

# Investment Commentary

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KOVITZ INVESTMENT GROUP

*Capital Ideas.®*

## In this issue...

**Market and Performance Summary ..... 1**

**To Time or Not To Time  
- Is That Really the Question? ..... 2**

**Leverage - The Good Kind ..... 3**

**A Bond Bubble? ..... 4**

**Portfolio Activity ..... 4**

**Top Holdings Update ..... 5**

**Roth IRA Conversion  
- Potential Opportunity ..... 6**

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Past performance does not guarantee future returns.

## Market and Performance Summary

In the fourth quarter of 2009, the KIG equity composite rose 5.6%, bringing the full year gain to 26.9%. The S&P 500, our equity benchmark, gained 6.0% during the quarter and 26.5% for the year.

As the market has rebounded since March, stock prices of industry laggards have generally outpaced those of leaders as fears of a calamitous economic meltdown have abated. This is not a surprising event as many of the “laggards,” particularly those with heavy debt burdens, faced the real risk of default and possible bankruptcy, thus the sell-off was severe. In the cases where those fears went unrealized, the snap back was powerful. Given that we are generally invested in high quality market leaders, we feel fortunate that our investment performance actually outpaced the overall market this year. Although it’s not talked about often, we consider keeping up with the market while bearing less risk a greater accomplishment than beating the market while assuming more risk. Our feeling is that at some point that extra risk will come back to haunt you, and you never know when that will occur.

On a longer-term basis, our results continue to be extremely favorable versus the benchmark, notwithstanding the lesser risk assumed. Over our 13 year equity track record, the KIG composite has increased in value by 235%, or 9.74% on an average annual basis. Over the same time period, the S&P 500 has improved by 89%, or 5.00% per year. The compound effect of these annual differences demonstrates why Albert Einstein allegedly proclaimed that compound interest is “the most powerful force in the universe.” (Oth-

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ers claim Benjamin Franklin called compound interest the “eighth wonder of the world.”) Regardless of who said what, the fact is that \$1 million invested in equities with us 13 years ago would have grown to approximately \$3,353,000 (after all fees) as of December 31, 2009, while the same amount put into an S&P 500 index fund (before fees) would be worth about \$1,887,000. We love it when our two favorite subjects - mathematics and investing - are able to work in concert to produce such dramatic results.

Generally, our goal is to discover value where most have overlooked it. In the current market it may be hiding in plain sight. High quality businesses, which we define as companies with enduring competitive advantages that are conservatively financed and need relatively low amounts of capital, are selling at valuations that in most cases are no greater than where average businesses are trading. We view owning these advantaged companies as a risk-reward scenario firmly slanted in our favor. From this point, if these businesses merely act as average companies, then they are already priced as such. But if, as we expect, they perform as superior businesses - continuing to increase market share, generating significant free cash flow, and increasing returns on capital employed - then the combination of increased earnings with an expanding multiple should provide significant upside from here. At worst, downside should be less than the overall market given the disparity in relative valuation.

## **To Time or Not To Time - Is That Really the Question?**

Exactly one year ago, in our Winter 2009 letter, we wrote,

*“While we are of the belief 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 you’re someone who needs your investment capital next month, next quarter or even next year), now might not be the time you want to make your wager. While we are of the belief that the stock market is likely to 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.” What there will likely be is that 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.”*

The point of regurgitating this missive is not to point out how prescient we were, but just the opposite. We are as surprised as anyone that the market has done what it has done since we wrote it. At the time, we were fully expecting to repeat the exact same sentiment in this letter one year later, and that’s the point. The timing of market moves is never certain, especially when it’s time to move in and out of the market, but if you take a longer-term view and you have confidence in your analysis, then there’s no need to try and figure out the answer to the “when” question.

Most investors’ response to the market roller coaster over the past year or two includes a belief that it’s absolutely necessary to time the market. However, if recent experience isn’t the poster child for the fallacies of market timing, we don’t know what is. Consider this statistical tidbit: since World War II, equity prices have declined by at least 33% on thirteen occasions, or roughly one year out of every five. These declines were obviously unpredictable (i.e. you couldn’t have known in advance), but ultimately imperceptible over the long-term. The market stands roughly sixty times higher (5900%) than it did before the first of the thirteen cataclysms, and this does not even include the impact of dividends received! The wild market price moves don’t cry out for wholesale exits and reentries, but for patience, perspective and confidence.

We have often noted that our most important competitive advantage is our time horizon. Acting on that advantage is dependent on having a view that equity investments are long-term ownership stakes in businesses rather than fast moving bits of paper. This advantage was never more appar-

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ent than this year. To be able to focus on “what” rather than “when” allowed us to hold positions in great companies with low fundamental risk through the turbulence of the market and economic gyrations and stress.

