

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

No beating around the bush. During the fourth quarter ending December 31st 2008, the equity portion of the accounts managed by the Kovitz Investment Group declined, in the aggregate, by 18.6% (net of fees); however, this was decidedly better than the 22.0% decrease in the S&P 500. For the full year 2008, the S&P 500 was down 37.0%, its worst showing since the 43.3% decline in 1931. KIG's equity performance declined 30.0% (net of fees) on a full year basis, exceeding our benchmark by 7% on a relative basis. Bear markets tend to be very democratic, leaving no one unscathed. While we can take some comfort from being less scathed and handily beating our benchmark, being down is still being down. We understand that this last quarter capped off an unusually difficult year, and there wasn't a lot of celebrating at the office this past holiday season. Instead, our focus has been, and will continue to be, on the things that we can control: relative performance on both our portfolios of stocks and bonds, identifying undervalued companies with competitive advantages and strong finances, and helping our clients navigate through these difficult waters and plan for their financial future.

While we believe that the recession may be long and deep, we also believe that stock prices probably have already discounted the worst of the economic decline. As investors searching for fundamental value, we are finding an inordinate number of investment opportunities. That being said, if you're a short-term speculator (or someone who needs your investment capital next month, next quarter or even next year), now might not be the time to make your wager. While we are of the belief that the stock market will likely

be significantly higher in several years' time, we cannot say with certainty whether the final low of this bear market has yet been seen. But if you're truly in it for the long-term, and truly willing to let your capital work for you over time, it is likely that this will be an exceptional starting point for highly satisfactory compounded annualized gains. *We cannot, nor will we attempt to, predict the timing of when the compounding will begin in earnest.* Please don't be disappointed and lose faith if it doesn't occur instantaneously. There will not be a single event or a water-shed moment to which one will be able to point. There won't be one day when the market closes that we'll all look at each other and say, "Sayonara bear market." More likely at some uncertain point in the future, we will look back and realize that the values we thought were being served up by a fearful market were authentic.

Observations on Current Environment

Coming off one of the worst quarterly performances in the history of the equity markets, it is easy to take a jaundiced view of what may be in store for future performance. Each bear market, when one is in the midst of it, seems to portend that the end of the world is near. Unfortunately, most humans are wired to extrapolate current conditions endlessly into the future. We, however, attempt to approach all the doom and gloom with a sense of measured confidence borne from our investment experience. But even we have to admit that there are still many unknowns. For instance, how much more will the deteriorating housing market react to the real economy and on the credit system? How much more will the flagging credit system react to the equity markets? Will cash-strapped companies be forced to continue layoffs, causing cutbacks in consumer spending that will push employers to cut even more jobs? Will deflationary conditions take hold? Will the government attempts to avoid deflation at any cost ultimately ignite a stretch of inflation? These are very real concerns and the answers to each are important.

However, taking a step back, these are the very reasons why the equity markets are down roughly 50% from their highs of October 2007. In other words, the fear of these unknowns is exactly what gets priced in during bear markets. Has it been completely priced in? From an economic standpoint, we would likely answer yes. From a behavioral standpoint, however, the answer is unclear. Fear and panic

can certainly drive an already cheap asset cheaper. It's always worth remembering Isaac Newton's words, "I can predict the motion of heavenly bodies but not the madness of crowds." But just as instructive is what Jeremy Grantham (Chairman of investment firm GMO) recently pointed out: if you recognize the market as cheap and you don't buy, and the market were to go up, "you don't just look like an idiot, you are an idiot."

History adds further perspective and provides a crucial insight regarding market crises: they are inevitable, painful and ultimately surmountable. None to date has permanently derailed the market's ability to compound over the long-term. For the better part of the last century, the US economy has grown over every decade and the market in the long run has managed to produce double-digit returns despite setbacks such as: prolonged bear markets; wars; recessions; an oil crisis; a hostage crisis; periods of double-digit interest rates, inflation and unemployment; political scandals; stock market crashes; the September 11th attacks; and much more. We believe that those investors focused on long-term objectives will be rewarded for their patience in the current environment, but we recognize the challenge of staying the course in times of great fear and pessimism. The hardest thing for an investor to do right now will be to remain patient and let time pass without getting anxious and prematurely running for the exits. Of course, the crummy thing about time is that it takes time. The current environment reminds us of an old New Yorker cartoon where the caption reads, "We're expecting stocks to rally but we don't know which ones and when." Well, at least we feel like we have some insight into "which ones".

