

# 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 Kovitz Investment Group (KIG) equity composite decreased in value by 13.9% during the third quarter, bringing the 2011 year-to-date return to -9.2% (net of fees). The broad market, as represented by the Standard & Poor’s 500 (S&P 500), decreased 13.9% for the quarter and is down 8.7% for the year.

For a longer-term perspective, the following chart details our annualized equity performance since beginning our audited track record on January 1, 1997.

**Annualized Net Performance  
For Periods Ended September 30, 2011**

	Latest 1-Year	Latest 3-Year	Latest 5-Year	Latest 10-Year	Since Inception
<b>KIG</b>	-0.5%	3.0%	-1.0%	4.5%	9.0%
<b>S&amp;P 500</b>	1.1%	1.2%	-1.2%	2.8%	4.8%

On a compounded return basis, the results over the same time periods are as follows:

**Cumulative Net Performance  
For Periods Ended September 30, 2011**

	Latest 1-Year	Latest 3-Year	Latest 5-Year	Latest 10-Year	Since Inception
<b>KIG</b>	-0.5%	9.1%	-5.0%	55.3%	257.4%
<b>S&amp;P 500</b>	1.1%	3.7%	-5.8%	32.0%	98.2%

From the most recent market top in late April through the end of the quarter, the S&P 500 declined about 17%, driven lower by the unresolved sovereign debt situation

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in Europe and the rising risk of recession in the U.S. Taken at face value, a market sell-off that leaves the market down less than 10% year-to-date may not seem particularly newsworthy. However, the return of what was once considered unprecedented daily volatility and high correlation of stock price movements has left investors with an eerie sense of déjà vu. In fact, it is likely that the emotion driving this current downturn has been intensified by the still vivid memory of the 2008-2009 financial panic. Nevertheless, though emotional and behavioral biases tend to win out over objectivity over *short* periods of time, all is not lost. For the patient and thoughtful investor capable of investing over *longer* periods of time, lower prices can be beneficial.

Not to be misconstrued, we are extremely cognizant of the current issues being faced here and abroad and recognize that they are serious in nature. We have had countless discussions about these concerns and the potential impact on the businesses we own. But we also recognize that the world has always had and will always continue to have problems that make investing (and life) scary and uncertain. Unless the issues demonizing the world today are severe enough to bring down civilization as we know it (or, to be slightly less dramatic, wreak very significant and prolonged economic havoc), then we believe that this time is *not* all that unique. In other words, we'll go out on a limb and conclude that if, for example, an uncontrolled Greek sovereign debt default occurred, the global economy would survive after the inevitable disruption. During this disruption, **Wal\*Mart (WMT)** (to pick one of our holdings) would continue to produce large sums of cash flow available to its owners thus making the current price still attractive. We are not being dismissive, but it is not a coincidence that every similar past period has proven to be an advantageous time to have owned solidly capitalized, profit-maximizing businesses that stand a good chance of protecting and growing cash flow on an inflation-adjusted basis.

Today's issues also do not change the fact that the highest quality businesses with strong competitive positions are trading at extremely attractive valuations. Earnings

will trump emotions over time; the laws of economics (and mathematics) make it so. In last quarter's newsletter, we dissected multi-year cash flows under a "normalized" and a "recessionary" scenario. We showed that, under the latter, intrinsic values of businesses should only be impacted by 3-4%, yet markets routinely sell off at 15-20% clips when recessionary fears are pervasive. For one inclined to notice, this creates a compelling opportunity - the ability to buy an asset that was already trading at a 30-40% discount to our conservative assessment of intrinsic value for an additional 15-20% markdown.

We don't make investments just for the sake of appearing active. In order for us to invest, we must believe we're being compensated in the price we are paying for the risks we are accepting. This seems to be the most misunderstood element of investing - PRICE MATTERS! At current prices, we believe (and this is not to say they couldn't move lower from here in the short run) the stocks (i.e., businesses) we own are extremely attractive in terms of their risk-adjusted return potential over a multi-year period.

