

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

During the third quarter of 2010, the Kovitz Investment Group (KIG) equity composite increased 10.8% (after all costs and fees) while the Standard & Poor's 500 (S&P 500) gained 11.3%. On a year-to-date basis, the KIG composite is up 5.7% vs. a 3.9% increase for the S&P 500.

Since the inception of our performance history (January 1, 1997) through September 30, 2010 (13.75 years), KIG's equity composite is up 254% (9.6% annualized), as compared to the S&P 500's rise of 96% (5% annualized).

Traders' Environment

For some time now, each day's trading appears to hinge, not on price or valuation, but on macroeconomic data points that apparently trip some remote signal declaring "risk on" or "risk off." Consequently, stocks trade in lock step - either up or down- relative only to their beta (i.e., their general/historic correlation to the greater market). Somewhere, Mr. Market delights.

It's not necessarily a new phenomenon that securities are often chosen, not because of their value, but because of other less tangible qualities. Recently, a *Wall Street Journal* article declared that the price to earnings (P/E) ratio, a fundamental yardstick used to quantify the value of a company's shares, is in danger of losing its prominence as

a market gauge. Its author, a former day trader, implies that the ascendance of computer-driven trading is making macroeconomic data and trading patterns more important than fundamental analysis of individual companies.

As an investor you have a choice. You can decide to invest in a business as an owner and share in the profits generated. Or you can decide to buy a piece of paper in hopes that someone will buy your paper at a higher price than what you paid for it. The problem most investors face is that the first method takes time and patience. Also, many measure the value of a business by the daily market price of the shares. We believe that thinking only about short-term price swings as opposed to the business operation's performance places you in a game that's hard to win. To play that game, you are forsaking logic and critical thinking for guessing how others are thinking and how others may react.

To us, however, a sound investment must be justified on both qualitative and quantitative grounds. We take comfort in investing in high quality, well financed businesses at meaningful discounts to our very conservative estimates of intrinsic value. Our strict price consciousness can be characterized by our willingness to only invest in those securities which we believe are attractively priced based on current normalized earnings rather than optimistic future forecasts which can, and often do, ultimately prove inaccurate.

We evaluate an investment opportunity based on the predictability of the business, its free cash flow, and a dispassionate calculation of its expected return. As impersonal odds makers, predictability is important to us. All that is readily analyzable is a company's past record (sales growth, margins, return on capital, competitive positioning, etc.). The challenge then is to determine the utility of the past record as an indication of future cash flow. Is the future of the business adequately predictable so as to permit a long-term investment? Is the industry going to attract numerous competitors? Is the business subject to being undermined by a new technology? Is consumer taste changing? Will the business be squashed by cheaper

imports? Is the internet changing the economics of the business or industry? In other words, we tend to think through multiple scenarios and determine a value for the business based on our probabilistic estimate of those outcomes. Our estimates and valuations are based solely on the facts.

We would argue that the market typically does not act in such a methodical or disciplined fashion. With time horizons compressing and the rate of high frequency trading strategies increasing, it seems that values are assigned without any fundamental analysis, and the rationales for those values are attached afterwards. For this reason, the prices of common stocks are not necessarily the result of carefully thought out computations, but the result of myriad human (and computerized) reactions. This is the primary influence behind Benjamin Graham's famous dictum that "the stock market is a voting machine rather than a weighing machine." Prices respond to the decisions of buyers and sellers and not necessarily to factual data. But Graham's pronouncement was confined to the short run. He was confident, as are we, that the market ought to approximate a weighing machine in the long run. In other words, market prices must ultimately converge with economic value.

While we must make assumptions about the future, which is admittedly uncertain, our fundamental basis of appraisal must be grounded in logic. There will be a time when the market must confront this reality as well.

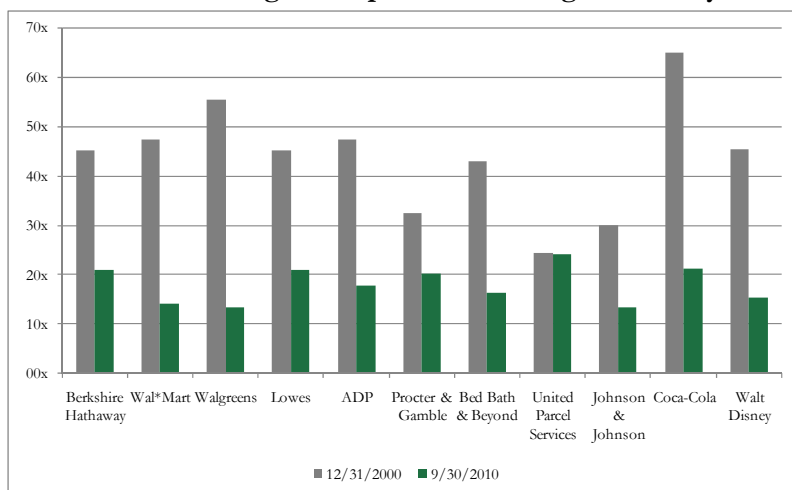
Lost Decade?

