Investment Commentary

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KOVITZ INVESTMENT GROUP
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Commentary on Current Environment

As of this writing, the situation remains fluid regarding the sputtering credit markets, Washington's response to this crisis and the impact of each on the stock market. As a rule, we do not favor government involvement in free markets (financial or otherwise) but there are times when it makes sense as no other single player can provide a coordinated response with enough firepower in a timely manner. Unfortunately, we are currently at such a juncture. While the 'rescue' plan as it stands may not be perfect, it, along with other concerted efforts on behalf of the Federal Reserve and Treasury, stand a good chance to break the log jam building in the credit markets and may be sufficient to restore confidence in our financial institutions - a necessary first step in restoring economic growth.

While our investment focus continues to be long-term, we are acutely aware of the current situation and mindful of its potential impact on your portfolios. As always, we continually monitor portfolio holdings to make sure each investment premise remains valid and upside opportunity outweighs risk. We believe unconditionally these characteristics remain intact. Looking ahead, there are many things to worry about – there always are – but we feel very good about the prospects for the businesses we own and their stock prices. As important, our fixed income allocation is invested in high quality credits that are somewhat more immune from the economy's broader issues. When one views in retrospect the major investing opportunities in history, they are times like these, when the public has panicked and overreacted to extreme news and bearish indicators.

No doubt that this is a confusing time for investors and uncertainty seems to rule the day. For those with a short time horizon there is not a lot that is obvious in the equity markets these days and emotion, not logic, drives many investment decisions. But as Bill Miller (Legg Mason Value Trust) aptly pointed out in his July 2008 investment letter, there may be many things that are obvious *longer-term*.

> "… it is obvious the credit crisis will end and it is obvious the housing crisis will end, and that the credit markets will function satisfactorily and house prices will stop going down and then start moving higher. It is obvious the American consumer will spend sufficiently to keep the economy moving forward long-term. It is obvious that the U.S. economy, already the most productive in the world, will get even more productive and will adapt and grow. It is obvious stock prices will be higher in the future than they are now."

While we agree with Mr. Miller, we know it's not that simple. We can't just bury our heads in the sand for the next couple of years and assume everything will come out all right on the other side. But it's a helpful construct to follow. The recently deceased legendary investor Sir John Templeton always said he tried to buy at the point of maximum pessimism, but he never knew when that was. We're never sure of that either, but have rarely seen the market this fear stricken. Mr. Templeton, like us, was a long-term optimist. Ultimately, stock prices converge to business values. We highly doubt the stock prices of today reflect the corresponding business values.

