

Investment Commentary

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KOVITZ INVESTMENT GROUP

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Market and Performance Summary

During the first quarter of 2010, the Standard & Poor's 500 Index (S&P 500) increased from 1,115 to 1,169. If one had owned the S&P 500 during this period, dividends received would have increased the overall gain of the S&P 500 to 5.4%. During the same time period, the Kovitz Investment Group (KIG) equity composite increased 9.1%, including dividends (and after all fees). Over the past 12 months through March 31, 2010, KIG's equity composite is up 57.1%, compared to the S&P 500's rise of 49.8%.

With only a few temporary setbacks, the stock market has continued its move higher since touching its most recent low in early March 2009. Much hand wringing has been done over the S&P 500's approximately 75% move since that time, but lost in translation is the fact that prices last March implied a pending financial and social breakdown (i.e., Armageddon). These "panic-driven" prices bore little resemblance to actual or going concern business values, and measuring from that point clearly overstates and exaggerates the return. As we all know, Armageddon did not take place, but the worries facing the United States and many other regions of the world are still prevalent. Fears, including ballooning government deficits, high sovereign debt levels, consumer deleveraging, a persistently high unemployment rate, potential for rising interest and tax

rates, a still deteriorating commercial real estate market, and a fragile residential one, indicate clearly that the world has not returned to normal.

Indeed, the future is never clear. Fortunately our job is not to solve the list of the problems mentioned above. Our task is easier: to buy good, undervalued businesses and wait for them to be revalued to their intrinsic values. Intrinsic values, as we determine them, are based on the discounted value of the sum of its future cash flows (no yawning). (Note: in the present economy it's sometimes necessary to normalize these cash flows as many companies may be currently under-earning their potential.) We don't decide to buy, sell, or hold stocks based on what others think the stock market or the economy is going to do, but rather based on how the intrinsic value of the business compares to the market price of its stock. Putting it another way, we select (or hold) our marketable equity securities in much the same way we would evaluate a business for acquisition (or retention) in its entirety. Would it make sense to sell an entire business, one that wasn't quoted in the market every second of everyday, because you suspected the market was about to fall? We don't think so. Our expectation is that excellent business results by corporations will translate over the long term into correspondingly excellent market returns for its owners regardless of short-term angst over the market or the economy.

In one of his many investment communiqués, Warren Buffet summarizes this philosophy well: “The course of the stock market will determine, to a great degree, when we will be right, but the accuracy of our analysis of the company will largely determine whether we will be right. In other words we tend to concentrate on what should happen, not when it should happen.” The quality of our company by company analysis, not necessarily economic forecasting, will always be a key determinant of our success, but taking the “whether” approach over the “when” approach also extends our

time horizon versus that of our peers. This makes patience, not rapid fire trading, another crucial element of our investment make-up. From a group that considers reading company annual reports a hobby, you can be assured that we have the necessary level of patience to make this happen.

We believe that our portfolios currently contain high quality companies whose intrinsic values exceed (to varying degrees) their market prices. Timing as to when this gap closes is, of course, uncertain.

Buckets of Value

When you think about the sources of market returns, there can be only two: expansion of the price-earnings multiple or growth in earnings. For example, a stock trading at \$30 with \$3 of earnings per share is trading at a price-earnings multiple of 10. If the multiple were to expand to 12 and earnings remained unchanged, the stock will increase to \$36 - the 20% move commensurate with the 20% increase in the multiple. Conversely, if the earnings increased by 20% to \$3.60 and the multiple remained at 10, the stock would trade to the same \$36 level driven by the earnings increase. A third situation exists whereby both the multiple and earnings increase (otherwise known as Nirvana). In our example, if the multiple expanded to 12 while the earnings increased to \$3.60, our theoretical stock would now trade at \$43.20 (12 x \$3.60), or an increase of 44%. Ah, the joys of compounding.