When times are good, the emotional cost of putting money into the stock market is very low. Similarly, when the market is abysmal, the emotional cost of investing is high. Ironically, when the emotional cost is low, the market may be near a peak - therefore, the financial cost may be very high as the risk of loss is greater. Likewise, when the emotional cost is high, the market may be closer to a bottom - it may be very likely that the financial risk is abnormally low. Such dichotomies are what create the booms and busts that we see playing out in markets time and time again. Economics 101 teaches that falling prices attract buyers and rising prices repel them - except when they don't. Just as there are thousands of reasons to buy stocks when the market is at its peak, there

are thousands of reasons to avoid them at the trough. It feels reckless, risky and dangerous to buy stocks low and sell them high, despite this being the primary goal of investing. In today's market, it is very uncomfortable for investors to commit capital as the macro environment is depressing, corporate news is generally negative, looming political changes create uncertainty, and for the last 16 months the market has been declining. These are the conditions that are ripe for creating a poor emotional environment. Our feeling is that these same conditions have created a financial environment that has become much more attractive.

A recent communication from investment firm Tweedy, Browne reminded readers of the fall of 1962, when Russian naval ships were on their way to Cuba to confront the US blockade. One of their former partners was in their trading room, feverishly buying stocks in one of the biggest market meltdowns in stock market history. When asked by Howard Browne how he could be so confident in the face of such impending doom, the trader remarked, "either this is going to turn out okay and the markets will turn around, or the world is going to come to an end. In either event, I'll be fine as long as God doesn't require cash." Not to be flip-pant, but we believe this has parallels to today's market.

One of the more compelling positives is that the current conditions have prompted enormous government-led, globally coordinated policy responses to address the issues. Without these responses, fears of a Depression-like scenario would be more than justified. Normally, a government-led solution would give us pause; however, the current situation offers no alternatives, as no stores of private capital exist that can be put to work as quickly and effectively. We believe that a great deal has been learned since the Depression, when many monetary and fiscal policies enacted actually served to exacerbate and prolong the economic difficulties of the time. Policy actions to date, although not without flaws, have been targeted and some have been quite creative. Because there is no playbook to follow, current strategies will likely be modified, and the new administration will bring a host of new actions. Some will work, some won't, but the sum of the actions will likely prevent the downturn from becoming too detrimental and lay a foundation from which to build.

These actions do not come without a cost, however. As a

nation, we will be racking up large deficits to be borne by future generations to fund the stimulus programs. We are going to have to rely on the continued willingness of the rest of the world to finance these deficits, potentially resulting in higher interest rates and a debasement in the value of the dollar. There may also be unintended consequences (there always are) which will result in costs or sacrifices unknown today. Intervention itself is a cost, as it creates a giant moral hazard. We feel that an important goal for future administrations should be to get us to the point where intervention in the future will not be necessary. We can't really offer a prescription other than that capitalism itself should be a self-directing and self-policing mechanism. We wonder how we fell so far off the wagon?

Fixed Income Skinny Dipping Championship Experiencing Record Entries

Longtime readers of our quarterly commentaries might wonder why we almost always focus our comments solely on the equity markets when a significant portion of the assets we manage as a firm are fixed income (i.e. bonds). The short answer is that, if done right, bonds purchased with a focus on preservation of capital at slightly above market yields with an intention to hold until maturity should be uneventful. Or put another way, no news is usually good news when it comes to high credit quality bonds.

