Investment Commentary

Winter 2012 Volume IX, Issue 2

KOVITZ INVESTMENT GROUP
Capital Ideas.®

In this issue…

Market and Performance Summary

The Kovitz Investment Group (KIG) Equity Composite increased in value by 12% during the fourth quarter, bringing the 2011 annual return to 1.5% (all performance numbers quoted net of fees). The broad market, as represented by the Standard & Poor's 500 (S&P 500), also rose 12% for the quarter and increased 2.1% for the full year.

It's not surprising our annual results did not differ markedly from the benchmark. As we have written about several times previously, correlations between individual stocks and the index are at all-time highs. The 50-day moving average correlation hit 86% in October and is still near 80% today. (If every stock moved exactly the same as the index, the correlation would be 100%. The historic average is 30%.) In the 54 year history of the S&P 500, there has never been a day that all 500 stocks have moved up or all 500 have moved down. However, there have been eleven days when 490-plus stocks all moved in the same direction. Of these, six have occurred since July 2011.

In addition to high correlations, volatility in the markets has been extraordinary. Bafflingly, on a number of days over the past several months, many stocks witnessed intra-day spreads between the high and low price in excess of 10%. That's a rather large amount, conceptually equal to an average stock's average year's historical return. With so much daily volatility in the stock market, one may conclude that business fundamentals are changing as quickly as the stock prices. However, fundamentals generally change quite slowly. Although investors may disagree regarding the ultimate investment implications, fundamentals tend to follow a somewhat predictable path. Our research primarily focuses on these fundamental paths and identifying price points for entry and exit.

Fundamentals for our portfolio holdings are generally robust. Balance sheets are strong due to healthy cash flow generation. Competitive positioning remains durable. However, fundamentals like these might not affect near-term investment results. With governments intervening in many economies, it certainly seems like global politics, rather than fundamentals, might determine these short-term outcomes. Hasty political decisions, interpreted through a trader's prism, will likely result in investment paths considerably more erratic than they might be if based primarily on fundamentals. We probably don't need to remind you that our investment strategy/philosophy is not geared towards generating short-term results. Successful investing must have a longer-term perspective. Therefore, we believe that looking past the political maneuvering and remaining focused on specific company fundamentals, which has been successful for us in the past, will continue to be the absolute right path from this point as well.

We also probably don't need to remind you that our longer-term focus is on minimizing permanent losses of capital. Our job is to intelligently bear risk for profit. Said differently, we look to take on risks that are less than commensurate with the potential returns. Current valuations of our portfolio holdings are such that we have confidence we will meet our goal of capital preservation regardless of near term fluctuations in the market. We are also confident that once the gyrations in the world political arena settle down we will meet our second goal of compounding your capital at a satisfactory rate.

The bottom line: Historically, market moves have tended to be along the lines of two steps forward and one step back, leading to long-term positive returns. This past year has seen the market take two steps forward as perceptions that the European Union is dealing with their issues positively only to take two steps back when the market is gripped with the fear that they're not doing enough. This pattern will likely continue for the foreseeable future. The wild market price moves don't cry out for wholesale exits and re-entries, but for patience, perspective, and confidence. Not trying to time the market is not akin to putting one's head in the sand. Our method of focusing on company-specific fundamentals, competitive positions, and valuation with the goal of compounding capital while minimizing permanent losses is well thought out and time-tested. At some point business fundamentals and valuations will matter. Until then, keeping emotions in check will be the determining factor for making sure we will be able to reap the gains when the market resumes a more normal pathway.

The chart below summarizes results through December 31, 2011 for the KIG Equity Composite compared with the S&P 500 Index. Our goal is to outperform this index after fees over the long-term as we have done in every ten-year rolling period since the beginning of our track record on January 1, 1997. Since inception, our results have exceeded the benchmark by 4.2% per year after all fees and expenses. Consequently, a hypothetical $1,000,000 invested with us fifteen years ago would now be worth $4,009,600. The same $1,000,000 invested in the S&P 500 would now be worth $2,232,500. As evidenced by the large spread between these two numbers, the power of compounding is indeed the eighth wonder of the world.

