

Investment Commentary

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KOVITZ INVESTMENT GROUP

Capital Ideas.®

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Past performance does not guarantee future returns.

Midnight at the Oasis

“...be aware that the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before.” – Jeremy Grantham, Chairman GMO

For most of the past six months the market has been shrouded in pitch black darkness. The economy has nearly fallen off a cliff, corporate news is overwhelmingly negative, the jobless rate continues to increase, and it appears that the new administration may be fumbling the handoff. Uncertainty as to where things unfold from here is high. And yet perhaps the greatest reason for hope at the present is that all hope seems to have been lost. When expectations are at the point where there are no expectations that anything good can happen, it's usually the right environment for creating a lens to see things slightly less black.

We may have reached the point of maximum pessimism in early March when the market, taking its cue from nothing really that noteworthy, began to rise after falling for the first two months of the year. Were investors finally seeing things somewhat less black? We never make predictions on the short-term movements of markets (can't is more like it), so we will resist the temptation to “call the bottom.” We have been watching stocks trade for 20 years, and the moves continue to confound us on a daily basis. After all, rationality is only an a priori assumption and not an actual description of the markets. In the current environment, it's almost as if one's thoughts and perceptions are prone to match the volatility of the prevailing market conditions. Or is it the other way around? But what hasn't confounded us

is that, throughout the years, we've witnessed that large gaps between fundamental value and market prices close over time. The time can be as short as a couple of quarters or as long as a couple of years. We know that market volatility will continue to run high in a continuation of the age-old showdown between greed and fear. We also know that if you view stocks as blips on a screen, you will be led astray. But if you regard stocks as units of ownership in a business, you will maintain proper perspective. This clarity of thought is particularly necessary in times of extreme market fluctuations.

You probably are growing weary of hearing the words "patience" and "long-term," and we look forward to the day when we can write about patience having been rewarded. In the mean time, please know that we are grateful for your partnership.

Market and Performance Summary

While the S&P 500 had its best monthly gain in March (up 9%) since October 2002, the index still finished the quarter ending March 31, 2009 down 11%. The equity portion of the accounts managed by the Kovitz Investment Group, in aggregate, was lower by 12% for the quarter even after an 11% move higher in March.

Over the past one year, the KIG equity composite portfolio is down 32% versus a 38% decline in the S&P 500. Taking a longer view, our 10-year and since inception (twelve and one-quarter years) annual gains have averaged 3% and 7%, respectively. Comparable results for the S&P show an annual loss of 3% (10-year) and a gain of 2% (12.25-year). On a cumulative basis, the results are illustrated below.

**Cumulative Performance
for Periods Ended March 31, 2009**

	Latest 10-Year	Since Inception 1/1/1997
KIG Equity Composite	35%	132%
S&P Index	-26%	33%

Revulsion Abounds

A final market bottom will be arrived at, market pundits say, when stocks are unambiguously reviled. We don't disagree with that statement, and, in fact, the equity markets may be approaching this type of sentiment. But while we don't track investor sentiment per se, we do believe it can be gauged somewhat appropriately in the pricing of assets and the hallmark of revulsion is unambiguously cheap asset prices. Based on our valuation work using normalized earnings levels (not the current "repression" induced levels), it is our opinion that cheap assets abound, and many can be found in your portfolios. Of course, valuation isn't a binding constraint in the short-term - cheap stocks can always get cheaper. However, as long-term investors (yes, we know, we know) and with many companies priced for an extended period of malaise, if not for outright extinction, these are compelling valuations indeed.

Consider a basket of ten stocks culled from our current holdings: **Boeing (BA)**, **Burlington Northern (BNI)**, **Coca Cola (KO)**, **Johnson & Johnson (JNJ)**, **Lowe's (LOW)**, **Procter & Gamble (PG)**, **Target (TGT)**, **3M (MMM)**, **Walgreen (WAG)** and **Walt Disney (DIS)**. (Incidentally, this is just a representative list. We could have included our whole portfolio, but have kept it purposefully small for ease of illustration). Each is what we would consider to be high quality, underleveraged, and possessing sustainable competitive advantages. Each is generating abundant cash even in the current environment. The average dividend yield is 3.1%. As important, each should weather the current economic storm and come out the other side bigger and stronger. Based on these characteristics, an enterprising investor would most likely presume he or she would need to pony up a substantial premium in order to purchase these assets. This presumption would be well wide of the mark. In fact, this basket can be purchased for an average of 11 times our estimates of normalized earnings - a multiple we would describe not as premium but cut-rate. For the ideal interpretation, multiples are viewed best in the inverse - as an earnings yield. For instance, think of an 11 multiple as a 9.1% earnings yield (1 divided by 11), meaning that, if you owned this entire basket of companies and were able to pocket its entire aggregate earnings, your return would be over 9%. That's a nice risk premium given that you could buy a basket of intermediate term bonds from these same

companies that would yield somewhere in the 5% range. Add in the fact that the bond yield is static and the earnings yield has potential to grow and you're talking about significant return differences. Doesn't sound that revolting after all.