If done well, there should be relatively small differences in total return performance among fixed income managers who tell their clients that they put safety first. True to expectations, the differences during most years in such fixed income returns among the majority of such managers, and between such managers and their benchmarks, is small. In most years, our clients will hear us talk about the value we add by understanding and exploiting certain nuances such as buying "odd lots" – generally, bonds under \$100,000 of face value that garner very little institutional interest. Given the nature of the bond market, we are able to purchase these bonds at slightly lower prices, resulting in slightly higher yields to maturity (the opposite of a volume discount). Our bond clients hear from us about the added benefit of our lower management fee as compared to the average bond mutual fund; how we can get incremental yield when we're

willing to accept short call windows or sinking fund provisions, or by paying a premium to par for high coupon bonds; and about how we buy and sell bonds directly from market participants (placing multiple bids) instead of from our own inventory. All of this remains true.

But 2008 was not “most years.” 2008 was a year that crystallized Warren Buffett’s often-quoted observation that “it’s not until the tide goes out that you see who is swimming naked.” In 2008, it turns out that there were many fixed income managers who were skinny dipping. While it’s hard to compare apples to apples when talking about bond managers, consider the 2008 total returns for the average bond fund category as determined by Morningstar (we believe these performance numbers reflect actively managed fixed income managers, as opposed to passive index benchmarks):

Intermediate Term - Taxable:	-4.7%
Intermediate Term - Tax-Free:	-2.5%

For taxable bond managers, the challenge has been avoiding the many companies (i.e. bond issuers) that blew themselves up (no small task) as previously highly rated companies like Lehman Brothers debt became nearly worthless and hundreds of other companies’ debt was significantly devalued.

For municipal (tax-free) bond managers, there were a number of less obvious dangers lurking. As credit ratings of municipal bond insurers (companies in business to insure against a municipality’s default) were downgraded, many managers who relied solely on the former AAA ratings that insurance provided (without considering the underlying credit quality of the bonds that were being insured) were shocked to see the value of their bonds fall precipitously. Our policy when buying insured bonds has always been to focus on the underlying credit rating and to always purchase underlying issues rated A or better. Interestingly, bonds that had an underlying rating of A or better barely budged when their insurers were downgraded. Thus, we were not significantly impacted by the downfall of the bond insurers.

Bond managers who accepted long call windows (the length of time between the call date and the maturity date) saw the prices of their bonds fall dramatically. For example, one year ago, a bond with a 5.25% coupon callable in 2014 with a maturity of 2024 would have traded more like a 6-year bond

because of the likelihood it would be called in 2014 (based on the high coupon). However, when prevailing rates rose in the municipal bond market, it quickly re-priced (downward) to trade at yields comparable to 16 year bonds as the call was deemed less likely. We saw many examples of these situations playing out in real life as clients and prospects asked us to review shrinking bond portfolios held with other advisors.

Finally, those who failed to recognize the potential dangers of stretching for yield by sacrificing credit quality, extending maturities, or employing leverage (i.e. closed end bond funds) had their heads handed to them in 2008. The lesson is that this extra yield is never free - it comes at the cost of additional risk. In some cases, returns on these types of securities were as bad as, or worse than, equities.

We steered clear of these pitfalls and stayed true to our fixed income focus. And as a result, we were fully clothed when the tide rolled out in 2008. Because we manage both taxable and municipal bonds for clients and customize each portfolio based on individually agreed-upon durations, credit standards, and tax considerations, performance among accounts will vary modestly. That said, in aggregate, our fixed income investments returned 4.69% (net of fees) in 2008. (Fixed income performance was measured on a monthly basis based on accounts at the firm for an entire month). We are exceptionally pleased with this return in a year where the focus was more on return of principal than return on principal. Most of the work that drove our 2008 fixed income performance was done in prior years by our fixed income team, led by Rich Salerno, in positioning the accounts to succeed in turbulent markets. Likewise, the seeds of success for 2009 and beyond are being sown today. Rich’s team is enthusiastic about future returns, as the chaos in the current bond markets has unveiled opportunities that we haven’t seen in years. Time will tell how long this window remains open, but, in the meantime, opportunities abound.