## The "Afraid Trade"

If uncertain markets are characterized by increased volatility and high correlation among individual securities, then we find ourselves in the middle of one of the most uncertain markets in recent memory. We've witnessed some extraordinary volatility during the quarter with multiple daily moves both up and down in the 4-5% range. Market participants appear to be treating each day's trading as a binary event - either the world's falling apart or it's not. On days when the end appears nigh (or at least when the media tells us so), markets tumble. When the collective view is that things just might be O.K., markets soar. (And those days may be one right after the other!)

It's tempting to believe that the markets have been responding rationally to global economic and political developments, and that volatility of this magnitude some-

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how makes sense. Don't believe it - "rational markets," particularly in times of great uncertainty, is an oxymoron of the highest degree. Today's 24-hour news cycle doesn't help the situation any. In a recent *New York Times* article, economist and author Robert Shiller (*Irrational Exuberance, Animal Spirits*) postulated that a more accurate explanation for the markets' wild gyrations may have been supplied by John Maynard Keynes who, in his book "The General Theory of Employment, Interest and Money," compared the stock market to a beauty contest. He described a contest where 100 photographs were displayed, and the contestants were asked to choose the six prettiest. "The winner would be the entrant whose list of six came closest to the most popular of the combined list of contestants."

Shiller continues, "The best strategy, Keynes noted, isn't to pick the faces that are your personal favorites. It is to select those that you think others will think prettiest. Better yet, he said, move to the "third degree" and pick the faces you think others think that still others think are prettiest. Similarly in speculative markets, you win not by picking the soundest investment, but by picking the investment that others, who are playing the same game, will soon bid up higher. We see [this] among stock market investors today. People are trying to guess whether other investors are thinking that yet others are thinking that the stock market is "dangerous," or whether it is instead a great time to invest. And investors are making that decision with little more information than..." the participants of the beauty contest had.

Shiller concludes, "In fact the best explanation for the market's back-and-forth swings is that each day we are conducting a Keynesian beauty contest and reassessing what others think that still others are thinking. On days without much news, the market is simply reacting to itself. And because anxiety is running high, investors make quick, sometimes impulsive, responses to relatively minor events. ... "The only thing to fear is fear itself," Franklin D. Roosevelt said of the Great Depression and he was right. We are con-

stantly trying to reassess the fear of others, and others' fear that others are also afraid."

Count us cowardly, but we fail to see how that game is winnable. The ability to predict these sorts of swings is virtually impossible (and the ability to explain them equally as hard). Investing decisions cannot be predicated on "third degree" prognostications. They need to be made on "first degree" fundamental analysis of the economics and sustainability of each business. The probabilities of successfully analyzing and valuing the fundamentals of a business are far better than the alternative of predicting whether others are thinking that yet others are thinking they feel like buying or selling stocks on a given day.

## Why We're Comfortable Being Uncomfortable

*"The loser is the trend-chasing, comfort seeking investor. The market doesn't reward comfort. It rewards discomfort."* – Rob Arnott

The world is a mess. There, we said it. Yet we continue to hold stocks and even look to purchase more of them. Why would we do this if we just admitted what we admitted? The answer lies in the critical distinction between having an investment philosophy and having a market outlook. An investment philosophy is akin to a tool kit and used to appraise the probabilities associated with each potential investment at any given time. A market outlook, on the other hand, is a best guess of what speculators en masse will do over a short period of time. We have a solid long-term track record of compounding wealth and we attribute this success to always working from our philosophy as opposed to from any particular market outlook. In fact, we firmly believe that if we did it the other way around and based our decisions on where we *felt* the market was going to go in the short-term, our results would pale in comparison to what they have been and we would likely not be in business today. After all, what value would we have added using the latter method? Many people will try to tell you that today's

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“mess” is different, and investment approaches and philosophies that worked in the past are unlikely to work now. They’re wrong. It doesn’t matter if the news of the day involves events surrounding Europe’s sovereign debt issues, the political games being played in Washington, DC with our national deficit and debt ceiling, or the haunting familiarities to the economic malaise and financial system uncertainties of 2008. None of these events have repealed the principles of economics.