The reason for taking you through the above exercise is to put in context how we think about our current portfolio in terms of both its return potential and its downside risk. We believe that the great majority of our positions fall into one of the situations described above. Let's call the first bucket “Low Multiple/Full Earnings.” This describes companies like **Wal*Mart (WMT)**, **Procter & Gamble (PG)**, **Johnson & Johnson (JNJ)**, **CVS Caremark (CVS)**, **Quest Diagnos-**

tics (DGX), and Diageo (DEO), each of which weathered the financial storm reasonably well and maintained flat to slightly up earnings over the past two years. Yet these companies still trade at a relatively low multiple of those earnings. In our minds, there's a reasonably good chance that the multiple will expand, producing higher stock prices commensurate with the percentage increase in the multiple. (It's also reasonable to assume there will be further earnings growth, but we're not going to quibble.) The next bucket, "Full Multiple/Low Earnings," includes less recession resistant companies whose earnings saw a decent contraction over the last eighteen months or so. The stocks of these companies (e.g., **Lowe's (LOW), United Parcel Service (UPS), Walt Disney (DIS), Boeing (BA), and Wells Fargo & Company (WFC)**) trade closer to full multiples but on earnings that may be well below what they can earn during a more normal economic environment. Assuming multiples stay constant and earnings return to anywhere near pre-recession levels, this will also result in higher stock prices (commensurate with the growth in earnings). The third bucket is the much-desired "Low Multiple/Low Earnings" bucket and is comprised of companies whose earnings are most likely below normal and whose multiple is most likely below what could be expected. Examples include **Bank of New York Mellon (BK), Walgreen Company (WAG), and Accenture (ACN)**. It's not unreasonable to assume that both earnings and the multiple will expand, which will produce higher prices that are turbocharged by the combination of the increases.

While the above describes the upside potential we envision, thoughts of downside always preoccupy our minds. In this regard, the bucket analysis also serves us well. To be clear, when we discuss downside risk, we mean the risk of permanent loss of capital and not short-term stock quotation loss (along the lines of the previous whether/when discussion). Recall that stocks in the first group trade at low multiples, which tends to

happen primarily because expectations for future growth in earnings are low. Therefore, surprises on the earnings front will likely not have a devastating impact on the share prices for these companies. We like to think of low multiple stocks as unstretched rubber bands - they are already limp (like the rubber band lying on the floor), so further contraction is hard to achieve. Contrast this with high multiple stocks being fully stretched rubber bands where the snapback can be severe. Barring a return to a severely recessionary economy, the companies in the first bucket seem fairly well protected from considerable downdrafts.

Now recall that the second bucket contains companies whose earnings have already been ravaged by the recession. Further earnings erosion from their low point, even if the economy slides backward somewhat, would be tough to justify as they were already at cyclical lows. In that case, we could see multiples contract somewhat, but we do not think they will be headed back to the trough multiples seen in early 2009 (for a discussion, see "Trough on Trough" in our *Spring 2009 Newsletter*). Again, we feel downside should be negligible in anything but a return to a tumultuous economic period.

The third group is protected by a combination of the factors of the first two and therefore has the least downside risk.

Investing is an activity based on the visualization of multiple scenarios and the placement of probabilities of occurrence on each. By our standards, the level of surety is fairly high for companies with valuation characteristics like those described above. It's even higher when these parameters are paired with the high quality nature of these businesses. These enterprises are long established, well-financed, essential in their industries, and presumed to remain competitively advantaged and generate substantial cash flows well into the future.

Portfolio Activity

We continue to really like what we own. Your/our portfolio consists largely of quantitatively cheap and qualitatively exceptional businesses. These enterprises are supported by high corporate cash levels, little or no debt, strong free cash flow generation, expanding profit margins, relatively little need to access the capital markets to fund growth, and sound management teams, and many have the ability to exploit growth via emerging markets. Just as important, they appear to be priced for average or even below average prospects for the future. A lot of value is being obtained for the current market prices. That doesn't mean we stood pat. We increased our position sizes in two companies we already owned, Lowe's and Walgreen. When given the option to hold a larger number of securities or fewer, our preference would be for fewer, more concentrated positions, assuming we could find truly attractive opportunities - outstanding businesses selling with a large margin of safety. These two businesses fit the bill.