Portfolio Activity

The nature of the sell-off this year has been exceptionally indiscriminate. In our opinion, the market has retreated beyond the point where you can say there is any rational judgment going into most stock prices. This kind of selling is usually suggestive of the presence of forced sellers. One source of such selling has come from the \$1+ trillion hedge

fund world, where funds have had to simultaneously satisfy the dual mandates of deleveraging highly levered portfolios and fulfilling a torrent of investor redemption requests. Just one of these dynamics would put pressure on the markets, but both playing out simultaneously creates havoc. The market also surely experienced the normal fear-redemption cycle of open end mutual fund investors (who have historically had a knack for getting out of, and into, the markets at just the wrong points in time) and investors attempting to sell in front of those they fear will be forced to sell. All of this has, in our opinion, created a lethal combination that produced outsized technical imbalances skewing stock prices lower, particularly in the October-November timeframe. Of course, the severe macroeconomic maladies and the near meltdown of our financial system, all trumpeted endlessly by the media, didn't help matters. Whenever we sense the presence of forced sellers through market action of this type, we tend to get energized. After all, this kind of seller is selling regardless of value and hence creates an opportunity for those of us who regard value as paramount.

Recent market experiences reinforce the cold, hard reality about investing; it is a process involving probabilities, not certainties. Dean Witter, speaking in May 1932, said "... some people say they want to wait for a clearer view of the future. When the future is again clear, present bargains will have vanished. In fact, does anyone think that today's prices will prevail once full confidence has been restored?" Parenthetically, Mr. Witter's comments came within weeks of the ultimate bottom in the bear market of the Great Depression. Since uncertainty is the rule, not the exception, we believe the key question to ask is not whether or when to invest, but rather how we should invest in order to maximize our chances of achieving a satisfactory long-term compound return. That brings us squarely back to our investment process of seeking to buy durable businesses with high returns on capital, high barriers to entry, and significant free cash flow generation over a cycle at value prices. We then hold them until the market prices converge with their higher intrinsic values. If you're right about the business, time should be your friend.

The companies we currently own are, for the most part, under-leveraged, and many enjoy net cash positions (more cash than debt). Virtually all of them have investment-grade ratings. We feel that these are the kinds of companies that

should be able to see their way through a recession and come out the other side stronger. The current environment will offer up significant opportunities for well-capitalized firms to augment their existing strengths. The strength of their capital structure and consistency of cash flows provide 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. Also, we believe our portfolios hold a much greater margin of safety than they did a year ago, and are at even better levels than those from which we have enjoyed solid returns in the past.

This past quarter, we were fairly active in adding new positions that we felt met all of the attributes discussed above. These positions included **3M Company (MMM)**, **Emerson Electric (EMR)**, **Diageo (DEO)** and **Philip Morris International (PM)**.

3M is one of the world's premier diversified industrial companies, with a vast mix of established products and brands. It is diversified by customer product and geography, selling more than 50,000 products in 60 countries. With its global scale and scope, the company benefits from very high-quality brands (i.e. Scotch, Nexcare, Post-it) and strong competitive positions in niche markets throughout the world. With sales spread among industrial and transportation (32% of sales), display and graphics (13%), health care (13%), consumer and office (13%), electro and communications (11%), and safety, security and protection (13%) end markets, it is a fair statement that while earnings will not be as volatile as most industrial companies', they will certainly follow the business cycle. Right now, that cycle is slowing worldwide (over 70% non-US operating income), and 2009 earnings will likely fall short of what was earned in 2007. However, the company possesses an extremely solid balance sheet and has consistently generated cash flow throughout the business cycle. Trading at the low end of its historical valuation with a 3.5% dividend yield, we believe that most of the dire news has been priced in at current levels while much of its strengths have not.

Emerson is another industrial company whose share price had taken a thumping as investors fled companies once

anointed as being part of the global growth phenomenon. Emerson is also widely diversified but primarily focused on the infrastructure and energy end markets.

Looking at Emerson, it's easy to see our attraction: a premier company in its niche markets, historically high returns on capital, steady margins, growing end markets (but possibly entering a cyclical decline), leading market share position with a large installed base, and a resolute focus on R&D. Like 3M, it also trades at a low valuation relative to its history and has a dividend yield approaching 4%. While earnings will most likely soften as world economic growth slows, we believe Emerson is well-positioned over a long period of time, and that earnings will be more defensive than many of its peers.