The prevailing view in the investment community has been that the equity market will earn a high rate of return if the holding period is long enough. But with returns for the S&P 500 over the last 10 years (a period many investors assumed to be "long enough") running negative, this central tenet is being thrown into question. It even has many questioning the next decade and forecasting similarly downbeat returns.

Let's try to put the last decade in perspective. While we will never make specific economic, political, or market predictions, we do evaluate potential future returns. We do this by making assumptions and assessing probabilities (not by making predictions - the difference is enormous). One way we accomplish this is to look at the current price of an individual asset (or general market) in relation to what it may be worth in the future under certain assumptions. If the current price is too high, the future returns will be lower than what they would be otherwise. Another way to say this is that the entry point of an investment matters as much as any other single variable. Entering at a low price doesn't assure good returns, but entering at a high valuation likely ensures lousy returns.

So what was the pricing like a decade ago? Looking at the comparison of P/E multiples of several of our current top holdings ten years ago versus today is informative. Each of these is a major constituent of the S&P 500 index and therefore may serve as a proxy for that market. (Incidentally, other than **Berkshire Hathaway (BRKB)**, we did not own any of these names back then as our opinion was that they were more than fully valued and upside over any reasonably long time period was severely limited.)

Price to Earnings Multiples: 10 Years Ago vs. Today



The high absolute level of these P/E multiples ten years ago suggests this was not an ideal entry point, and it's totally unsurprising that performance was less than stellar

over the ensuing time period. The question to have asked at that point was not what the historical performance of stocks had been but what the future performance is likely to be when priced at historically high P/E ratios.

Throughout this period, we objectively and methodically stuck to our discipline of balancing risk and reward by investing in high quality companies at attractive valuations. Preparing for (though not necessarily predicting the occurrence or timing of) severe declines in valuation, being opportunistic during the ensuing turmoil, and remaining objective throughout allowed us to produce solid results in what proved to be an otherwise difficult ten year period for the S&P 500.

Over this time period, the KIG equity composite returned a positive 43% compared to a negative 4% for the S&P 500. \$1 million dollars invested with KIG on September 30, 2000 would be worth \$1,430,000 on September 30, 2010, while the same amount invested in the S&P 500 would be worth \$960,000.

As for the next decade, we are optimistic. This view is based primarily on two factors. The first is the entry level. We believe that current valuations of our portfolio holdings are very attractive, both on an absolute level and relative to history. While it doesn't guarantee any outcome, starting at these levels certainly stacks the probabilities firmly in our favor.

The second is the characteristics of our current portfolio. Our holdings produce significant amounts of free cash flow, possess extremely strong balance sheets, and have dominant market shares in many of their product categories. Should the economic fears that dominated the last couple of years revisit the market, these businesses should offer far better than average downside protection based on current valuations and these characteristics. Should a moderate or strong economic environment emerge, appreciation potential should be ample. These businesses also possess the ability to take pricing higher if inflation becomes an issue at some point down the road. Alternatively, should a deflationary environment take

hold, the strength of their financial conditions should protect their competitive positioning and keep them from cutting their dividends.

Our final thought on the subject: Perhaps a tremendous disservice is perpetrated by the idea that stocks are for the long run, because you have to make sure you are around for the long run. That means that when you have unexpected pain, as most investors did in 2008, you don't panic and get out. As uncomfortable as it may have seemed, absent exigent circumstances, that was the time where you at least needed to be a holder of the risk-related assets you already owned, and preferably a net buyer of more. Investment outcomes are usually dictated more by temperament than by intellect, and the single greatest obstacle to investment success is one's proclivity to panic. Remaining unemotional as we consistently strive to do keeps us in the game and around for the long run where we can profit through the ups and downs.