Annualized Net Performance
For Periods Ended December 31, 2011

	Latest 1-Year	Latest 3-Year	Latest 5-Year	Latest 10-Year	Since Inception
KIG	1.5%	14.1%	0.1%	4.3%	9.7%
S&P 500	2.1%	14.1%	-0.3%	2.9%	5.5%

Portfolio Outlook

Our portfolio, in aggregate, is currently made up of the highest quality companies we have ever owned. We believe a significant percentage of them are best-in-class across a range of different industries, including **Johnson & Johnson (JNJ)** and **Abbott Laboratories (ABT)** in health care, **Costco (COST)** and **Bed Bath & Beyond (BBBY)** in retailing, **Procter & Gamble (PG)** and **Coca-Cola (KO)** in consumer products, **Wells Fargo & Company (WFC)** and **American Express (AXP)** in financial services, **Berkshire Hathaway (BRKB)** and **Markel (MKL)** in insurance, and **Apple Inc. (AAPL)** and **Accenture (ACN)** in technology. These companies tend to have deeper moats, stronger balance sheets, and often more pricing power or lower costs than their competitors. Many also have broad product portfolios and wide geographic diversity that give them exposure to higher growth economies around the world. These attributes helped many of these companies deliver strong business results throughout the worst economic downturn since the Great Depression. A number of our holdings, including Coca-Cola, Abbott, Wells Fargo, and Berkshire Hathaway, took advantage of the financial crisis by making opportunistic acquisitions, and others such as **Lowes (LOW)**, **Wal*Mart (WMT)**, **CVS Caremark (CVS)**, and Bed Bath repurchased a meaningful amount of their outstanding shares at distressed prices.

However, the economic characteristics of these companies are only half the reason we are so optimistic about future returns. The other half of the equation is valuation. We note the observation of Oakmark's Bill Nygren in his recent commentary below.

> In March 2000, the 50 largest companies in the S&P 500, as measured by market capitalization, traded at about 40 times earnings. The other 450 companies in the S&P had an average P/E of just over 16 times. The largest were priced at a premium of 150%. Back then, many investors argued that large-caps deserved their very high premium because of their economies of scale, diversified businesses, superior access to capital, greater liquidity and their ability to capitalize on global growth opportunities. At that time, we argued that this huge large-cap premium was indefensible.
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> Today, the 50 largest companies sell for 14 times expected 2011 earnings, which is a 7% discount to the other 450 companies in the S&P 500. Today, most investors argue that large-cap companies deserve a discount because they tend to be less focused, less nimble and are less likely to be acquired. Again, we disagree with that rationale. Balancing the advantages and disadvantages of large-cap companies, we conclude that large businesses deserve a moderately higher P/E than small businesses because they tend to be less risky. Over generations, large-caps have cycled from big premiums to small discounts relative to small-caps. Today, large-cap equities as a class are priced at a 7% discount, so we believe that they are poised to achieve better long-term performance than the small- or mid-cap categories.
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> At the end of the quarter [9/30/11], investors were worried about [Europe's] debt problems, the end of QEII and the stalled political negotiations over the U.S. borrowing limit. We are focused instead on modest P/E ratios (especially for big businesses), strong corporate balance sheets, improving earnings, share repurchases, higher dividends and low returns on competing investments. I believe that business fundamentals and valuations will be more significant drivers of long-term returns than the crisis du jour.

Historically, our portfolios have mirrored Mr. Nygren's sentiment. Back in 2000 we owned only two of the fifty largest companies (4%), while today we own sixteen of them (32%). Our analysis is very much cash-flow focused and concentrates on businesses where we can see where the cash is coming from and where it is going. We tend to focus on companies that are self-funding (i.e. don't need to rely on capital markets for financing) and have strong enough balance sheets to get them through any downturn. Typically, investors who wanted these characteristics had to give up some return by paying higher than average valuations. Today, you can get these durable businesses at a discount.

Although future value is the most important investment consideration, the process of estimating future value requires forecasts that are open to conjecture. As a result, a better starting point may be to look back over a number of years for examples in which solid growth in value was not fully reflected in comparable price appreciation. A particularly good example of this is to be found in one of our largest holdings, Wal*Mart. (Though focused on a different holding of ours, Johnson & Johnson, we thank the Tweedy Browne Fund's most recent semi-annual report for their insight on what follows. The wording in quotations is directly attributable to them, though we modified certain parts accordingly.)