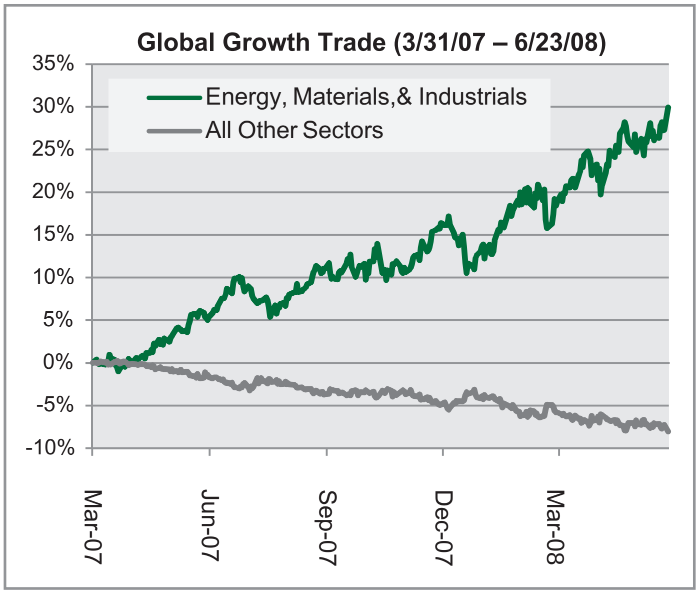
Market and Performance Summary

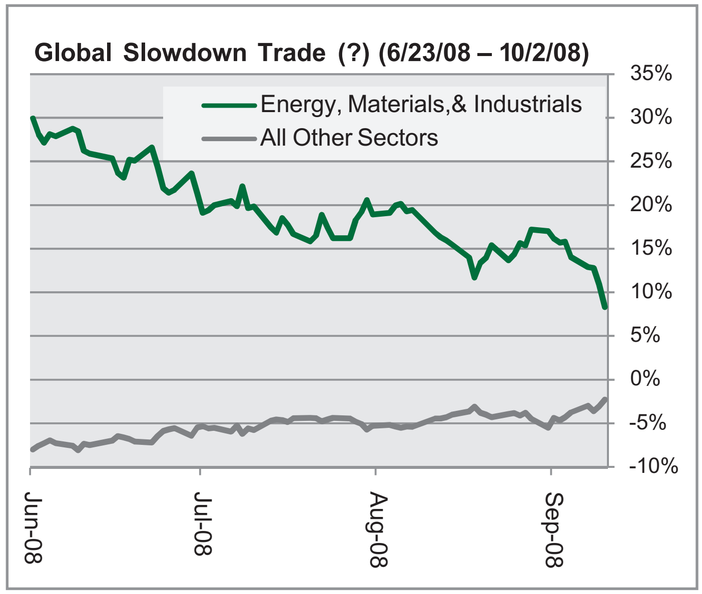
Despite a generally devastating period for the equity market, the equity portion of the accounts managed by KIG had a *positive* return of 1.3% (net of fees) during the third quarter ending September 30, 2008, while the Standard & Poor's 500 Index *fell* by 8.4% (including reinvested dividends and no fees) over the same period. In a tough investment climate, generating a positive return for the quarter was gratifying. However, even more gratifying was the substantial outperformance of the benchmark. Interestingly, not a single one of the 75 largest stock mutual funds showed a positive return for the quarter, with the average loss being 10.3% (preliminary figure from Lipper Inc.). International funds, once deemed a safe haven from the flagging U.S. economy tumbled over 20% on average, with some emerging markets down 30% or more.

That said, we have always preached that one should not read much into short-term results (including ours) as they may be more indicative of "noise" than anything else. We are in an industry obsessed with near-term outcomes over which we have little direct control. However, we can and do control the process by which we invest. We can confidently say that our process does not change regardless of the prevailing environment or to attempt to influence short-term results. We believe this is something that much should be read into. We will talk more on the topic of process vs. outcome below.

Year-to-date, the KIG equity composite has declined 14.0% while the S&P 500 has posted a return of negative 19.3%. While we constantly hope to reward our clients' trust with growth in their investments, losing less may be as important in regard to compounding capital over the long-term. In fact, we believe it is and has been a vital source in generating our long-term outperformance. Since inception of our audited equity track record (1/1/97), a period now covering eleven and three-quarters years, the KIG composite has over performed the S&P 500 by almost 5 full percentage points on an annual average basis (10.5% vs. 5.7%). Compounding this difference over the full time period results in a more than tripling in value for our composite (223.5%) versus a less than doubling of the S&P (91.2%).

Especially in these turbulent times, we know to be successful long-term investors we need to be thoroughly patient. We patiently and diligently learn about a company to ensure that it has an excellent business model, inherent quality and a sustainable competitive advantage while waiting for the stock to achieve a reasonable valuation before purchasing. Just as important, we demonstrate patience by holding onto our investments through good news and bad news, as well as the unavoidable ebb and flow of the company's stock price, reacting only to developments fundamentally impacting long-term value. Our reward has been the superior returns earned by great companies over long time horizons. We continue to believe the rewards will be the same in the future.





Speculation Does Not Equal Manipulation (But it May Equal Bubble), Continued

The title above is a reprise of one that appeared in our commentary last quarter. What follows is an update. Summarizing our argument, we wrote:

> "… oil's march upward looks and feels to us like a classic bubble in the making. Sure, there are fundamental underpinnings that argue for higher priced crude (surging demand in emerging economies, slowing production in oil rich states). However most bubbles start with something logical that is then extrapolated ever upward from there. The internet bubble had its roots in the fundamental explosion of eyeballs glued to their computer screens, telecom began its bubble with the simple concept that internet use would continue to fuel the necessity for broadband expansion, and even the recent housing bubble was grounded in the notion that prices, seldom, if ever, went down. As more and more investors bought into the internet/telecom/housing "story," the self-fulfilling prospects of upward price movements amplified gains until they eventually collapsed from their own weight. The oil story and resulting escalating futures prices has begun to draw some eerie parallels…What will cause this phenomenon to reverse? We don't know. Nobody ever really does before the fact. At some point, just like bubbles before, the trade becomes so lopsided that even small amounts of selling prompt a run for the exits. Just like the entry door, the exit door is way too small for everyone to fit through."

No sooner had we gone to press, the run for the exits began. Energy and commodity related stocks began tumbling in July and the drop has continued even into the first days of the fourth quarter. While the actual hard commodities (oil, natural gas, soy beans, corn, aluminum, etc.) fell, on average, about 30% during the quarter, stocks related to these areas were down as much and in most cases more. Energy related stocks, in aggregate, fell approximately 30% in the quarter, basic materials down 32%, agricultural related stocks down 40%, and metals and mining stocks were down 50%. (These results are all based on sector specific ETFs). Even the staid utilities index (a play on rising natural gas prices?) fell over 18%. As discussed in previous letters, we have largely stayed away from these areas as most did not fit our investment criteria and fundamentals did not justify the ever increasing prices.