Dividend Yields vs. Bond Yields

The current dividend yields of some of the highest quality companies in the world are comparable to or exceed the bond yields of the debt issued by those same companies. This is strange. A brief historical review illuminates why we feel that way. There was a time, up until about fifty years ago, when dividend yields consistently exceeded bond yields. The thinking then was that since equities were riskier than debt, stocks should yield more than bonds. Eventually, however, investors came to understand that stocks contain a growth element, unlike bonds, which only contractually obligate the issuer to pay a fixed amount of interest and return the principal at a given date. This means that the total return for bonds held to maturity is the yield determined at purchase - no more, no less. However, for stocks, the equity owner theoretically has limitless profit potential. As a general rule (assuming no expansion of the P/E multiple), the total return to stocks is the dividend yield plus the rate of growth in earnings per share. As a consequence, dividend yields have been in general decline versus bond

yields, and for quite some time debt yields have exceeded dividend yields. Today, however, we are seeing signs of that reversing.

Recently, companies such as **Johnson & Johnson (JNJ)**, **IBM (IBM)**, and **Microsoft (MSFT)**, among others, have issued debt at historically low levels. In each case, debt at various maturities was priced at yields below the company's dividend rate. **Abbot Labs (ABT)**, **Coca-Cola (KO)**, and **Procter & Gamble (PG)** (all current holdings) also have dividend yields approximately equal to yields on their long-term debt.

These are all strong multinational companies with fantastic brands. Why are their bonds yielding less than or equal to their dividend yields? We think it is primarily due to fear. Many investors whose portfolios were crushed during the recent financial and economic crisis sold out at the bottom and never bought back in. The crisis seared an indelible imprint on the psyche of the investing public, scaring it out of stocks and into bonds. This can readily be seen in the massive inflows into bond funds over the past 18 months and the continuing outflows from domestic equity funds.

Bonds are usually labeled as the "safe" asset and stocks the "risky" one. But these labels cannot always be relied upon. It all depends on price. Nothing is so safe that at a high enough price it won't cease to become so. Alternatively, a risky asset at one price (higher) may become safe at another one (lower). At today's prices, the usual labels may well be reversed. Of course, if you hold the bond to maturity and there is no default, you will get your principal back and the bargained for yield. The inherent risk today is one of opportunity cost. Holding a low yielding instrument versus the potential for a higher return elsewhere - high quality dividend paying stocks.

Portfolio Activity

It was another relatively quiet quarter in terms of activity. As you can probably tell, we really like what we own and

therefore our quality filter is turned up very high. We have to really love an alternative investment to displace one of our current holdings and we are finding relatively few of those.

Among those we did find were two healthcare companies, **Becton Dickinson (DBX)** and **Medtronic (MDT)**. The healthcare sector has been in upheaval as the passage of the new healthcare reform legislation has turned what has always been perceived as a defensive sector into one with new risks. The downbeat economy has also contributed to the uncertainty and missed earnings expectations as doctor office visits and elective procedures have been deferred. These risks are real but price has a way of curing many ills. Valuations in the sector have compressed and share prices of many of the leading companies appear to be discounting the current environment into perpetuity. We are more sanguine on the future of important and essential companies like Medtronic and Becton. Each is a market leader with high levels of financial strength and competent managements who have demonstrated a prudent approach to capital deployment and the repatriation of cash to their shareholders. Like most of our purchases, we are not saying that we're convinced that the market's valuation is wrong, but rather we're not convinced that its valuation is right.

Becton Dickinson and Company is a medical technology company that has been around for over 100 years. In that time, the company has created, maintained, and advanced a swath of product franchises, primarily in basic devices such as needles, syringes and surgical blades/ scalpels. More recently, the company has developed large diagnostics and biosciences units. Many of their products are leveraged to powerful secular trends underway in healthcare, including an intensifying focus on patient safety, a rapidly increasing prevalence of diabetes and cancer, and a rising proportion of therapeutics delivered intravenously or intramuscularly. While not impenetrable, most of Becton's franchises are largely insulated from the heightened reimbursement, regulatory, and innovation risks that are impacting many healthcare companies today. Becton has a \$17 billion market cap and does

north of \$7.5 billion in very diversified (by product line), global sales with 23% operating margins. It also generates impressive free cash flow, regularly returns 16% on a full counting of invested capital, and yields a 2% dividend at its current price.