Why Not Just Wait for a Sunny Day?

As pessimism towards the market gathered steam in early March, discussion of "Dow 5000" made the rounds on all the media outlets. Reaching this lower level would have implied another 15% to 20% decline from trading levels at the time. An already unsettled investor may have used this as an opportunity to go to cash, wait for the inevitable further decline in the market (people on TV said so!), and then reinvest at the new low level. Easy as pie. Just one problem with this idyllic scenario: what if the market doesn't go there? What if it starts moving up, seemingly within days of all the petrifying news stories, just like it did recently? What then? Could the doomsday scenarios have been wrong? Has the all clear been sounded? Should I just jump back in now even after missing a 15%+ upside move? But what if this is just a head fake?

Another potential flaw in the master plan is thinking that it will be emotionally easy to just plow back in when the market declines to the "predetermined" bottom (Dow 5000). Would this same shell-shocked investor that sold at the higher level really feel any better after this even further decline? He or she would most likely be looking out over the same abyss as before, perhaps feeling the same fears, and maybe thinking, "I'll wait until it goes a little lower."

By contrast, our process, admittedly mundane, is to remain nearly fully invested to the extent prices provide investment opportunities. This process is employed with clear thinking and logic. We believe that, over long periods of time, equities as a whole will provide a risk-adjusted return that will most likely be higher than that of any other asset class, and we further believe that the portfolios we select will perform better than the aggregate. We also know we cannot predict the direction the market will take over any short period of time. The market timing investor described above stands the real chance of getting whipsawed - selling at the wrong point in time and then compounding the problem by buying back in at yet another inopportune moment. We don't

think we, nor anyone else, can successfully time the market on a regular basis. Not only do you need to be clairvoyant on the direction of the economy, interest rates, government policy, etc., you need to predict how other investors, who may or may not act rationally, will react to the information you had already prophesied.

In the Baupost Group's annual letter, Seth Klarman expressed it this way:

"While it is always tempting to try to time the market and wait for the bottom to be reached (as if it would be obvious when it arrived), such a strategy has proven over the years to be deeply flawed. Historically, little volume transacts at the bottom or on the way back up and competition from other buyers will be much greater when the markets settle down and the economy begins to recover. Moreover, the price recovery from a bottom can be very swift. Therefore, an investor should put money to work amidst the throes of a bear market, appreciating that things will likely get worse before they get better."

Of course, we couldn't leave out Warren Buffett's take on the subject, who said in his October 2008 New York Times article:

"Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: 'I skate to where the puck is going to be, not to where it has been.'"

We have suffered mark-to-market losses in the short-term, understanding the near-term economic challenges to a number of businesses, in order to be long-term owners rewarded for the competitive strength of our holdings over the next several years. When the dust settles, we believe very little capital will be lost on a permanent basis. We don't think we could make this claim if we were selling these same companies at prices below what we feel they're worth solely on the hope that we could jump back in again at some further discounted level. We'd be forsaking logic for hope and that doesn't strike us as a reasonable tradeoff.

Trough on Trough

One of the quirks of markets is just how far from reality perception can take asset prices. Bull markets breed such euphoria that it seems no price is too high to pay. Bear markets often result in an equal, yet opposite, reaction where it becomes tough to hold an asset at any price. This atmosphere, where perception becomes reality, is particularly prevalent in the realm of stock valuation. Today, whether attempting to determine fair value for an index like the S&P 500 or for an individual stock, market strategists and stock analysts seem to be in a race to the bottom with each invariably placing a low multiple on current year's earnings to arrive at their target valuation.

Being in the midst of a severe economic downturn, most would agree that corporate earnings this year (and possibly next) are going to be pretty awful. Unless one believes that this is what the world is going to look like from this point forward (we don't), what companies earn this year will likely be considered below some semblance of normality. When companies are under-earning relative to their long-term potential, investors should be willing to assign a higher than "normal" multiple to those "low" earnings. (Similarly, if a company is producing peak earnings, a lower multiple should be assigned.) If investors don't confer a higher multiple, they are in effect ordaining the current earnings as normal. Furthermore, since a price-to-earnings multiple is shorthand for the simultaneous combination of an assumed growth rate and the assumed riskiness of the earnings stream, using a low (trough) multiple implies that both the growth in the earnings will be lower and the risk permanently higher (or some combination thereof). Putting this all together, a trough multiple on trough earnings implies that your earnings base assumption, which is below trend already, is going to grow more slowly and be riskier, all at the same time. It's likely that all three of these assumptions are wrong, thus resulting in projected price targets that are egregiously low.

