

Investment Commentary

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KOVITZ INVESTMENT GROUP

Capital Ideas.™

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Past performance does not guarantee future returns.

Market and Performance Summary

The equity market's attempt to rally early in the quarter proved to be short-lived as investors sense that the worst of the credit crisis and the economy's woes were behind us proved illusory. In fact, a "perfect storm" generated by a renewed surge in oil prices and other commodities, an uptick in the unemployment rate, continuing stress in the financial sector, and an ostensibly impotent Federal Reserve conspired to dash any hope for the economy's second half comeback scenario. Declines were exacerbated in the last two weeks of June culminating in the market's worst monthly performance since September 2002, with the S&P 500 posting a loss of 8.4% and the Dow Jones Industrials down over 10%. June was particularly cruel for those following a fundamental, value-based investment approach and KIG's equity portfolio was not immune, losing 10.6% for the month, dragging down our quarterly return to a negative 7.0% (net of fees).

Year to date, through June 30, the S&P is down 11.9%, while the equity portion of the KIG portfolio is down 15.1% (net of fees). To the extent a particular account held cash and/or bonds, results would be less negative.

This is a bear of a market, to be sure. While we have been fortunate to have larger than average cash reserves on hand, a legitimate question could be, why haven't we been more aggressively selling? Unnerving as it may be, it's because bear markets end without a warning and the ensuing rise can often be powerful. Trying to time the turnaround is a fruitless endeavor. As we quoted Barton Biggs in last quarter's letter- "Only egotists or fools try to pick tops and bottoms, which one are you?" Missing even a few trading sessions of gains (as you're trying to gauge if this is the real turn) can be severely detrimental to long term returns. More so, we believe many stocks we own are already pricing in the dire economic scenario many are predicting. Selling those now would most likely be

capitulating at the bottom, and in fact, we have rarely been more optimistic on the outlook of our holdings.

Uncertainty has always been a prime factor contributing to securities being available at a discount. We believe there is merit, then, in remaining invested before such uncertainties, and presumably the discounts, are removed. We don't know when the jitters will subside, but stocks have a way of bottoming long before all the uncertainties are removed.

In volatile and, let's face it, crummy markets like we've been in for some time now, it's very important to filter out the noise (and it's loud!!!) and focus on the underlying investments. It goes against the survival instinct to keep oneself exposed to a declining market, but that has traditionally been the time to sow the seeds for good returns later on.

We own a great number of quality companies - some of the best franchises in the world. However, the wall of money that has moved into commodity and natural resource stocks has likely caused the prices of many high quality businesses to decline more than what is justified. At some point this will change, and that is why we believe our eventual returns will be accentuated, albeit deferred. In investment environments like this, cheap stocks often trade more cheaply. While we view much of the recent selling as irrational, we will never profess that we can pick bottoms. As always, timing is suspect, but we look forward to better days ahead.

Quality vs. Commodity

The market is currently distracted, focusing primarily on daily moves in the oil market. Not to minimize the negative impact of high oil prices, but the extreme focus on one factor implies that other factors, which may be more important to value creation over the long-term, are being ignored. The list of these factors will sound familiar by now, but if companies demonstrate a current competitive advantage that proves to be durable, generates significant free cash flow, possess strong and flexible balance sheets, and have management that allocates capital wisely, then shorter-term macro factors should prove less significant.

If your yardstick for progress over the past 6 months is Mr. Market's judgment of your holdings, you are likely disappointed. If however, you can shift your scale to one that measures intrinsic value growth, it should prove satisfying. Most of our portfolio holdings generated and retained significant free cash flow and many companies repurchased significant amounts of their shares, thereby boosting per share values.

Tom Gayner, who manages the investment portfolio at insurance company Markel, accurately characterizes our view (why reinvent the wheel when someone does it so elegantly for you?): "Today we believe that there are many productive long-term investment prospects. The very good news amidst the current market environment is that this is a rare opportunity to upgrade the quality of our holdings at attractive prices. The *very* best companies are on sale... We are prudently invested and investing in a list of proven, long-term financially successful, global powerhouses, while maintaining an above-average level of margin of safety to acknowledge the heightened volatility and uncertainty of the current marketplace."

