Investment Commentary

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Kovitz Investment Group
Capital Ideas.™

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## Market and Performance Summary

The equity portion of the accounts managed by KIG declined 8.7% (net of fees) during the quarter ending March 31, 2008, which was slightly better than the Standard & Poor’s 500 Index, which decreased 9.5% (including dividends reinvested and no fees). The quarter marked the largest drawdown for the S&P since the third quarter 2002.

On a longer term basis, it may be instructive to look at our equity performance since the stock market peak of March 31, 2000, a period now covering eight full years. $1,000,000 invested with KIG on that date would equal $1,268,000 as of March 31, 2008, while the same investment in the S&P 500 would equal $1,011,000, or an amount 20% lower. This, despite our relative underperformance during the last half of 2007. Patient investing with our long-term mindset has produced considerable rewards, which we believe will continue.

This past quarter was one of the more eventful in recent memory as credit concerns, born from the easy-lending days of the housing market bubble, continued to spill over to the general economy and thus affecting the equity markets. Concerns also raged over the falling value of the U.S. dollar and its impact on rising commodity prices potentially leading to an inflationary environment while in the midst of a slowing economy. The Federal Reserve, with its tried and true primary tool of setting short-term interest rates, was, as most pundits believed, rendered somewhat powerless to help the situation much, as lowering rates to spur the economy could also have the negative consequences of fueling the dollar’s fall and igniting further inflation. Fears reached a crescendo in mid-March when rumors started to swirl about the solvency of Bear Stearns (a major player in U.S. investment bank circles) and the cascading effect its failure would have on the stability of the financial markets both here and abroad. However, the Fed showed that it had more ammunition (and creativity) at its disposal than was assumed as it simultaneously spearheaded a J.P. Morgan Chase led bailout of Bear Stearns while expanding its lending facilities from commercial banks to investment banks and brokerage firms, which heretofore had not been allowed access. While the economy is by no means out of the woods (things could get worse before they get better), these actions had a calming, though perhaps temporary, impact on the markets.

We have experienced and studied markets like this before (e.g. 1974, 1982, 1987, 1990, 1998, and 2002) when it seemed hard to imagine stocks could ever go up again. Scares and uncertainties continually crop up in financial markets, but those are the kind of environments that have presented great opportunities for investors willing to look beyond the near-term crises. Uncertainty has always been a prime factor contributing to securities being available at a discount. We believe there is merit, then, in remaining invested and continuing to enter new investments before such uncertainties, and presumably the discounts, disappear. We don't know when the panic will completely subside, but stocks have a way of bottoming long before all the uncertainties are removed.

We are generally impressed with the quality of the companies we currently hold and even more captivated by the valuations at which most are selling. Our portfolio companies consist primarily of a collection of businesses with competitively entrenched franchises that generate high returns on capital employed and significant free cash flow, possess sturdy balance sheets and have above average intrinsic value (and earnings) growth potential. Despite the slowing economy, the underlying businesses are strong allowing them to take market share in a tough environment and grow solidly when conditions improve. We also have cash on the sidelines to be able to take advantage of further opportunities.

## Portfolio Activity

The inherent volatility during the quarter allowed us to take advantage of what we believe will prove to be "buy low" opportunities, as we initiated or increased several positions. To make room for these purchases we sold or trimmed positions that had either reached our intrinsic value targets or where we felt the certainty of the upside of the new ideas outweighed those of the old. Taking advantage of these opportunities has required slightly higher than normal trade activity. Our time horizon remains long and our patience has not worn thin. We are in a volatile market and our goal is solely to have the flexibility to take action as prices dictate.

Having patiently built our knowledge bank of good businesses, we are prepared to make purchases when the prices come down to levels we feel represent good value. Some of the principal activities during the quarter were the addition of the following companies:

**Boeing Company (BA)** - This major designer and manufacturer of commercial and military aircraft is one of only two companies (with Airbus) worldwide that focuses on large commercial airplanes. Over the past six months, worries about the impact of delays in the development of the new and innovative 787 Dreamliner and the loss of a recent U.S. Air Force tanker contract have caused investors with short time frames to sell the stock, driving the price down over 25%. At current levels, we find the price attractive as we believe the mainly short-term negative effects of the 787 delays are fully discounted while the long-term positives for the company are going unrecognized, primarily the fact that we are in the midst of one of the strongest airplane order cycles in history. The current order backlog is approximately 3,400 planes, which is the equivalent of over 7 years of deliveries, and 2007 saw a book-to-bill ratio of 3.5-1 (back logged orders vs. booked revenues). Even factoring in the delays in 787 production and potential for a near-term recession related slowing of demand for domestic air travel, it is unlikely that there will be a significant number of order cancellations due to the need of the carriers to upgrade their fleets to more fuel efficient aircraft (the 787 is expected to use 20% less fuel than comparable sized planes). But this is more a story of global growth as increasing demand for air travel in Asia, Mideast, and Africa create the need for international airlines to build out their infrastructure to accommodate expected growth. The weak U.S. dollar makes Boeing's planes more competitive on world markets as well.