Since we began maintaining our audited track record in 1997, there have been four market declines (measured from peak to trough) in the neighborhood of 20% or more, and averaging around 35%. The world seemed like it was a mess at each juncture. It may be hard to recall exactly what you were feeling at the time, but we assure you it was not pleasant. Well, four “ends of the world” later and our compounded return on the equity portion of our portfolios has been 257%. What we accepted over this time period, and through each such disruption, was that there is no way to accurately predict these large market declines in advance of them occurring, nor how long they will last or what the short-term impact might be. By adhering to our strategy, we were able to patiently ride out those dislocations. In fact, we even welcomed those declines - not because we’re masochists, but because they allowed us to purchase more of the companies we liked at lower prices. Lowering your average cost is rarely a bad thing.

As today’s environment is particularly unsettling, we would be hard pressed to have any type of positive market outlook (even if we felt compelled to have an outlook). It feels uncomfortable to be invested. Fortunately, we have our investment philosophy to draw upon, providing us the comfort necessary to move forward. We would like this comfort to be extended to you (sleeping at night is important), so let us reaffirm just how we think about the investment process as it relates to the world of equities.

Owning shares of stock should be thought of no differently than owning a piece, albeit small, of a business. In

assessing whether we want to own even a small piece of a particular business, it helps us to think about whether we would want to own the whole business if we had the financial wherewithal to do so. We assess many qualitative and quantitative factors to point us to businesses that have historically provided solid returns to their owners and from which owners will receive similar returns going forward. But it’s not enough to just find quality businesses that meet these criteria. They have to be priced in such a way that *we* can earn a return from the investment that justifies the risk we are taking, primarily being that the solid business you thought you were buying is a little (or a lot) less solid than you thought.

In a nutshell, our investment strategy is based on assessing the economics of a business and the probability scenarios applied to the future cash flows it can generate, and it requires us to answer three basic questions:

1. What are the economics of the business?
2. What is the sustainability of its competitive advantage (its economic moat)?
3. What is it worth (intrinsic value)?

Answered correctly, this approach and the resulting information supersedes any market prediction. Superior investment results may not be detectable over the ensuing two or three *quarters*, but we believe that, over two or three *years*, this approach will perform substantially better than trying to duck in and out of the market.

**Q.** *What do you look at to determine the economics of a business?*

**KIG.** There are many factors that we analyze, but if we had to highlight one that encapsulates whether a particular business possesses good economics, it would be return on capital. For an intuitive grasp of return on capital, think of it as the level of earnings a business generates as a percent of the total amount that has been invested in the business. For instance, a business that earns \$15 mil-

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lion on a total capital base of \$100 million has a return on capital of 15%. At a minimum, we want to own a business that generates a return on capital that exceeds its cost of capital (how much it pays to a lender or equity provider for the use of money). If a business can generate a return on its capital higher than the cost of the capital it utilizes to generate those earnings, then it is creating real economic value. Conversely, if the cost of the funds exceeds the return it is getting, economic value is destroyed.

*Q. Why are competitive advantages important and what types do you look for?*

**KIG.** Consistent high returns on capital are symptomatic; they are indicative of heightened economics most likely the result of certain company strengths. These strengths are typically advantages that keep competition at bay and result in increasing market share and potentially higher margins. Strong competitive advantages can also act as barriers to entry from new competitors as the cost of displacing the incumbent is economically unattractive. These advantages have a significant upshot; in times of economic stagnation or stress, the effect magnifies itself versus weaker competitors. Most of the companies we own emerged from the last recession with a stronger market position than before. Some of the key advantages we look for are brand name awareness, low cost structure, network effects, and high customer switching costs. The following are specific examples among the companies that are owned in your portfolios.