“What” as opposed to “when” serves as the basis for what we regard as intelligent investing. “What” not only encompasses our focus on owning only the best businesses but also our belief that estimates of intrinsic value drive every decision. An asset isn’t an ephemeral concept you invest in because you think others will think it’s attractive or avoid because you think others may think it’s unattractive. An asset (at least those that we consider for investment) is a tangible object that should have an ascertainable intrinsic value. If it can be bought well below its intrinsic value, you should consider doing so. Price in relation to value has to be the starting point. There’s no such thing as a good investment regardless of price.

So if trying to time the market is not the right approach, what is? In our opinion, the focus should be on setting the correct asset allocation between stocks and bonds. Going into 2008, many investors were assured that divvying up their portfolio into many different types of equity classes (i.e. large cap growth, small cap value, emerging markets, commodity-related, etc.) would protect them from large market losses, and this emboldened them to reduce their exposure to high quality bonds. We call this ersatz diversification in that diversification among risky assets is no substitute for genuine diversification. Genuine diversification includes “risk assets” combined with “safety assets.” In other words, it comes from stocks versus bonds not stocks versus stocks.

Our view diverges from many in the investment business who can’t seem to alter their attention from “when” to “what.” However, we prefer rational thought to irrational convention.

We thought we’d conclude this analysis with the views of someone with a fairly high stature in the investment world.

*“Increasing importance has been ascribed in recent years to the desirability of buying and selling at the right time, as distinguished from the right price. In earlier periods, when the prices of investment issues did not usually fluctuate over a wide range, the time of purchase was not considered of*

*particular importance... The past decade has witnessed very wide fluctuations. Under these conditions it is not surprising that successful investment seems, like successful speculation, to be bound up inescapably with the choice of the right moment to buy and to sell. We thus find that forecasting of the major market swings appears now to be an integral part of the art of investment in common stocks.”*

While this sounds as if it could have been written at any point in the last year, it was actually taken from Benjamin Graham’s classic investment primer, “Security Analysis,” which saw its first edition published in 1934. (Apparently, we’ve been fighting this battle for quite some time.) Graham wraps up his thoughts on the matter with this:

*“It is our view that stock market timing cannot be done, with general success, unless the time to buy is related to an attractive price level, as measured by analytical standards... We cannot avoid the conclusion that the most generally accepted principle of timing- viz, that purchases should be made only after an upswing has definitely announced itself- is basically opposed to the essential nature of investment. Traditionally the investor has been the man with patience and the courage of his convictions who would buy when the harried or disheartened speculator was selling. If the investor is now to hold back until the market itself encourages him, how will he distinguish himself from the speculator, and wherein will he deserve any better than the ordinary speculator’s fate?”*

We’re guessing he felt that an ordinary speculator would likely fare worse, in the aggregate, than an investor. Amen.

## Leverage - The Good Kind

We have witnessed that leverage (in its strictest sense, taking on liabilities and investing the proceeds in order to magnify returns) has a dark side. In good times, it can be an investor’s best friend, but it can lead to ruin in times of stress or panic. However, there are certain forms of leverage that can benefit an equity investor. Companies can employ financial leverage whereby they can take on fixed cost debt. This is not much different than the type of leverage first mentioned, but done conservatively and assuming the business can generate enough cash flow to service the debt, taking on this leverage may be a reasonable way to enhance equity holders’ returns by financing profitable growth without issuing addi-

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tional equity and diluting existing shareholders. Operating leverage is another form of leverage from which an investor can benefit. This occurs when a company's costs are primarily fixed (as opposed to variable with revenue generation), whereby revenue increases lead to more profit falling to the bottom line. It can cut both ways, however, as we have seen how recent declines in revenue have led to large earnings declines. Earnings growth leverage is a third type. Investors in companies which are perceived to be able to grow their earnings quickly can experience increased returns as the market discounts that growing earnings stream. We must be weary, however, of companies with astonishing growth prospects whose stocks become priced for perfection, as any small deviation from the expected can lead to massive share losses. These three forms of leverage, while not without peril, can benefit equity investors if carefully employed. Many of the companies we buy or consider buying use or are benefited by one or more of these types of leverage.

