

Investment Commentary

Fall 2007 Volume V, Issue 1



KOVITZ INVESTMENT GROUP

Capital Ideas.™

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Past performance does not guarantee future returns.

Market and Performance Summary

The equity portion of the accounts managed by KIG declined 4.6% (net of fees) during the three-month period ending September 30, 2007, compared to a 2.0% increase for the Standard & Poor's 500 Index. Year to date, the KIG composite is ahead 3.2% (net of fees) while the S&P 500 has advanced 9.1%.

We will not mince words; the performance of our stock portfolio, on both an absolute and relative basis, was dreadful. It's inherent in the very nature of our private business valuation investment thesis that we'll occasionally experience underperforming quarters. The recent quarter was such a time. Much of the underperformance reflects continued strength in cyclical, commodity-based and low quality stocks – areas where we have little representation (by design). This has been the case for quite some time now and though frustrating, we are not tempted to change course. The current market environment has rewarded traders of stocks and not necessarily those who use the market as a conduit to invest long-term in business fundamentals. Areas where we have substantial representation – consumer and finance – have been unpopular with the mainstream, as conventional wisdom dictates these are areas to avoid in a slowing economy. Over the years, we have been rewarded by ignoring conventional wisdom. By our reasoning, by the time something becomes conventional, there is rarely wisdom in pursuing it. Sir John Templeton once observed, "It is impossible to produce a superior performance unless you do something different than the majority."

Even though we'd like to, we can't force better performance. As frustrating as periods of underperformance are to us (and you), we know they have historically led to opportunity and

ultimately to periods of substantial outperformance. What we can do is stick to the analytical and intellectual framework that we've always used to make investment decisions. We will also continue to exhibit the same patience and discipline used in compiling our successful ten-plus year track record. (Since inception 10 ¾ years ago, the KIG composite has returned 14.0% annually after fees (turning \$10,000 into \$40,800), while the S&P 500 returned 8.7% per year (turning \$10,000 into \$24,500)).

(A) Little Help (?)

As expected, in periods where our performance is strong it is usually highly correlated to the fact that our largest positions, where a large portion of our assets are invested, did well. Likewise, when we underperform, the blame can generally be placed squarely on those same positions. As the chart below demonstrates, this has certainly been the case during this past quarter and year-to-date.

Positions in the Top 10 are generally our highest conviction names from a long-term value perspective. Given that fact, we don't expect this drag on our performance to continue indefinitely. In fact, these same positions could lead to significant outperformance in quarters to come as they reprice to levels that we believe are more appropriate.

Our equity investing strategy remains unchanged from what we have written (and implemented) over the years. We select our partial ownership in marketable equity securities the same way we would evaluate a business for acquisition in its entirety. We invest in businesses we can understand with strong competitive positions and strong finances. Furthermore, they must be available at very attractive prices. The positions below more than qualify on the first three aspects, and we would classify their current prices as being extremely attractive. There always seem to be periods where prices decouple from intrinsic value and that is why we remain focused on long-term value as opposed to near-term performance. Investors make poor decisions when they flip that focus around.

KIG Composite: Top Ten Holdings as of September 30, 2007

<u>Company</u>	<u>Position Size</u>	<u>3rd Quarter Performance*</u>	<u>YTD Performance*</u>
BERKSHIRE HATHAWAY	5.6%	9.6%	7.8%
WAL*MART STORES	4.2%	-9.3%	-5.5%
BED BATH & BEYOND	4.2%	-5.2%	-10.5%
BANK OF NEW YORK MELLON	4.0%	6.5%	12.1%
FIRST MARBLEHEAD	3.3%	-1.9%	-1.5%**
AMERICAN EAGLE OUTFITTERS	3.3%	1.0%	1.0%**
QUEST DIAGNOSTICS	3.2%	11.9%	9.0%
ROYAL CARIBBEAN CRUISES	2.9%	-9.2%	-5.7%
PROCTER & GAMBLE	2.9%	15.0%	9.5%
JOY GLOBAL	2.8%	-12.8%	16.8%

* Does not include the impact of dividends

** Purchased in 2007, performance from date of purchase

As we look out into the cloudy future, one thing is clear to us: At current prices, it's difficult to imagine a scenario where we can lose money over the long-term on the above group, collectively. In our opinion, then, the only sure way to suffer permanent loss of capital from this point forward would be to lose our patience because the upside doesn't materialize as quickly as we'd like. But we can guarantee that won't happen.