A high level of customer satisfaction usually engenders strong brand awareness, and that leads to a loyal customer base with a high level of retention. Not having to continuously win new customers to replace departing ones leads to potentially higher growth rates. Companies can also charge higher price points for products that enjoy a high mind share. One of the best examples of a company with a strong brand is **Coca-Cola (KO)**. Years of advertising support coupled with high levels of customer satisfaction have made Coke products household

names with leading market share. In fact, Diet Coke recently surpassed Pepsi as the number two soda brand in the U.S. (behind only Coca-Cola Classic). While Pepsi is a strong number two competitor, and pricing is typically similar between the two, consumers are willing to spend extra on these products as compared to less favored rivals.

Retailers that don't even sell their own branded products can also enjoy the benefits of a strong brand. We would argue that **Bed Bath & Beyond (BBBY)** has such a high share of mind when it comes to household goods that it is typically the first destination customers choose when shopping for those products.

A low cost structure is a powerful competitive advantage in that it enables a company to generate higher profits that it can reinvest into its business and distance itself from its competition. A low cost structure also provides a business flexibility to use price as a weapon to take market share, weakening higher cost competitors who must match price and risk potential losses. **Biglari Holdings (BH)** (Steak 'n Shake) subsidiary has done a tremendous job in recent years reducing its cost structure without detriment to its customer service levels. Running a low cost operation enables the restaurant to offer several meals for under \$4.00, which is tough for its competition to match. These bargain deals have resonated with stretched consumers and have resulted in large increases in traffic, translating into increased market share in a tough operating environment.

A network effect is the phenomenon whereby a service or product becomes more valuable as more people use it, thereby encouraging ever-increasing numbers of adopters. Online social networks such as Facebook and Twitter are current examples where the network effect is proliferating. As more people sign up for these services, it is perceived to be more valuable, which leads to even more people signing up, and it becomes a self-reinforcing virtuous circle. **CarMax (KMX)** is patiently building very strong network effects. Through its 100+ store network, CarMax offers the largest selection of used cars in the

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country. As this model attracts new purchasers, more of them sell their old cars to the company, which enhances the selection further and leads to still more customers. In fact, CarMax wants to be the leading destination for people looking to sell their cars in order to secure the best inventory. This cycle will enable the company to continue to open stores in new and existing markets, further strengthening their lead over the competition. **American Express (AXP)** is another example of a strong network effect. As the company grew its credit card customer base, retailers were more willing to accept the American Express card. The more retailers that accepted the card, the more desirable it became for a consumer to sign up for the card, and the self-reinforcing loop continues.

Switching costs refers to the time and/or money it takes for a customer to switch from one product to another. If the switching costs are high, then customers are reluctant to switch from their current provider. Airlines that use **Boeing (BA)** airplanes have invested a lot of time and money in training their pilots and mechanics on the intricacies of Boeing models, thus switching to an Airbus platform would be very disruptive to the operations of the airline.

*Q. How do you define intrinsic value?*

**KIG.** Intrinsic value is really a long-term value concept. While we may sound like a broken record, we think a long-term perspective should guide investment decisions. Intrinsic value represents the full life cycle cash flows that a business generates, priced in today's dollars. The basic approach is to conservatively calculate normalized cash flows, apply a conservative growth estimate for those cash flows (one that declines over time), and discount them at a rate that approximates the cost of capital.

*Bonus Question. What else do you emphasize?*

**KIG.** A strong balance sheet is extremely important. Many of the companies we own have very little or no net

debt (the amount by which debt and liabilities exceed cash). Others that have a modicum of debt are generally in stable businesses where cash flow amply exceeds debt service payments. In good times, a company's strong balance sheet provides the flexibility to continue to invest in its business, but it's even more important in times of stress, as it allows the company to operate business as usual while its competition may have to pull back. Many of our companies came out of the last crisis better positioned vis-à-vis their competitors as the strength of their balance sheets allowed them to take market share from weaker competition.