Another form of leverage, which so often gets overlooked by investors, is "revaluation" leverage. This is the leverage achieved when a stock is revalued by the market and its price-to-earnings (or price-to-book, price-to-sales) multiple expands. Revaluation can occur when temporary business underperformance reverses, pessimism towards a whole sector (i.e. consumer discretionary) subsides, or company specific issues thought to be significant turn out to be manageable. This concept of revaluation/multiple expansion embodies two of our most strongly held investment beliefs: intrinsic value and margin of safety. Constantly reminding ourselves to relate what is being paid to what is being offered (value) is constructive, and we naturally seek companies that offer a lot of value for a low price. Intrinsic value rarely follows stock price movements in the short-term, and downside is much more limited for companies selling at depressed multiples with expectations low, than for stocks of companies that are market darlings or those that are in high momentum sectors. Not getting sidetracked by issues or events that don't truly relate to business value provides a constant flow of potential candidates for revaluation and offers a solid foundation for what should be the sole focus of any sound investment philosophy: buying low and selling high.

## A Bond Bubble?

As equities have risen more than 60% off the depressed

March valuations, we've heard a lot of talk about a "bubbling" stock market. While we don't share that view (see our Fall 2009 Newsletter at [www.kovitzinvestment.com](http://www.kovitzinvestment.com) - "Historical Performance & Commentary"), what we haven't heard much about is that the bond market might be a bit frothy and perhaps in some form of a bubble. While domestic equity mutual funds and ETFs have actually seen outflows over the last two years, bond funds have seen a massive inflow of funds during 2009 as investors have looked for higher yields than are available in money market funds and short-term CDs. Over the first eleven months of 2009, more than \$400 BILLION flowed into bond mutual funds and bond ETFs. We have some concerns about the impact on those investors who have plowed their capital into these funds, especially those that have never experienced the affects of a rising interest rate environment. We're not sure that many of those bond fund investors appreciate what can happen to the value of their funds if/when interest rates begin to rise, especially since the last time we had a sustained rise in intermediate bond rates was 1994-1995. We suspect that once intermediate rates start rising and those bond fund investors start seeing the value of their bond funds decline by 5%, 10%, or 15%, those net inflows could turn into net outflows fairly quickly, and put further pressure on bond prices.

None of this should be a major concern for you, our clients. First of all, unlike bond fund investors, owners of individual bond issues can rest assured that absent issuer default (which remains negligible in our portfolios), you will ultimately receive 100 cents on the dollar as bonds mature vs. being at the mercy of a fund's net asset value at the time of exit. Secondly, you may recall from our Summer 2009 Newsletter that we have shortened our bond ladders a bit in hopes of having more funds available to purchase bonds with higher yields later in 2010 and 2011 should interest rates rise.

Financial advisor and contrarian extraordinaire Nick Murray put it best: "Buying bond [funds] here looks like slipping past the entire Bolivian army so you could join Butch and Sundance down there in that stable."

## Portfolio Activity

Back in March, it seemed all our portfolio companies were cheap. As the market has trended upward, our stocks have

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moved along with it in varying degrees. Some have moved powerfully off their lows while others have lagged. As a result, we have used the strength in certain names to pare back exposure while increasing our exposure in those that currently seem the most undervalued. In other words, we are concentrating the portfolio on our highest conviction names based on our assessment of upside potential versus downside risk. After all, capital allocation, our primary responsibility, is a matter of discovering where we can generate the highest return adjusted for the relevant risks.

During the quarter we trimmed our positions in **3M (MMM)**, which was up approximately 100% from its low, **Bed Bath & Beyond (BBBY)**, which was up over 100%, **Walt Disney (DIS)**, which was also up over 100%, **Boeing (BA)**, which was up over 90%, and **Franklin Resources (BEN)**, which was up almost 200%. We still maintain positions in all of these despite the stratospheric gains since March as we still believe each of these companies is undervalued. The gains are somewhat deceptive as they are being measured from a base to which they probably should have never traded down. We also exited completely our positions in **American Eagle Outfitters (AEO)**, which was up over 100%, **Target (TGT)**, which was up almost 100%, and **UBS (UBS)**, which was up about 120%. Again, all of these percentage gains are measured from these holdings' 2009 lows.

The capital freed up from these fourth quarter trims was used to increase position sizes in the following: **Berkshire Hathaway (BRKB)**, **Wal\*Mart (WMT)**, **Automatic Data Processing (ADP)**, **Johnson & Johnson (JNJ)**, **Procter & Gamble (PG)**, **CVS Caremark (CVS)**, and **Lowes (LOW)**. We believe that the market is giving us a rare opportunity with the under-pricing of these high quality names, and we are attempting to exploit this opportunity by further concentrating our portfolios in them.