This type of illogical valuation trend tends to persist in bear markets because the typical investor mindset is so clouded by the current state of affairs that they fail to grasp that things can get better. Just like the manic bubble of the late '90s priced stocks for perfection, the current market is pricing many stocks for extinction. We constantly try to look

beyond the current economic predicament to envision what the other side may look like. While we can't predict too many specifics, we do believe that the current environment is offering up significant opportunities for well-capitalized firms to augment their existing strengths. The strength of these companies' capital structures (not overly leveraged) and consistency of cash flows provides real competitive advantages at times like this as they afford stability while many of their competitors face uncertainties and constraints. It also allows them to continue to invest in their businesses and aggressively pursue new business opportunities, further strengthening their competitiveness in the rebound.

We know for most companies 2009 earnings will look poor in comparison to prior year's, and 2010 may not look much better than 2009. Regardless of the perception, mathematically, a couple of bad years of earnings doesn't materially affect long-term corporate value of going concerns. However, at some point in the not too distant future, earnings comparisons will begin to turn positive, perhaps dramatically so. Companies that come through this with higher market share while using the downturn to recalibrate their cost structures may greatly enhance their operating leverage. It should come as no surprise that when the market tends to price assets on a "trough on trough" basis, few stocks are priced for this potential outcome.

Portfolio Activity and Comments

"...this exact moment in time is so off the charts in terms of its unusualness, that I don't think one's behavior at this moment is representative of what one should do over a long career. At a moment like this, we are frantically selling some things and buying others, because the market keeps coughing up better bargains. We want to own the best possible things we can – where we're as rock solid as we can be that we're going to have more money after 3 to 5 years than we have today." – Seth Klarman

The above pretty much sums up the quarter regarding our portfolio activity. Prices for high quality companies continued to tumble if for no other reason than their public ownership. History shows that it pays to be selectively bullish when most are indiscriminately bearish. Therefore, as the crowd sold we continued to purchase shares in high

quality companies where we believe the question of financial viability is off the table. We increased our position size in a host of companies including, **Automatic Data Processing (ADP)**, **Berkshire Hathaway (BRKB)**, Boeing, **CVS Caremark (CVS)**, **Lowe's**, **Philip Morris International (PM)**, Procter & Gamble, Target and 3M. We initiated only one new small position in **Costco (COST)**, a company we have owned in the recent past.

To fund these purchases, we trimmed our **Wal*Mart (WMT)** position and completely sold our positions in **Cintas (CTAS)**, **Kohl's (KSS)** and **Kraft (KFT)**. Each of these decisions was one of capital allocation; we simply saw more upside in each of the purchased names than in those sold. We also exited our position in **SLM Corp. (Sallie Mae) (SLM)** as the new administration appears intent on taking all forms of government student lending in-house, thus depriving Sallie Mae of an extremely large portion of its earnings stream.

We've consistently driven home the message that we are using this downturn as an opportunity to continually upgrade the overall quality of our portfolio. The market doesn't seem to be charging any premium for financial or competitive strength - strong balance sheets, consistent cash flow generation, wide moats - so we are taking advantage of the anomaly. One sign that we are perhaps succeeding is that while companies are on track to cut their dividends by as large a percentage as in any year since 1938, our portfolio tells a strikingly different story. Since September, when the financial crisis began in earnest, only two portfolio companies have cut their dividend (**Private Bancorp (PVTB)** and **Royal Caribbean (RCL)**, which eliminated it completely), while eleven others have increased theirs at an average rate of over 14%.

Berkshire Hathaway has become somewhat of a controversial investment. We believe this has more to do with the perception of the riskiness of its assets than with the actual risk of its business. Understanding this difference is the key to discerning the level of intrinsic value inherent in the franchise. Besides the catcalls about Warren Buffett losing his touch (recall the same things were said in 1999 because of his refusal to purchase shares in technology companies), the primary criticism is that it is going to suffer large losses in certain derivative transactions- the very securities he

termed "weapons of mass destruction" several years ago. More than a tad disingenuous? We don't think so. For one, Buffett would surely admit not every derivative is toxic as many are legitimate investments or risk management tools. It's only when they become overly complex or serve no real economic purpose other than as fodder for Wall Street bankers that danger is inherent. Secondly, we don't believe losses will be large if there are any at all. Berkshire's derivatives portfolio is composed of long-term equity put options and credit default swaps where Berkshire is holding the cash, has the use of it to invest in the interim, and is required to post minimal, if any, collateral. As equity markets around the world recover over the next decade (the minimum term left on the shortest contract), current mark-to-market losses on the put options will reverse and trend toward breakeven. Meanwhile, Berkshire's use of the option premium received will have been invested (earning positive returns, we assume) over this same time period.