Medtronic is one of the largest and most diverse medical device companies in the world with approximately \$16 billion in sales, 40% of which come from outside of the United States. The company operates in seven distinct segments, the largest of which are cardiac rhythm management (pacemakers and implantable cardioverter defibrillators), spine, and cardiovascular (drug eluting stents). While pricing has come under certain pressures, demand for its products should stabilize as the products are primarily needs and not wants. We believe Medtronic has a durable franchise with significant competitive advantages, and is trading at a trough multiple on depressed earnings and free cash flow while yielding 2.7%.

We like the companies and we like the valuations. Based on the prices paid - Becton Dickinson was valued at 13x calendar year 2010 earnings and Medtronic 9x - we feel most of the negative headwinds are priced in. If results turn out even slightly less dire, earnings growth and the expansion of the P/E multiple should provide for substantial upside.

Fun With Warren

Now and again, as we reread Warren Buffett's letters to shareholders (going back to 1957), we come across a passage that may strike us differently or have more relevance to current events than the last time we read it. The one we've reprised below from his 1966 edition certainly has significance today.

“After the Dow declined from 995 at the peak in February to about 865 in May, I received a few calls from partners suggesting that they thought stocks were going a lot lower. This always raises two questions in my mind: (1) if they knew in February that the Dow

was going to 865 in May, why didn't they let me in on it then; and (2) if they didn't know what was going to happen during the ensuing three months back in February, how do they know in May? There is also a voice or two after any hundred point (*equivalent to roughly 1000 Dow points today*) or so decline suggesting we sell and wait until the future is clearer. Let me again suggest two points: (1) the future has never been clear to me (give us a call when the next few months are obvious to you – or for that matter, the next few hours); and (2) no one ever seems to call after the market has gone up one hundred points to focus my attention on how unclear everything is.”

While we love his tongue and cheek observations above, his conclusion (below) is what's really important in providing a blueprint for investing as a pragmatic, and not an emotional, endeavor.

“If we start deciding, based on guesses or emotions, whether we will or won't participate in a business where we should have some long run edge, we're in trouble. We will not sell our interests in businesses (stocks) when they are attractively priced just because some astrologer thinks the quotations may go lower even though such forecasts are obviously going to be right some of the time. Similarly, we will not buy fully priced securities because “experts” think prices are going higher. Who would think of buying or selling a private business because of someone's guess on the stock market? The availability of a quotation for your business interest (stock) should always be an asset to be utilized if desired. If it gets silly enough in either direction, you take advantage of it. Its availability should never be turned into a liability whereby its periodic aberrations in turn formulate your judgments. A marvelous articulation of this idea is contained in chapter two (The Investor and Stock Market Fluctuations) of Benjamin Graham's “The Intelligent Investor”. In my opinion, this chapter has more investment importance than anything else that has been written.”

Our Promise

In these letters we typically lay out our investment principles, report on recent and historical performance, and recap moves made in the portfolio. But we're not sure we've really ever explicitly laid out what we promise each and every client. While we wish we could promise investment results, we are, of course, unable to do so. However, we fervently believe that following the guiding principles set forth below will serve our performance, particularly relative to our benchmark, well.

- We will follow our investment strategy regardless of the environment. When markets are in turmoil, when it's toughest to stay the course, is when it's most imperative (and ultimately most rewarding) to do so.
- The above referenced investment strategy includes: 1) choosing investment holdings based on value and not popularity or emotion, and 2) incorporating a large margin of safety in each investment decision in order to limit the risk of permanent capital loss (as opposed to short-term quotational loss).
- We will think more than we act. Most of the investment world does the opposite.
- Partners and employees of KIG will continue to have virtually all of their liquid investable assets in the same holdings as you.

Please Join Us In Welcoming

KIG is proud to announce three additions to our firm. Matthew Wieneke, a recent graduate of the University of Wisconsin at Madison, and Samuel Lee, a recent graduate of the University of Illinois at Urbana-Champaign, will be assisting in many operational areas of our organization, including the bond desk, equity trading, and client service. Maria Brumbach also joins our organization as an administrative assistant with over 15 years of experience in executive and administrative support.

Quotes

“Evidently the processes by which the securities market arrives at its appraisals are frequently illogical or erroneous. These processes are not automatic or mechanical but psychological, for they go in the minds of people who buy and sell.”

- Benjamin Graham

“No constant reader of *Grant's* needs to be reminded how rarely the light of prediction illuminates the darkness of the future.”

- James Grant, *Grant's Interest Rate Observer*



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