We made only one new purchase during the quarter, medical device maker **St. Jude Medical (STJ)**. St. Jude operates primarily in the cardiac rhythm management sector where it has grown its market share steadily in both pacemakers and implantable cardioverter defibrillators (ICDs). The stock sold off with its last quarter's earnings release as sales to its hospital customers came in less than expected. Further concerns about the uncertain impact of health care reform

on device makers also served to dampen enthusiasm for the stock. As a result of slowing market share gains and potential impact from reform, we believe the future earnings growth rates are likely to come down from their recent lofty levels, but we believe that the valuation at the price we paid more than compensates for these headwinds.

On November 3, Berkshire Hathaway announced its intention to acquire a portfolio holding, **Burlington Northern Santa Fe (BNI)**. Given that BRK already owned 22% of the shares outstanding, the intent to acquire the remaining shares was not a complete surprise, even if the timing of the announcement was unexpected. The 30% premium (Berkshire's offer price) to the then current market price was in line with our intrinsic value estimate, so we feel fairly compensated. Because we are also holders of Berkshire, it's one of those rare times where our elation at owning the buyout target quickly dissipated and our attention turned to the acquirer to make sure the acquisition adds value. Our litmus test regarding an acquisition is whether it's a better use of cash (or stock, or debt, or a combination of all three as it is in this case) to acquire the target or allocate a similar amount to shareholders in the form of a dividend or stock buyback. We are not disappointed. We feel Berkshire got an extremely valuable asset to add to its stable of businesses. More importantly, Berkshire should be able to generate an attractive return on capital at the price paid even assuming large future capital investments into the railroad. It also solves a problem for Buffett as to how to deploy Berkshire's steadily increasing cash balances.

## Top Holdings Update

As you know, one of our criticisms of mutual funds is that they often hold too many companies in the name of diversification. We wonder why you would want to invest in their 100th favorite name as well as why they invest so little of the fund's assets in that name. Our portfolios are concentrated in our highest conviction ideas. The performance of these names will most likely have the greatest impact on the overall performance of the portfolios. As of December 31, 2009, these are the top 15 holdings in our portfolios:

Company	Percent
BERKSHIRE HATHAWAY	6.2%
WAL MART STORES	5.7%
WALGREEN	4.6%
LOWES	4.0%
AUTOMATIC DATA PROCESSING	4.0%
PROCTER & GAMBLE	3.7%
BED BATH & BEYOND	3.5%
BOEING	3.4%
ACCENTURE	3.4%
DIAGEO	3.2%
CARMAX	3.2%
ROBERT HALF INTL	3.2%
BANK OF NEW YORK MELLON	3.2%
QUEST DIAGNOSTICS	3.1%
JOHNSON & JOHNSON	3.1%
TOTAL	57.5%

As a reminder, if you are new to KIG, you may not own some of these stocks in that they are no longer trading at the substantial discount to their intrinsic value that they were at the time they were first purchased.

## - Client Notification -

### Roth IRA Conversion - Potential Opportunity

Until now, high income taxpayers have not been eligible to convert traditional IRAs to tax-exempt Roth IRAs. Beginning on January 1, 2010, all taxpayers will have the opportunity to convert IRAs to a Roth IRA. For many taxpayers, a conversion to a Roth can be a smart decision, but such a decision should not be made lightly, as a conversion involves paying current income tax on your IRA balances.

#### Some of the advantages of a Roth conversion include:

- Tax-free versus tax-deferred growth of your assets going forward
- No required distributions during your lifetime, thereby providing longer periods for tax-free compounding if the assets are not needed

- Greater flexibility to manage taxes in retirement
- Estate tax savings for taxpayers who are in estate taxable situations.

#### Furthermore, there are many variables that can affect the attractiveness of a Roth conversion, including:

- Current and future marginal tax brackets all are assumptions
- Age/life expectancy
- Whether you can pay the tax generated by the conversion with non-IRA assets
- Whether you expect to need the converted IRA asset to support your retirement versus passing them on to your heirs
- Whether you are in an estate taxable situation
- Who your IRA beneficiaries are likely to be
- The amount of your current IRA balances, if any, which were funded with after-tax dollars.

Other considerations include the ability to do partial conversions, potentially over multiple years, to take advantage of lower tax brackets, and the unique ability to change your mind and “un-convert” as much as 21 months later if facts and circumstances no longer make conversion attractive.

**If you would like us to take a closer look at whether a Roth conversion could make sense in your particular situation, please contact your KIG advisor or email us at [rothconversion@kovitzinvestment.com](mailto:rothconversion@kovitzinvestment.com).**

## Quotes

“The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant but a giant.”

- Arthur C. Pigou, English Economist (1877-1959)

“Business bookshelves overflow with titles promising formulas for success in the stock market. It makes one wonder why everyone is not yet wealthy. Could it be there is no magic formula?”

- Paul Orfalea, West Coast Asset Management





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