We like businesses that generate high levels of free cash flow. Free cash flow is defined as cash generated from operations less capital expenditures. This is the cash flow that matters to the owners of a business (us, the shareholders). A highly capital intensive business must plow the cash it generates back into the business in order to keep running. As an owner of these types of businesses, it is difficult to ever get our money out. Contrast this with businesses with low capital intensity, which leave their owners with more options as to how to allocate excess cash. Excess cash can be used to pay down debt, buy back stock if the business is selling below intrinsic value, make strategic acquisitions, or pay dividends.

Since a good deal of our return over time will depend on management deploying excess cash intelligently, it is imperative that we partner with a management team that has a proven track record in allocating capital. Assessing past acquisitions and stock buy-backs (when and at what price) gives us insight into how effective future capital allocation decisions are likely to be.

## Portfolio Activity

Increased market volatility brought increased portfolio activity in this past quarter. As is typical of periods of high uncertainty, we believe much of the price movement was disconnected from changes in intrinsic value. As a money manager who bases its decisions primarily on

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price, we found the lower prices to be attractive opportunities to add to several portfolio positions. It also enabled us to establish one new position. Selling was commensurately light, though we did sell out of two positions in order to fund the purchases of the companies we deemed more attractive. In a testimony to the volatility, in early July we sold a partial stake in **Accenture (ACN)** in the low \$60s and then had the opportunity, only one month later, to repurchase some shares below \$50. We find it hard to believe that in one month the value of Accenture's business changed anywhere near the magnitude of its stock's 15-20% price drop. Such are the times we are in.

For client portfolios with a lower than target position size, we added to our positions in **Bank of New York Mellon (BK)**, **Becton Dickinson (BDX)**, Biglari Holdings, Boeing, CarMax, **Johnson & Johnson (JNJ)**, **Lowes (LOW)**, **Walt Disney (DIS)**, **Wells Fargo & Company (WFC)**, and **Target (TGT)**. We increased our target position size for **Goldman Sachs (GS)**, a name we first purchased last quarter, as the stock traded down from about 1 times tangible book value at initial purchase to 80% of tangible book. As we stated last quarter when we highlighted this new purchase, we believe Goldman's business is worth substantially more than book value and view the heavily discounted price a result of investor fear that we are falling back into a 2008-type financial crisis.

Given the theme of this letter, it may be surprising that we added only one new position during the quarter. While we examined many potential opportunities, the bar is set high; we must feel the new position is clearly better than companies we already own. And as always, price is paramount. The fact that we only found one is a testament to the quality and cheapness of what we already hold. The new position established was in **Markel (MKL)**, an insurance company in niche property and casualty markets. While not widely known, we believe it is a high quality business possessing strong competitive advantages and is selling at a steep discount to our assessment of readily ascertainable net asset value. Markel is a

disciplined writer of insurance, generally eschewing policies that are uneconomical. This is a rarer quality than you might imagine as many insurance companies are wired for growth and find it difficult to turn down business at any price. Besides underwriting profitability, Markel has a distinct advantage on the asset side of its balance sheet as it has historically generated higher returns on its capital than most in the industry. Markel utilizes a Berkshire Hathaway-type strategy, where a large portion of its insurance assets are invested in publicly traded equities and private businesses. It's no wonder that its Chief Investment Officer, Tom Gaynor, adheres to a Buffett-like investment philosophy focused on long-term intrinsic values of high quality companies.

We sold our positions in both **Lockheed Martin (LMT)** and **Medtronic (MDT)** to fund the purchases described. We still like both businesses, but tough decisions need to be made when more purchase opportunities come your way than you have capital to put to work. Based on a combination of factors, we identified these two businesses as the least attractive in a portfolio full of attractive businesses.

## Quotes of the Quarter

"The trouble with the world is that the stupid are cocksure and the intelligent full of doubt."  
– Bertrand Russell

"It's easy enough to make the calls, the difficult part is getting them right."  
– Terrance Odean



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