Portfolio Activity

The market volatility during the quarter had at least one positive aspect – it provided us opportunities to make portfolio adjustments as we sold stocks near or at our target prices (i.e. intrinsic value estimates) and used that capital to acquire some new ideas and to add to existing names. In fact, we were unusually active during the quarter, selling eight holdings and trimming three, while purchasing four new positions and increasing our holdings in four others.

Reasons for selling fell into three primary categories: 1) price reached our intrinsic value estimate, 2) buyout related, or 3) upside less defined than alternatives. In the first category, we sold long-time holding **Abercrombie & Fitch (ANF)** after seeing its price more than triple from our initial purchase in late 2003, and sold our less than long-time (Summer '06) holding **Hewitt Associates (HEW)**. We also trimmed holdings in **Nokia (NOK)**, **Apollo (APOL)** and **US Bancorp (USB)** for reason number 1. Under the second category, we sold **CDW Corp (CDW)** as the price approached the agreed upon offer price from a group of private equity players. Given the recent turmoil in the debt markets related to the financing of going private transactions, it did not seem prudent to wait around for what was very little implied upside. The third group included five companies – **Dow Chemical (DOW)**, **Pfizer (PFE)**, **Motorola (MOT)**, **Gap (GPS)** and **Limited (LTD)**. While the recent fundamentals of these companies have been a little shaky, that was not the primary reason we sold. We would have been content holding each as we felt the valuations placed on them by the market were discounting much more than just recent poor operating results. However, when viewed in the context of the entire portfolio and the new opportunities we were finding to place limited capital, we had to make some difficult decisions. We felt the upside for these five companies, while potentially significant, was less clear and well-defined than for alternative investment choices.

As mentioned, the cash freed up by the above sales was put to use in both new and existing holdings. New purchases were made in department store operator **Kohl's (KSS)**, home improvement retailer **Lowe's (LOW)**, building services and products supplier **Building Materials Holding (BLG)**, and cement and concrete producer **Cemex (CX)**.

We entered our second go-around with Kohl's, having recently successfully bought and sold it. Kohl's has been sold off with the retail group as fears of a consumer slowdown took hold this past quarter. While we are unsure whether this much debated topic will actually materialize, and if it does, how severe and protracted it might be, we are decidedly bullish on the prospects for continued cash flow growth for Kohl's over the long term. We don't pretend to know which way the economic winds will blow from quarter to quarter, but we do think we have an edge in valuing companies like Kohl's as the market's implied growth rate at current prices is dramatically lower than our expectations.

The investment community's reaction to the slowing housing and mortgage markets has been severe for companies that are directly or even tangentially involved in these activities. While it is justified on many levels, it still presents an opportunity for those who are willing to look past the current horrific operating environment and focus on companies that not only should survive the current meltdown but potentially flourish as competition pulls back, or disappears. Besides current holdings **Home Depot (HD)**, **Mohawk (MHK)** and **Bed Bath & Beyond (BBBY)**, which we believe fit this bill, we have now added three others: Lowe's, Building Materials Holding and Cemex. Notwithstanding the current housing slump, we are comfortable increasing our exposure to this area for a couple of reasons. First, these companies are recognized leaders in their respective niches and as such, have solid business models, durable competitive advantages, and sturdy balance sheets. Second, in our opinion, current valuations more than discount the challenges each are facing and as such, we see substantial upside when fears subside. Of course, we are unable to discern the exact timing of when that might happen so we scaled our exposure accordingly (less than 15% of the portfolio is invested in these names in aggregate).