We also think Berkshire's business prospects have never been better. The moat around its insurance businesses keeps widening as its balance sheet continues to be the "Fort Knox" of the industry. Also, the \$59 billion in float (amount of money that an insurer has collected in insurance premiums but has not been paid out in claims) should be able to generate more than adequate returns. Buffett has already locked up several 10% (and higher) preferred equity returns from high quality companies and we like his odds of finding other interesting (some uniquely offered to Berkshire) investment opportunities in this environment. Finally, for only the second time in its 44-year history, Berkshire's book value declined during 2008 (by 9.6%, handily outpacing the market averages), and a large portion of the decline came from market losses in its publicly traded equities portfolio. We look for the portfolio to be additive to book value going forward from current depressed valuations.

Calmer Waters?

Last quarter we included a section on fixed income in our commentary. Given that bonds have long been more than one-third of our assets under management, a number of you asked, "What took us so long?"

Though entertainment is not the primary purpose of our quarterly newsletter, prior to 2008, our answer might have

been that it was fear of putting people to sleep that caused the omission. Our strategy has always been to keep the bond portion of investors' portfolios safe. As such, most taxable accounts include high quality municipal bonds that are laddered out about 10 years and most tax deferred accounts consist of similarly laddered high quality corporate or taxable municipal bonds. Not particularly sexy.

As to the first quarter of 2009, investors have continued to favor higher quality bonds, allowing us to post another quarter of positive returns, despite the continued dysfunction of many parts of the credit markets. With the exception of Treasuries, which have been bid up to silly levels under just about any scenario other than a second great depression (resulting in miserly yields), we still see good value in stronger municipal issuers and high quality corporate bonds. In the municipal market, it remains the norm to be able to get a higher tax-free yield on high quality municipal issues than can be had on a pre-tax basis investing in Treasuries. As to taxable bonds, despite the problems that highly levered companies are having, many companies are sitting on record amounts of cash due to the premium they and others are putting on liquidity in this environment. As such, we think that the unusually large spread we can get on high quality corporate bonds over Treasuries more than compensates for the credit risk. Over time, we believe that we will see funds flow out of Treasuries into other high quality fixed income – be it municipal or corporate bonds, as the credit markets begin to thaw.

In short, boring continues to be a good thing when it comes to our bond portfolios.

Quotes

“For perfectly logical evolutionary reasons, the human brain constantly triggers immediate physical and emotional responses to external events. While these may work beautifully for choosing a mate or avoiding danger, they can also form the basis for behavioral biases that get investors into trouble.” – Value Investor Insight, October 31, 2007



KOVITZ INVESTMENT GROUP

Capital Ideas.®

Mitchell Kovitz, CFA, CPA

312-334-7301

mkovitz@kovitzinvestment.com

Marc Brenner, JD, CPA

312-334-7302

mbrenner@kovitzinvestment.com

Skip Gianopulos, JD, LL.M., CFP®

312-334-7303

sgianopulos@kovitzinvestment.com

Jonathan Shapiro, CFA, MBA

312-334-7324

jshapiro@kovitzinvestment.com

Bruce Weininger, CFP®, CPA

312-334-7334

bweininger@kovitzinvestment.com

Mary Anderson, MBA

312-334-7355

manderson@kovitzinvestment.com

Andrea Cohen, CFP®

312-334-7312

acohen@kovitzinvestment.com

John Conway

312-334-7343

jconway@kovitzinvestment.com

Ed Edens, MBA

312-334-7333

eedens@kovitzinvestment.com

John Erickson, MBA

312-334-7315

jerickson@kovitzinvestment.com

Amanda Falkum, CFP®

312-334-7351

afalkum@kovitzinvestment.com

Ken Fink, CFA, MBA

312-334-7330

kfink@kovitzinvestment.com

Sanford Kovitz, JD, MBA

312-334-7352

skovitz@kovitzinvestment.com

Mark Rosland

312-334-7322

mrosland@kovitzinvestment.com

Ted Rupp

312-334-7317

trupp@kovitzinvestment.com

Rich Salerno

312-334-7304

rsalerno@kovitzinvestment.com

Jenny Simmons, CPA

312-334-7316

jsimmons@kovitzinvestment.com

Patrick Wiese

312-334-7305

pwiese@kovitzinvestment.com