On December 31, 1999, Wal*Mart was trading at $69 per share, earned $1.28 per share (for the year ending January 31, 2000), paid a dividend of $0.20 per share and had 4.457 billion shares outstanding. Today, twelve years later, WMT trades at $60, yet the company is on schedule to earn $4.55 per share (for the year ending January 31, 2012), or over three and a half times what it earned in 1999. Management's capital allocation policies have been particularly impressive over this time period as it has ramped up its dividend to a current $1.46 per share and has repurchased almost one billion shares, or over 20% of the shares it had outstanding at the end of 1999.

"So, during a period that saw the bursting of the technology bubble, the 9/11 tragedy, the Iraq and Afghanistan wars, the bursting of the credit and housing bubbles and the resulting financial crisis, Wal*Mart was able to compound its earnings per share at an 11% annual rate. The business performed well during this period, but what about its stock price?" On December 31, 1999, WMT had a price earnings (P/E) ratio of 54 times earnings. Today, it trades at roughly 13 times earnings. Its price earnings ratio has fallen precipitously since 1999, completely negating the impact of its increasing earnings, resulting in a total return, including the impact of dividends received, of -1% over these twelve years.

To be sure, Wal*Mart's stock was wildly overpriced in 1999 - a stark reminder for anyone who doubts our aversion to paying lofty multiples. However, its strong corporate performance over this time has left it attractively valued today. So what should the next several years or so hold for WMT's stock performance? We readily admit we don't know and we will never claim we do. "What we do know is that the stock currently trades at 13 times earnings, which equates to an after-tax earnings yield of 7.7%. The current cash dividend yield today is 2.4%, up from 0.30% in 1999, which implies an annual dividend compound growth rate during the period of 18%. As with any stock, if the current P/E ratio is simply maintained going forward, the return for shareholders would be the earnings growth of the company combined with its dividend yield. Over the next few years, that translates into a 13.4% annual total return if the company is able to continue to grow its earnings annually at the 11% rate it has generated since 1999 and maintain its dividend yield at 2.4%. If we lower our expectations of the company's future earnings to a more conservative growth rate of 5%, and also maintain the dividend yield, an investor would still receive an annual return of roughly 7.4% in the stock. But let's be ultra-conservative and assume that the P/E ratio for WMT continues to decline over the next three years to, say, 10 times earnings coupled with more modest 5% earnings growth and a similar dividend yield. Under these assumptions an investor would just about break even. Even in this dire scenario, the downside is limited by the strength of the company's earnings power and its dividend. If, as we feel, the more likely scenario is modest P/E expansion coupled with solid growth in its earnings and dividends, we could earn a very attractive double digit return in the stock."

"This kind of math is working for us in any number of companies in which we are invested today. We cannot stress enough that the robustness of this potential return math is largely a function of attractive current pricing in larger, steadier, higher quality, and globally diversified businesses like WMT. As we have said in previous letters, these are businesses that are attractively valued, underleveraged, generate more cash than they need to fund their operations, and pay an attractive dividend yield. More importantly, these are the types of companies that have the financial strength to weather economic turbulence and come out the other side stronger."

Of course, fundamental to what we do is Benjamin Graham's simple insight that a share of stock is a fractional interest in a business. We constantly remind ourselves that behind every stock is a company, and, if the company does well and we paid a reasonable price for it, the stock should in time do well. Graham also reminds us that value is independent of emotions. It is the relationship between subjective prices and objective value that drives our outlook at any given time. Today, after years of falling prices and rising business values, our outlook is especially positive. The fact earnings and dividends have some component of inflation protection, if it ever were to materialize in a meaningful way, adds to our stocks' attractiveness. A deflationary environment would cause a temporary drag on earnings, yet the quality of the balance sheets (strong cash positions/nominal debt) and competitive strengths would provide a buffer to enable our companies to live to fight another day. In other words, these companies have both the durability and resilience to weather the inevitable shocks as well as a proven record of adapting and growing through different economic and business environments.

You can have cheap equity prices or good news, but you can't have both at the same time. With stocks, you have to be prepared to suffer some volatility, but the reward is to be able to own the highest quality companies at prices that are as cheap as we have ever seen them in our career. Only in the stock market does the best merchandise occasionally sell cheaper than the lower grade merchandise.