While most are likely familiar with Lowe's (the big "blue box" vs. Home Depot's big "orange box"), Building Materials is probably less familiar. The company provides residential construction services and distributes building products to professional homebuilders and contractors in the western

and southern regions of the United States. With the words “building” and “materials” prominently fixed in the company’s name, it appears to be squarely at ground zero of the housing bust, and we believe already priced accordingly. While that may be the case, on any longer term outlook, we believe this sub-contractor provides an exceptional opportunity to profit from an eventual recovery, with a low risk of permanent loss of capital. In fact, if liquidated today, the market value of the assets less liabilities likely exceeds the stock’s current price.

Lastly, we established a position in Cemex, one of the world’s three largest cement and aggregate producers. While the stock has sold off on U.S. housing concerns, Cemex’s direct domestic housing exposure is only 25%. Cemex also benefits from the fact that over 40% of operating profit is derived outside the U.S. and Mexico. The company has many key attributes we look for, including favorable competitive positioning mainly due to high barriers to entry, and historic high returns on invested capital. While a slowdown in U.S. housing could certainly be a drag on near-term results, the predictably growing and diversified nature of Cemex’s cash flows suggests a large margin of safety over a more reasonable time frame.

We also increased our position size in existing holdings, **American Eagle Outfitters (AEO)**, **Wal*Mart (WMT)**, **Robert Half (RHI)** and **E*Trade (ETFC)** as price weakness caused the gap between market prices and our estimate of business value to increase.

Competitive Advantage, KIG

Last newsletter we discussed competitive advantages as they relate to the businesses in which we invest and how they are extremely critical in generating shareholder value. We have never really discussed in detail the competitive advantages KIG, as a firm itself, possesses. In some ways, this may be an even more critical component in our ability to continue to generate long-term wealth for our clients (and for us as we personally invest our own funds along side of our client’s).

We feel that our investment philosophy and our ability to

stick to it regardless of what may be going on around us is most certainly our strongest trait. But you’ve heard us talk about this already so we thought we’d share what we believe to be our other advantages that may not get much attention but are as important for creating the sustainability we strive for – sustainability in long-term performance. Three of these key advantages are:

- We invest with a longer time horizon than our peers.

We have built our business with clients who believe in investing for the long term. Prior to establishing an account, we ask each prospect that he or she be comfortable investing the assets with us for at least three years (minimum time frame over which we feel confident our philosophy will outperform our benchmark). Under these guidelines KIG is not impacted by the quarterly performance game, allowing us to adopt a long-term view on each investment. As a result, we are able to use our perspective and judgment to hone our thought process on the three or four pertinent issues from within the multitude of concerns surrounding a security at any point in time. Effectively, we use short-term oriented missteps by companies possessing sustainable competitive advantages to establish positions in above-average businesses at below-average valuations.

- The firm is run by investors, not marketers.

KIG is not a marketing organization. Performance is central to everything we do, with our overriding concern being the continuation and protection of our investment track record. As a result, there is never a sales or marketing based decision that takes precedence over our investment decision making process. We believe this differs substantially from many of our peers, and furthers our ability to focus on the performance of our assets under management. It is our belief that the gathering of additional assets is merely a byproduct of superior investment performance.

- There is no pressure to invest all newly attained capital immediately.

When establishing a new portfolio we ask our clients to understand that, as a result of our investment philosophy, it may take 9-12 months (perhaps longer depending on the market environment) to invest a substantial portion of

their portfolio. This ensures we only invest client capital at prices we believe to be exceptionally attractive, and allows us to institute the same level of commitment to preservation of capital for all of our clients irrespective of what day they happen to entrust us with the management of their assets. In executing our disciplined investment philosophy in this manner we are able to offer our clients a significant advantage in long-term performance versus our peers.

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

Quotes

“... it isn't exactly an uncomfortable position for me to view things one way and everybody else view it the other way. As a matter of fact, historically, that's been an absolute formula for profitability.” – Sam Zell

“The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values.” – Warren E. Buffett, letter to Forbes, 1979



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