Diageo is a London-based seller of spirits, beer, and wine. Spirits account for the majority of revenue (70%), while beer (25%) and wine (5%) make up the rest. Top brands include Smirnoff (top vodka market share worldwide), Johnnie Walker whisky, Captain Morgan rum, Jose Cuervo tequila, Seagram's 7, Crown Royal and Guinness beer. All in all, Diageo boasts eight of the top twenty spirits brands worldwide.

Philip Morris International was spun off from Altria Group in March of 2008. While normally a spin-off is a less glamorous or out-of-favor business within the corporate structure, in this case, it was the prime jewel. With no domestic business, a clean balance sheet, and limited litigation risk, PM is set to focus on aggressive growth of its premier brands internationally. Its strong stable of brands and worldwide distribution network represent a sizeable competitive advantage. Brands include Marlboro, Philip Morris, Chesterfield, Parliament, and L&M.

"Even in recessions, people will still smoke and drink" is not our investment thesis on these last two consumer staple companies. That would be naïve. The fact that each has preeminent brands known the world over with global marketing scale, vast distribution systems, substantial cash flow generation capabilities, somewhat defensible earnings streams, and are trading at low valuations with dividend yields in excess of 5% is, on the other hand, a valid thesis and one that we feel will be rewarded over time.

These four situations highlight not only that price and value are different, but that it's precisely the fact that they can differ widely that creates opportunities to earn excess returns. In a world where immediate gratification is the watchword, the main reason companies' stock prices may differ from value is that there is a mismatch of time horizons (ours being of the longer variety).

We increased our position in **Target (TGT)** during the quarter and funded it with a reduction in what had been our second-largest portfolio position, **Wal*Mart (WMT)**. The decision to pare back Wal*Mart, a company that was seemingly built just for economic times like these, was not an easy one. However, part of our sell discipline is driven by constant comparison to alternatives. As the discount to our intrinsic value target shrinks, either because the market price increases (as was the case with Wal*Mart) or the target price decreases, we respond. We want to own less of a stock as it gets closer to our target and more of a stock that is farther away. As Wal*Mart was closing the gap, the share price of Target was moving the opposite direction from its value. Target's recent performance, whether due to the impact of the economy or certain company missteps (more the former in our opinion), has been lackluster and well below the high standards investors have come to expect from the retailer. Disappointment in a slew of monthly negative same-store sale announcements has caused a massive dumping of the once "fair-haired child" of retail. We've always felt the best time to buy a great company is when everyone else hates it. Coincidentally, that is when we first began accumulating shares of Wal*Mart.

We completely exited only one position during the quarter, selling our **Carters (CRI)** holding for what amounted to an essentially break-even transaction. Still, given the performance of the market over the holding period, it was one of our better performing stocks.

For those clients with taxable accounts, we conducted a series of trades with the purpose of capturing tax benefits from holdings currently in unrealized capital loss positions. The decline in the equity markets has provided us with an opportunity to shield a substantial amount of current and future capital gains and at what may be payable at a higher tax rate than which exists today. We structured these as a series

of paired trades (selling one and buying the other and then reversing it 31 days later) where we felt there would be high correlation between the movement of the two companies' share prices. We did it this way so that we maintained a similar aggregate exposure to the applicable industry and to the overall market. Some examples included **Home Depot (HD)/Lowes (LOW)**, **Walgreen (WAG)/CVS Caremark (CVS)**, and **Walt Disney (DIS)/Comcast (CMCSK)**.

Quotes

“People have always had this craving to have someone tell them the future. Long ago, kings would hire people to read sheep guts. There’s always been a market for people who pretend to know the future. Listening to today’s forecasters is just as crazy as when the king hired the guy to look at the sheep guts.” – Charles T. Munger, Vice-Chairman, Berkshire Hathaway

“... bear markets sometimes end with a bang, sometimes with a whimper. You’re more likely to see a unicorn in your backyard or a chimera in your kitchen than you are to spot an indisputable sign of market capitulation.” – Jason Zweig, The Wall Street Journal

Please Join Us in Welcoming

Susan Herrick joins us from Harris Associates and comes to KIG with over 10 years experience in the financial field. Prior to Harris Associates, she worked at American Family Insurance and William Blair & Co. LLC. She will be working closely with clients and portfolio managers on client services, the new accounts process, and account maintenance.



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