Continuing, Mr. Gayner says, "The world continues to grow and develop - and in general, we have chosen to participate in this worldwide growth through companies with intangible brand values, manufacturing networks and intellectual expertise, rather than direct commodity exposures. While this puts us out of phase with certain turbocharged sectors of the market, we think we will enjoy long and durable returns from this approach."

Ultimately, capital migrates to under-priced businesses. We believe most, if not all, of our portfolio companies meet that definition. Like Mr. Gayner, we have chosen to participate in the growing and developing world, not through direct commodity exposure but with proven businesses with competitive advantages. Our top holdings include many globally established companies such as **Berkshire Hathaway (BRKB)**, **Wal*Mart (WMT)**, **Walt Disney (DIS)**, **Boeing (BA)**, **United Parcel Service (UPS)**, **Procter & Gamble (PG)**, **Johnson & Johnson (JNJ)**, and **Accenture (ACN)**. These are companies with strong advantages that are not being reflected in current valuations.

Companies denominated in U.S. dollars are also on the bargain counter for international business buyers. Foreign buyers enjoy the benefit in what amounts to a "30-40% Off Sale" due to currency exchange rates, in addition to an already depressed U.S. market in dollar terms. It would not surprise us if many of our holdings are being eyed by overseas capital pools. Regardless, probabilities are good that over time, through merger, going private, or most likely, through the conventional economic arbitrage of the market, many of our equities will rise to our business appraisals within a reasonable time horizon.

Great Chapter Eight

KIG believes the current investment horizon adopted by most investors is too short. Equities are long, if not indefinite-duration assets. If the downside of an opportunity is no short-term return

or “dead money,” we can live with that. The trick is to avoid the losers. We strive to preserve capital on each investment. It does not always work out that way, but that is the goal.

Over the past year we have had a few losers. We have embarrassed ourselves in **E*Trade (ETFC)** and we look pretty dense so far in **First Marblehead (FMD)** and **Building Materials Holdings (BLG)**. These have left dents in our performance that will take time to repair. But repair we will. We approach this difficult period just like we have others: determined to improve and confident in our process.

In times like these, we find it instructive to go back and re-read Chapter 8 in Benjamin Graham’s landmark book “The Intelligent Investor.” This chapter focuses on investing in publicly traded equities no differently than if you were purchasing a stake in a private business. The only difference is that owning pieces of businesses that trade on financial markets forces you to see how others are pricing them on a daily basis. If you own the local dry cleaner, no one is stopping by each day to tell you what your business is worth; but you probably have a good idea based on your past earnings history, trends for future growth in cash flow, a new competitor (or lack of one) down the block, and the demographic characteristics and trends in the neighborhood. According to Graham, when looking at your investments it is highly instructive to think like the store owner. Doing this allows you to avoid the emotional stresses that come with seeing daily fluctuations in how others are valuing your business.

Quoting Graham, “Let us return to our comparison between the holder of marketable shares and the man with an interest in a private business. We have said that the former has the *option* of considering himself merely as the part owner of the various businesses he has invested in, or as the holder of shares which are salable at any time he wishes at their quoted market price.”

Continuing, “But note this important fact: the true investor is scarcely ever *forced* to sell his shares, and at all other times is free to disregard the current price quotation. Thus the investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. That man would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by *other persons* mistakes of judgment.”

Finally, “The true investor is in that very position when he owns a listed common stock. He can take advantage of the daily market price or leave it alone, as dictated by his own judgment and inclina-

tion. He must take cognizance of important price movements, for otherwise his judgment will have nothing to work on. Conceivably, they may give him a warning signal which he will do well to heed: this in plain English means that he is to sell his shares because the price has gone down foreboding worse things to come. In our view such signals are misleading at least as often as they are helpful. Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times, he will do better if he forgets about the stock market and pays attention to the operating result of his companies.”