As we said, you never know what will cause runs like this to end, and this was no different. It appears the impetus for this one was the realization that underlying commodities cannot keep increasing indefinitely and that, in retrospect, contrary to conventional wisdom, emerging markets cannot completely decouple from the U.S. economy. The global growth trade has turned into the global slowdown massacre.

(Pictorially, the two extremes are illustrated above.) The first time period (left-side graph: 3/31/07 through 6/23/08) illustrates the exuberance the sectors related to the global growth movement (green line) versus all other sectors of the market. The second (right-side graph: 6/23/08 through 10/2/08) depicts just how quickly the excitement waned.

Nice Hit?

While not regular perusers of the San Diego Padres' website, we were alerted to an interesting blog entry by their General Manager, Paul DePodesta, one of the new breed of numbers-focused major league baseball executives made famous in Michael Lewis' book, *Moneyball* (itself a source for past newsletter material). In this blog post, DePodesta discusses a concept of considerable relevance to investors, the importance of process over outcome.

> "Many years ago I was playing blackjack in Las Vegas on a Saturday night in a packed casino. I was sitting at third base, and the player who was at first base was playing horribly. He was definitely taking advantage of the free drinks, and it seemed as though every twenty minutes he was dipping into his pocket for more cash.
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> "On one particular hand the player was dealt 17 with his first two cards. The dealer was set to deal the next set of cards and passed right over the player until he stopped her, saying: 'Dealer, I want a hit!' She paused, almost feeling sorry for him, and said, 'Sir, are you sure?' He said yes, and the dealer dealt the card. Sure enough, it was a four.
>
> "The place went crazy, high fives all around, everybody hootin' and hollerin', and you know what the dealer said? The dealer looked at the player, and with total sincerity, said: 'Nice hit.'
>
> "I thought, 'Nice hit?' Maybe it was a nice hit for the casino, but it was a terrible hit for the player! The decision isn't justified just because it worked."

In the example above, a bad process led to a good outcome, but as Mr. DePodesta states, that does not necessarily mean it was the right decision. For the player, the probability of a good outcome was low and does not justify the riskiness of the decision. In other words, more often than not, the player would go bust and therefore the risk far outweighs the reward. Similarities with investments are obvious. Investment decisions need to be made where the likelihood of reward far outweighs the risk. Having a solid process, or processes, in place in order to facilitate sound decision making is paramount. If the process is sound, good outcomes are more likely than bad.

Like the blackjack table, it may appear that investment returns are all about outcomes, but just think of all the processes that are at play during the generation of these returns. For example, processes in equity investing include: defining the universe of investable companies, determining criteria used to evaluate companies and what sources of information are used, and formulating valuation models, to name a few. The processes should be repeatable with the output having a high degree of success.

From experience, we know the management of return is impossible. Outcomes (returns) are highly unstable because they involve an integral of time. Effectively, it is perfectly possible to be "right" over a two to three year view and "wrong" on a six month view, and vice versa. Therefore, our focus has always been on refining the processes and making sure they are followed. The process is the one thing we know we can manage and over which we can exert influence.

In their book, *Winning Decisions: Getting it Right the First Time*, J. Edward Russo and Paul J.H. Schoemaker devise a very simple matrix that we believe provides the framework for this kind of decision making.

	Good Outcome	**Bad Outcome**
Good Process	Deserved Success	Bad Break
Bad Process	Dumb Luck	Poetic Justice

The object is to be in the upper left box - deserved success resulting from a good process. The box in the upper right, however, is the tough reality we all face in industries that are dominated by uncertainty. A good process can lead to a bad outcome in investing; in fact, it happens more often than we'd like. After any bad outcome we try to determine if it was due to a bad break or deserved poetic justice (i.e., did we follow our proven process or not).

As tough as a good process/bad outcome combination is, nothing compares to bad process/good outcome. This is the wolf in sheep's clothing that allows for one-time success but almost always cripples any chance of sustained success – like the blackjack player hitting on 17 and getting a four. It's incredibly difficult to look in the mirror after a good outcome and admit that you were lucky. However, if you fail to make that admission, the bad process will continue and the good outcome that occurred once will most likely elude you in the future. We regularly look ourselves in the mirror and try to determine whether the good outcome was deserved or lucky.