We have long argued that, despite challenging near-term market conditions, home improvement retail is an excellent business. Supporting this view is the lack of serious competitive threats (even Wal-Mart doesn't have the scale to disintermediate many product categories), the importance of the home to the typical consumer, and market share consolidation among **Home Depot (HD)** and Lowe's (currently being accelerated by the downturn), which has helped support pricing. All of these factors have contributed to historically high returns on capital, and while recent results have been below average, we believe returns will move back up as the economy stabilizes. Because of these factors, we had maintained a position in both companies. While we still view Home Depot favorably, its stock price appreciation has outpaced Lowe's by a meaningful margin over the past couple of years. Because of the relative underperformance and the fact that we believe Lowe's normalized earnings have more room

to grow from the current depressed levels, we decided to reallocate our Home Depot capital to Lowe's.

We also believe the pharmacy business supports extremely attractive economics. A combination of a health care business (prescription and over-the-counter drugs) and sundry retailer, customers looking to fill a prescription can also pick up everyday necessities in one trip. Walgreen and CVS have grown to dominate this market over the past decade and both continue to take market share and further consolidate the market. The increased penetration of generic drugs is a boon for the industry as both margin and absolute dollars on generic prescriptions are higher than a branded equivalent. The wave of blockbuster drugs going generic (Lipitor, Viagra, Plavix) over the next few years will accelerate this trend and provide a major source of earnings growth. While not part of our primary investment thesis (more of a free call option), both Walgreen and CVS run in-store health clinics that could see a dramatic ramp up due to healthcare reform as there may be a shortage of primary care physicians to attend to the newly covered. These companies have weathered the recession better than most, although their higher margin "front end" (retail) sales have been pressured, which has weighed on overall sales growth and kept earnings multiples below where we believe they deserve to be. This may be a case of being way too shortsighted (it's not the first time we've seen it) as we don't think the current valuation factors in any of the longer-term positives. Taking advantage of others' short-term thinking, we increased our Walgreen's position while also maintaining our stake in CVS.

We did manage to initiate two new positions, **Lockheed Martin (LMT)** and **Vodafone (VOD)**. Besides liking each business and its financial strength, they share another quality- the interplay between limited downside and low investor expectations. As we mentioned earlier regarding the timing of investments, it's usually difficult at the time of purchase to identify with

any certainty a compelling reason why the stock price should appreciate in the near-term. Yet this is the precise reason, the lack of any clear catalyst that might create a favorable market reaction, that they are available at very cheap prices.

Lockheed is a major defense contractor that supplies aircraft, electronics products, and IT services primarily to the U.S. government but also to several foreign ones. The primary concerns pressuring the stock had been the pervasive sentiment that defense budget cuts were coming under the Obama administration, including a cut in funding for its important F-35 joint strike fighter jet program. However, a low multiple can compensate for a great deal of uncertainty, and that's the situation we felt we were entering. While not completely clear yet, it appears that both of these concerns are unlikely to materialize. The balance sheet is strong, free cash flow is stronger, and management has allocated it well, returning almost three-quarters of it to investors in the form of dividends and share repurchases over the past few years.

Vodafone, the world's largest mobile phone service provider by sales, is based in the United Kingdom and provides services throughout Europe, Asia, and Africa. A large source of its value though is in its 45% ownership of the Verizon Wireless assets in the United States. In fact, as we back out our assumed enterprise value of Verizon Wireless, the implication is that all of Vodafone's other business are trading at a low mid-single digit multiple. This is far too low even for a company whose growth may be constrained for a while by the global economic slowdown. We don't know how long it will take for this valuation disparity to be corrected in the market, but we are prepared to wait with what we perceive as limited downside from current levels.