These are more than just quotes to us. They, in our opinion, provide the cornerstone for the only sensible way to invest. Putting it to work in practice is difficult, particularly when the market is screaming at you to do something else, something much less disciplined. We have not perfected it yet, but everyday, we try to take the necessary steps to improve and instill the discipline crucial to adopting the Graham mindset.

Portfolio Activity

While we increased position sizes in several existing names during the quarter, only one new position was initiated. With the purchase of **Walgreen Company (WAG)**, we feel we upped our portfolio’s quality quotient even further. In the mid 30’s, shares of Walgreens are currently trading at levels first reached in mid-2000. Over this time period, the company has doubled its store base and nearly tripled its earnings. Walgreens’ stock was likely overvalued back then, however, we believe it is undervalued now, trading at about 15 times our estimate of earnings for the fiscal year ending August 31, 2008. Besides the sell-off in the general market, several issues have conspired to push the valuation down to attractive levels, including Wal*Mart’s \$4 generic rollout (minimal impact), the purchase of a pharmacy benefits manager by its primary competitor CVS (impact unknown at this point, but unlikely to be a game changer), company specific missteps with cost control (fixable) and a lull in new generic introductions (temporary). Doing the math (please see the Winter 2008 newsletter for an example of “doing the math” using Wal*Mart at www.kovitzinvestment.com/newsletters.html) on Walgreens’ share price shows that market expectations for earnings growth is in the low single digits, a level we feel will prove low under any longer-term time horizon. This is just one example of the opportunities offered by today’s nervous market to acquire a position in a solid business at a reasonable price.

Other examples are companies already owned, including Boeing

and UPS, and each were increased as a percentage of the portfolio. Share prices of these two companies have declined recently, held captive over concerns of a slowing domestic and global economy. These concerns are valid, of course, but seem to overlook the long-term value embedded in each of these franchises. Each operates globally in duopolistic industries where barriers to entry are extremely high for new competition and the threat of substitute products is low. Already competitively advantaged, we see each of these companies' economic moats continuing to widen.

We also used price weakness in the quarter to shore up positions for existing clients or to initiate positions for new clients in **ConocoPhillips (COP)**, Procter & Gamble, Berkshire Hathaway, **CarMax (KMX)** and **Robert Half (RHI)**.

On the sell side, we used relative price strength and trimmed back **Kohl's (KSS)** to reduce some consumer exposure and sold our remaining position in **Dell (DELL)**. We have continually reassessed Dell's competitive advantages since purchase and now believe that they have deteriorated to the point that further upside is limited. We also trimmed our **Microsoft (MSFT)** position slightly. Despite a fairly low valuation, Microsoft's lack of an internet strategy has been exposed by its failed attempt to purchase Yahoo. Its core software business remains strong and continues to throw off tremendous amounts of cash that if deployed wisely will temper downside risks. However, upside may be limited in the near term and so, while we want to maintain an average size position, amounts in excess of that were sold to deploy elsewhere.

We also liquidated two holdings, **McDonald's (MCD)** and **Joy Global (JOYG)**, which reached our fair value estimates. McDonald's (a long time holding, though one to which we hadn't committed new capital for some time), which had benefited from a reinvented menu, extremely smart capital allocation decisions (management spent more money refurbishing existing stores than in building new ones and embarked on large repurchases of stock and dividend increases), and a weakened dollar, reached a level where we felt comfortable that a great deal of the upside had been realized. Similarly for Joy Global, the commodity boom has lifted its price to levels where downside risk appeared more prevalent than further upside.

We used proceeds from these sales to buy some of the aforementioned companies and increase cash levels.