We have discussed our investment principles (our processes), in part or whole, in practically every newsletter we write. The point of this discussion is not to rehash that but to let us quickly summarize. While each company we analyze is different we look for certain common qualitative and quantitative characteristics. We look for businesses that have simple and easy to understand business models, possess wide moat competitive advantages, generate high returns on capital employed, have strong balance sheets with financial flexibility, produce recurring revenue, and have low capital requirements. Once these are confirmed, we will not act until we believe that the business is being substantially undervalued in the marketplace. Following these processes does not guarantee a good outcome, but certainly minimizes the bad ones.

Portfolio Activity

During the quarter we initiated one new position, **CVS Caremark (CVS)**, while increasing position sizes in four existing holdings: **Walgreen (WAG)**, **Bank of New York (BK)**, **Franklin Resources (BEN)** and **United Health (UNH)**. We sold out of one position completely, **Dell (DELL)**, and trimmed our exposures to six others: **Wal*Mart (WMT)**, **Bed Bath & Beyond (BBBY)**, **Procter & Gamble (PG)**, **Microsoft (MSFT)**, **Carters (CRI)** and **Kohl's (KSS)**. We sold Dell for fundamental reasons as we felt less comfortable that its turnaround was sustainable as computers have become more commoditized than ever before. All of the trims were done on relative price strength and solely for the purpose of freeing up cash for current and future purchases. Wal*Mart and Bed Bath & Beyond were, and still are, our 2nd and 3rd largest holdings.

We also used price weakness in the quarter to shore up positions for existing clients or to initiate positions for new clients in **Coca-Cola (KO)**, **ConocoPhillips (COP)**, **Berkshire Hathaway (BRKB)**, **Boeing (BA)**, **United Parcel Service (UPS)**, **Mohawk (MHK)** and **Quest Diagnostics (DGX)**, exemplifying our strategy of capitalizing on exceptional opportunities in a period of extreme pessimism.

After several years of slim pickings, many companies are dropping to levels we are finding attractive. We're looking at more companies than ever before and are preparing to act when companies hit our buy target.

We have previously owned CVS, but the company we purchased this quarter has been transformed by the acquisition of Caremark in 2007. Caremark is the country's second largest pharmacy benefits manager (PBM). PBM's are managed care companies that focus exclusively on managing prescription drug benefits on behalf of employers and health insurers. In recent years, PBMs have been instrumental in reigning in the growth in drug spending through formulary design, generic switching and increased utilization of mail order programs. As a combined pharmacy and PBM, we believe the organization will have a compelling value proposition to offer both employers/insurers choosing a PBM and consumers who are already members of Caremark's PBM. Through the combination, CVS has become indifferent as to where prescriptions are filled.

At the time of the merger, we were skeptical about CVS's ability to hit its integration targets and unsure of the impact of the new business model. As time has passed, the integration has progressed smoothly, however fears have developed about the company's ability to take PBM share. We believe the depressed valuation more than takes this into account and provides a margin of safety at current prices.

Quote

"A year ago, two years ago, in the markets for credit and assets, you had no perceived credit risk whatsoever and you had terrifying actual risks. Today, we stand in a position where there are terrifying perceived risk and much lower actual risk." - Peter Briger, President of Fortress Investment Group

Please Join Us in Welcoming

Sanford Kovitz joins us from Rothschild Investment Corporation, where he was previously an Executive Vice President. Prior to that, Sandy was a first Vice President and Senior Trust Officer at the Exchange National Bank of Chicago. He comes to KIG with over 40 years experience in the investment industry. Sandy graduated from the University of Illinois and received his MBA from Northwestern

University. He received his law degree (J.D.) from DePaul.

John Erickson joins KIG as a Fixed Income Portfolio Manager primarily focusing on the construction and management of client portfolios, especially those with income or capital preservation objectives. Prior to joining Kovitz, John served for eleven years as the Director of Fixed Income Strategy for LaSalle Bank's Wealth Management Department. In that capacity, he chaired the Fixed Income Strategy Committee which set strategy and tactics for bond portfolios within the Department. He also managed client portfolios with fixed income allocations. Prior to that, he served as the Senior Bond Fund Manager of First Chicago's Private Wealth Department where he managed both the Bank's municipal bond mutual funds and common bond funds. In that role, John received three Performance Achievement awards from Lipper Analytical Services and special recognition from The American Banking Association for top performance. His career at First Chicago spanned 17 years, all within the Private Wealth Management department. John Erickson received his Bachelors degree in Business Administration from The University of Notre Dame, and his MBA from the Kellogg Graduate School of Management.

Kate Jonynas joins us as an Associate, focusing on client service and account maintenance. She graduated from DePaul University with a Bachelor of Science in Economics and a minor in Management.

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