off the beaten path for most U.S. investors as its shares are listed on the Toronto Stock Exchange. Similar to MHK, Cinram trades in line with negative free cash flow growth expectations. Cinram recently converted its corporate structure into a Canadian Income Trust, simultaneously shielding earnings from taxes while paying out the increased cash flow to shareholders. While this sort of corporate restructuring would generally coincide with an increase in stock price, heightened fear due to the encroachment by electronically distributed movies coupled with a weak DVD release schedule from Warner drove the shares down instead. While electronic content distribution is a legitimate threat, a number of structural and financial impediments suggest physical media's decline in video will differ substantially from that of audio and the issues surrounding Warner are short-term focused. At purchase, Cinram traded at 5.6x free cash flow, and because the trust structure forces it to pay out most of its earnings the current dividend yield is 15% (this will likely result in a K-1 being issued to investors). If the business does not enter an immediate and prolonged decline the valuation will prove overly pessimistic, the distributions will not be cut, and the equity value should rise. As is customary, timing of this is uncertain.

Finally with SLM, known more commonly as Sallie Mae, we believe that we have purchased a dominant company in a business with exceptional growth prospects for a very average price. SLM's business is education lending; the company originates, buys and services student loans. As is typical of most purchases, an exogenous event (in this case the Democratic control of the House and Senate) triggered a decline in the shares to a point where we felt the risks were priced in. Recent political chest thumping aside, there is a low probability that the desire of certain Democratic legislators (i.e. subsidizing student loans to compete with Sallie Mae) has much chance for passage or will result in a significant negative impact on Sallie as we know it. While there are certain political actions that would result in a one-time hit to SLM's earnings, over the long run SLM's preferred lender status at a majority of institutions, its ability to grow its more profitable private loan business, and the potential to move into additional products augur for a better than market multiple. When this is placed in the context of an industry highly likely to experience annual increases in volume, it is hard not to be excited about owning the dominant industry player.

We made the decision to increase our position in much maligned **Wal*Mart (WMT)**. Notwithstanding the current stagnation in its stock price, this is one of our highest conviction names and is now our third largest position behind Berkshire Hathaway and Home Depot. Recent stumbles aside, Wal*Mart remains the country's dominant retailer accounting for almost 10% of all U.S. retail sales. This size brings tremendous opportunities for scale, which the company takes advantage of by offering low prices driving traffic to its stores.

Historically, our best results have come from investments in high-quality businesses. We think the following from Charles T. Munger is probably the best explanation for why this is so. "Over the long-term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns six percent on capital over forty years, you're not going to make much different than a six percent return- even if you originally buy it at a huge discount. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, even if you pay an expensive looking price, you'll end up with one hell of a result." While we occasionally try to buy a fair business at a great price, it's the great businesses at fair prices that really get us excited. At current prices WMT is one such investment. We just don't see too many better opportunities out there in which to compound your capital.

We exited our position in **Tribune (TRB)**, seeing risk/reward as about even. This is a pretty amazing statement given that the company has done just about everything possible to increase shareholder value, including a $2 billion Dutch tender offer, various asset sales, and finally, throwing in the towel and putting itself up for sale. The bidding was apparently lackluster as the company has not yet decided upon a suitor and is leaving its options open including selling the company in pieces or splitting up the company through an LBO by current management and its largest shareholder. The value we thought was there at purchase obviously wasn't as its problems haven't diminished as quickly as we believed and expectations remain low. Still, with a slight gain in our investment at disposal, "mistakes" such as this can be tolerated.

We pared back our position in newspaper company **Gannett (GCI)**. While we still believe upside exists from current levels we thought a certain amount of this capital could be deployed in names with potentially higher return characteristics.

Shareholder Communications Now Available Electronically

In an effort to help reduce the amount of mailings you receive regarding your account, we have worked with our clearing firm, Pershing, to enable you to sign up to receive certain shareholder communication electronically. This includes annual reports and proxy statements (sorry, no statements or confirmations yet). The service is easy to sign-up for, and it will send you an email link to a website where your shareholder communication can be found whenever a new piece of shareholder communication becomes available. In the event that you are entitled to vote on an issue, this will also be available.

To enroll for this service, visit www.icsdelivery.com and select Kovitz Securities, LLC under the "K" option on the right-hand side of the screen. At that point you will be required to enter your account number (starts with ADV), as well as your email address and last four digits of your social security number (for multiple accounts you will need to enter them one by one). Once you have finished entering all required information, a confirmation email will be sent to you. Your PIN and enrollment numbers will be sent to you via regular mail. This PIN can be used to enter voting instructions at www.proxyvote.com and the enrollment number will be needed to update your email address, change your PIN, or cancel the service.

It is important to note that there are some companies that still do not offer this information electronically. In the event that you own any of these companies, a hard copy of any shareholder communication will still be delivered to you.

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