Stocks of Note

Shares of CarMax were pulled lower during the quarter as its quarterly earnings results missed analyst expectations, primarily due to sluggish sales and lower earnings in the company's finance unit resulting from higher borrowing costs. We believe these trends are symptomatic of the current environment and not an indictment of the company's business model, which has many built-in advantages that will be highly evident come the other side of the current malaise. Even in the current downturn, CarMax is executing. Comparable sales have been well above the industry average and conversion rates are up. Outperforming the competition in down markets is hugely important and when traffic recovers, CarMax will be in an even stronger competitive position. The company also has considerable expansion opportunities ahead as it expands its base well beyond the roughly 100 stores currently in operation.

Similarly outperforming the competition, **Bed Bath & Beyond (BBBY)** has continued to show the resiliency of its operating model and the advantages of its unique decentralized culture even as housing suffers through a dreadful downturn. While we expect earnings to come in below last year's, they have been stellar in comparison to its largest rival Linens 'N Things which, as we anticipated, was forced into a Chapter 11 bankruptcy filing. Bed Bath continues to open new stores and buy back stock with a balance sheet free of any debt and over \$550 million in cash and securities. Even in this tough environment, recent quarterly results showed positive comparable store sales and earnings that were above expectations. The closure of at least 120 Linens stores (we think there will be additional closings announced well beyond these), many in close proximity to Bed Bath locations, will prove rewarding over the long term (though liquidation by Linens of closed store inventories may dampen the near-term). Frank Blake, the current CEO of Home Depot, remarked recently that "a downturn is a terrible thing to waste," meaning that for a financially strong company, making investments in the business when your competition cannot serves to widen the gap when good (or just normal) times return. We believe that Bed Bath management is applying this mentality, and when normalcy returns they will have further distanced themselves from the stumbling competition. Shares are down approximately 4%, year-to-date, performing better than the overall market.

Berkshire Hathaway, in our opinion, is a classic example of a company with a growing intrinsic business value but a declining stock price (down 15% year-to-date). We have extolled the virtues of Berkshire's business model many times in these letters. Briefly, its

competitive advantages include the strongest capital base (balance sheet) in the insurance industry, generation of low cost insurance float which can be directed to investment opportunities, a collection of non-insurance private businesses with good economics and competitive advantages of their own, a company to whom business owners feel comfortable selling their companies, and capital allocation by management that creates a (whole) company greater than the sum of its parts. Beginning this year, Berkshire used its balance sheet strength to step into the municipal bond insurance business that had been left void by the demise of its major players. The company has already written several hundred million in premium dollars out of the gate (at very strong pricing). There is always the concern that once Warren Buffett is out of the picture Berkshire will revert to mediocre status. We have more optimistic expectations. The company has several quality candidates to replace Buffett as CEO and several more to replace him on the investment side. More importantly, the culture that Messrs. Buffett and Munger have fashioned at Berkshire will endure long beyond their tenures.

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

The rise in oil prices has led many, politicians chiefly among them, to conclude that speculators are manipulating the price of oil. Government-led investigations of the futures markets have been launched searching for the smoking gun of market manipulation. We don't buy into these conspiracy theories. We believe the explanation is much simpler: energy futures markets, while becoming increasingly more liquid, remain far too small to absorb the huge sums of global capital being wagered on oil price movements. Reviewing some numbers illustrates this point. At the end of 2003, when oil was trading at approximately \$30 per barrel, there was \$13 billion invested in commodity index funds. By March of this year, that amount had grown 20 times to \$260 billion and oil had breached \$100. Nothing nefarious necessarily going on other than good old fashioned greed.

In fact, 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, go 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. Adding fuel to the fire has been the noticeable increase in long oil trades as a hedge against the weak U.S. dollar. In a spectacular example of circular logic, the rise in oil prices pressures economically sensitive stocks causing investors to abandon what is falling and jump into what is rising, pushing oil prices up further and stocks lower still. 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.

Please Join Us In Welcoming

Ruth Fiorentino joins KIG as an Associate where she focuses on client service and account maintenance. Prior to joining KIG, she was as a Financial Representative at the Northwestern Mutual Financial Network. Ruth graduated from the University of Illinois at Urbana-Champaign with a Bachelor of Arts in Finance.



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