**Automatic Data Processing (ADP)** - ADP primarily provides outsourcing solutions, including payroll services and traditional in-house human resources functions, to a wide range of businesses. Before entering this position, the shares had recently been beaten down to valuation levels not seen since 2003 due to two short-term fears. One, that a U.S. economic slowdown would cause employment levels to drop, which, in turn, would slow growth in ADP's outsourced payroll services; and, two, that decreases in prevailing interest rates would decrease the income ADP generates from the funds it holds for its clients' payrolls. However, and stop us if you've heard this one before, these fears caused the share price to fall to a level where the short-term negatives provide the opportunity for us to buy an industry-leading company with a strong business model at an attractive price. We believe the economics of the payroll processing business are good. It offers a universal value proposition to small and medium sized businesses that utilize it, revenues are recurring (around 90% in ADP's case) and predictable, there are high incremental returns on capital, and switching (to a competitor) costs are relatively high and increase with the size of the client.

Furthermore, ADP is the nation's largest payroll processor with nearly 1-in-6 U.S. workers receiving their paychecks from ADP. This scale provides a large barrier to entry for potential competitors. The company is also several years ahead of its competitors in developing and implementing a global payroll services platform that caters to large multinationals, has net cash on its balance sheet, and has shown a commitment to shareholder interests by consistently repurchasing shares and increasing the dividend (currently yielding around 3%). As for those short-term fears, besides being, well, short-term and not necessarily impacting long-term business value, ADP is well equipped to deal with an economic slowdown due to the company's breadth and global expansion. Also, companies that outsource their payroll processes are still the minority, so even if employment levels decline from recent record highs, we believe ADP is looking at a brief period of slowing growth, but not negative growth, as it will increase its penetration in the marketplace by aggressively marketing its value-adding, cost-efficient services to companies looking to reduce corporate expenses.

**Kraft Foods (KFT)** - We believe that this manufacturer and marketer of several ubiquitous franchise brands (Oreo, Kraft Mac 'n Cheese, Philadelphia Cream Cheese, Maxwell House, Oscar Mayer, among others) is cheap at this price level. After several years of weak volume growth and compressing margins, Kraft is intently focused on revitalizing its core brands, capitalizing on its scale and reinvesting in marketing and R&D. Kraft's sheer breadth of category exposure and exceptional distribution system create a deep competitive advantage that will need to be utilized to offset rising input costs (primarily wheat and dairy). We see little downside as the company continues to use its balance sheet to repurchase stock and make acquisitions. Kraft is also engaged in winnowing its product portfolio to better focus on its "growthier" categories. The recent acquisition of the Danone biscuit business adds more than $2.7 billion in international sales, including some important exposure to developing markets.

Share price volatility also allowed us to increase our position sizes in **Accenture (ACN)**, **Carmax (KMX)** and **Lowe's (LOW)** where our conviction for long-term share price appreciation remains extremely high.

We sold out of five positions entirely during the quarter: three hit our business value targets; **Adidas (ADDDF)**, **Apollo Group (APOL)** and **Costco (COST)**, and two where we felt the capital would be more productive elsewhere **American International Group (AIG)** and **E*Trade (ETFC)**. We also trimmed **Coca-Cola (KO)** and **Joy Global (JOYG)** as share price appreciation in each considerably closed the gap to our fair value estimates, as well as **Bank of New York (BK)** resulting from increased uncertainty relating to potential legal exposure.

## Retail Detail

Owning retail stocks ahead of what may develop into an acute slowdown in the economy may seem a bold investment play. But while we may be suffering from what one of our investing role models, Bruce Berkowitz - the long time manager of the Fairholme Fund - characterizes as "premature accumulation," we see merit in continuing to hold these stocks. Each of the retailers listed below has developed into a market leader in attractive niche markets, has tremendous financial flexibility to withstand a slowing in momentum, and the ability to take market share from weaker players. Most importantly, however, is that we believe current valuations already incorporate all the bad news about crimped consumer spending (i.e. minimal further downside) and therefore there should be substantial upside on the "other side" of this downturn. The timing is of course uncertain, but historically we have been rewarded by sticking with high quality companies regardless of the environment. Keep in mind, while many of these may be considered contrarian plays, we are not betting the farm. Excluding **Wal*Mart (WMT)**, these retail names make up only about 15% of the average portfolio in the aggregate. And even with all of the economic angst directed at the consumer, retail stocks outperformed the broader market last quarter, perhaps suggesting a great deal of pessimism is already discounted in their stock prices.