We eliminated our position in **Emerson Electric (EMR)** and **Mohawk (MHK)** as each reached our

fair value estimate. For taxable accounts with holding periods less than 1 year, we wrote covered calls in an attempt to receive favorable long-term capital gains treatment at expiration.

Incentive to Perform

"Having clients with a long-term orientation is crucial. Nothing else is as important to the success of an investment firm."

The above quote comes as one of Seth Klarman's (Baupost Group) "Forgotten Lessons of 2008". We, however, have not and will not forget it. As regular readers know by now, we talk a lot (OK, obsessively) about the need for a long-term horizon in making capital allocation decisions. We believe that possessing a long-term view is absolutely necessary to being able to invest successfully (i.e., outperforming a benchmark over multi-year periods). By extension, this can only be practiced successfully if the audience that controls the capital base (our clients) allows us to ply our trade in a manner that is consistent with this approach. You have allowed us to work in this way and our performance validates Mr. Klarman's assertion: Since 1/1/97, the KIG equity composite has increased 265% vs. 99% for the S&P 500 over the same time period.

So why don't others act in a way that is obviously mutually beneficial?

Much of it can be explained by the typical compensation structure utilized by most money managers which provides incentives centered largely around short-term performance. Our structure gives us the ability to focus further down the road, so our decisions can be based on long-term business values rather than whether next quarter's earnings will beat expectations or whether the next tick of the stock price is up or down. Value is not necessarily at the core of the typical portfolio manager's investment process. Most managers are measured quarterly against one index or

another, corralled into a certain category (large cap growth, small cap value, etc.), and defined by statistics (tracking error, Sortino ratio, information ratio, etc.). Such forces restrict and otherwise impair the manager's ability to invest intelligently and are likely to be more of a distraction from the true aim of investment, which is simply to generate maximum net risk-adjusted total returns (after tax, where applicable). That's a hard enough goal without having to respond to such inputs or be restricted on where to find investment opportunities. We have attempted to set up our firm so we are free from such distractions. Having a client base that allows this is therefore a great advantage towards accomplishing our objective.

The institutional framework of many money management firms regards average as "safe" and the rewards for independent action are in no way commensurate with the risk attached to that action. It's the embodiment of John Maynard Keynes' decree: "...that it is better for the reputation to fail conventionally than to succeed unconventionally." Put in our terms, many investment managers are more worried about career risk (losing their job) or business risk (losing funds under management) than they are about doing the right thing. Most active investment managers fail to outperform a passive index, yet, if such investors are obsessed with career risk and business risk, then the failure to outperform is hardly surprising.

Almost by definition, having a long-term view means we will have periods of shorter-term underperformance. For our clients to be able to look past these and remain focused on the likelihood that this path leads to higher long-term net worth defines what Mr. Klarman meant by long-term orientation. Thanks for the opportunity.

Quotes of the Quarter

"I feel no shame at being found still owning a share when the bottom of the market comes....I would go much further than that. I should say that it is from time to time the duty of a serious investor to accept the depreciation of his holdings with equanimity and without reproaching himself. Any other policy is anti-social, destructive of confidence and incompatible with the working of the economic system. An investor....should be aiming primarily at long-period results, and should be solely judged by these."

– John Maynard Keynes

Please Join Us in Welcoming

Julie Zakarias joins us as a Senior Financial Advisor with over 14 years experience working with both individual and institutional clients in investment, financial, and tax planning. Julie brings a unique background to Kovitz Investment Group with experience from Deloitte, Credit Suisse, and a boutique wealth management firm. Julie received her Bachelor's degrees in Finance and Accounting from Western Michigan University in Kalamazoo, Michigan.

Terri Studds joins us from Harris Private Bank where she previously focused on fixed income securities. She continues to focus on fixed income at Kovitz Investment Group as a Senior Trader. Terri has over 20 years experience in the financial industry and received her Bachelor of Science degree in Quantitative Methods from the University of Illinois at Chicago.



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