Wal*Mart - Defined the value segment of retail with everyday low prices and is currently in the process of further refining its relevance in areas from groceries, to electronics, to prescription drugs. Wal*Mart may actually be in a position to benefit from a slowdown as price conscious consumers trade down. Noteworthy? Wal*Mart was the best performer of the Dow Industrials for the quarter, up approximately 11%.

**Kohl's (KSS)** - This new breed of off-mall department store has been differentiating itself by offering a strong collection of national, exclusive and private label brands that offer a unique combination of value and satisfaction. While sales trends have slowed along with most other apparel focused retailers, the company's strong operating history and sturdy balance sheet suggests that it can weather the current storm and be in solid position for the rebound.

**American Eagle (AEO)** - Consistently ranked as one of the "coolest" brands by teenage shoppers, we believe American Eagle will continue to be a top destination during and after the slowdown. Margins may take a hit in the near-term as the company clears slow moving merchandise, but with no debt and a large cash position, the company is committed to buying back meaningful amounts of stock.

**Bed Bath & Beyond (BBBY)** - Similar to American Eagle, Bed Bath has a hefty net cash position that it too will use to buy back its own stock. Key to the story will be the ultimate fate of its largest competitor who we believe is teetering on the verge of bankruptcy after having been taken private and adding considerable amounts of debt onto an already wobbly balance sheet.

Lowe's - While near-term market conditions in the housing market appear grim, in our view, home improvement is one of the best businesses in retail, given the lack of serious competitive threats (no Wal*Mart effect), the importance of the home to the typical consumer, and market share consolidation among Home Depot and Lowe's that is only being accelerated by the downturn. Moreover, they operate as a true duopoly and do not cut into each other on price and are protected by their vendors. The company continues to invest in the business even during the downturn which will only serve to widen its moat (competitive advantage) over the long haul.

Carmax - Not a retailer in the traditional sense, but this operator of used car superstores is pioneering the way used cars are sold through its in store experience (no haggle pricing, low pressure salespeople), sheer scale and information system advantages. Still in the early stages of its growth trajectory, the company is creating huge barriers to entry as its competitive positioning gains even more traction.

## Steak 'n Shake Update

The shareholders of **Steak 'n Shake (SNS)** have spoken and it's out with the old and in with the new, management that is. We wrote to you about the impending proxy battle for the venerable peddler of steakburgers ("after all a hamburger isn't chopped ham, it's chopped steak") and milkshakes being launched by representatives of the Lion Fund, Sardar Biglari and Phil Cooley, the largest holders of Steak 'n Shake common stock who coincidentally began accumulating shares in the company at approximately the same time we did last year. After meeting with Mr. Biglari and Mr. Cooley we became convinced that their involvement was not just an attempt to generate a short-term profit, but that they shared our vision that with the right management team in place Steak 'n Shake could leverage the company's iconic brand and create true long-term value. They assessed the situation very similarly as we did: one where a company with great brand awareness and enduring franchise value was slowly losing its way under a firmly entrenched management team; a board that has been slow to react to competitive changes in the restaurant landscape, and unwilling to make the tough decisions to restore the company to its leadership position in the value niche of the fast casual restaurant sector. The fact that they had past successes with restaurant companies in similar situations as Steak 'n Shake gave us even more confidence in their plan. We therefore decided to back their plan of ousting the current Chairman of the Board and acting interim CEO. We appreciate your help in this endeavor as we asked you to vote the GOLD proxy - and you responded.

While the slowing economy will continue to be a headwind for SNS, we remain optimistic about the long-term value proposition.

## Please Join Us In Welcoming…

**Amanda Falkum** joins KIG as a Senior Financial Advisor where she focuses on financial planning and the construction and maintenance of client portfolios. Prior to joining KIG, Amanda was a manager within the Private Client Advisors group at Deloitte & Touche LLP where she provided comprehensive financial planning and investment consulting services to high net worth individuals and corporate executives. She's also worked in a similar capacity within the Personal Financial Counseling group at Ernst & Young LLP. Amanda graduated from the University of Wisconsin - Madison with a Bachelor of Science degree in Personal Finance and is a Certified Financial Planner™ Professional.

## KIG's New Office

Effective February 19, 2008 we moved into our new office at 115 South LaSalle Street, 27th Floor, Chicago, IL 60603. Our telephone numbers and email address have remained unchanged. The move was necessary to accommodate the growth we have experienced since becoming an independent company in 2003. We are very proud of our new office space and extend an open invitation to any and all who would like to see it firsthand.

## Quotes

"Only egotists or fools try to pick tops and bottoms, which one are you?"
- Barton Biggs, "Hedgehogging"

"You make your best money in a bear market; you just don't know it at the time."
- Anonymous (old Wall Street axiom)

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