"Our perspective is to ask ourselves where we are likely to be over the next three to five years. That nothing gets addressed at the macro level and corporate profits and cash flows will not matter as underpinnings to the market is not an outcome we are inclined to subscribe to. While we are not starry-eyed optimists, we don't see the world in some state of terminal economic decline. Moreover, we own businesses; they are adaptive, competitive organizations that can survive in most monetary and fiscal settings. So, through all this we stay very focused on the progress of the businesses we own while constantly looking for better opportunities."

Regarding the progress of the businesses we own, a useful metric we track is the Price-to-Value (P-V) ratio of our portfolio. Conceptually, this statistic measures the current price of a portfolio company to its intrinsic value, conservatively estimated through our multiple valuation techniques. It provides an estimate of how undervalued a certain stock or the portfolio in aggregate is. For example, Wal*Mart's current Price-to-Value Ratio is 80%, determined by taking its roughly $60 stock price divided by our current fair business value estimate of $75. This implies, based on what we know today, Wal*Mart is roughly 20% undervalued, providing approximately 25% upside from current levels (not including dividends). As a quick reference for how undervalued our total portfolio is at any point in time, we market weight each holding's P-V ratio to come up with a P-V ratio for the portfolio in aggregate. So what's this number telling us today? At December 31, 2011, our portfolio P-V ratio stands at approximately 74%. Interestingly, at the end of 2010, this same figure was at 80%. So, despite a year in which our portfolio moved marginally higher, the under-valuation increased versus where it was at the same time last year. This implies that the progress the stocks of our companies have made has considerably lagged the progress they have made in increasing their value.

Today, long-term investing in a portfolio of carefully selected companies is, to say the least, unfashionable. Our goal is not to be fashionable, but to do all we can to ensure that clients who stayed with us through these difficult times can benefit from the bargain prices produced by the current disinterest in equities. The fundamental laws of economics and the basic tenets of common sense are timeless. Consistently reminding ourselves and our clients of this keeps us on course when times are uncertain and helps resist the tendency to get caught up in the prophecies and manias being pushed by promoters and pundits.

On behalf of all of us at KIG, we thank you for your continued trust.

The Year in Review

For a year that saw little change in the overall market level, the movements of individual stocks were far less serene. Of the stocks we own, ten were up 10% or more for the year, while eight were down by 10% or more. While the winners came from a variety of sectors, the losers were primarily financial services related. As concerns about the debt crisis both in Southern Europe and the U.S. surfaced and resurfaced (and resurfaced), the financial stocks in which we were invested contracted. **Goldman Sachs (GS)** and **Bank of New York Mellon (BK)** were both down approximately 30%. We've discussed Goldman Sachs in each of the last two newsletters but suffice it to say, with the stock trading at nearly a 30% discount to tangible book value, we believe it remains significantly undervalued even under a draconian regulatory scenario.

Despite having the word bank in its name, the Bank of New York Mellon, is not really a bank in the traditional sense as more than 90% of its profits come from securities processing, custody, and asset management. It has more than $25 trillion of assets under custody and a large market share in most of its businesses. However, even with these impressive characteristics, let alone the fact the company's earnings have grown more than 30% from its prior peak in 2007, its stock price is almost 50% below where it was then. Low interest rates have been a drag on earnings as management fees on its $323 billion money market business as well as interest income on its $76 billion investment portfolio have cycled lower commensurate with the interest rate environment. We don't know when we will see higher interest rates, but the day will come. With a company of this quality, we will never be swayed by the pricing mechanisms of other investors. We must stay true to our character, faithful to the process. Our long-term record gives us confidence in our process. In time, we believe investors will once again recognize Bank of New York's unique franchise and place a more appropriate multiple on its normalized earnings.

Contrary to common perception, the earnings of Wells Fargo, whose share price was down 10% for the year, have made steady progress even as the impact of the financial crisis continues to hamper much of its competition. However, in this controversial sector filled with headline risk, misperception is quite common. Wells Fargo's superior management and relatively strong balance sheet allowed the company to raise necessary capital and to acquire rival Wachovia at the depths of the financial crisis. The combined company now generates earnings of about $35 billion per year before taxes and provisions for bad loans. Although the weak economy and loan charge-offs may persist for several more years, the underlying earnings power of this well-run bank has significantly increased and may now be almost 50-75% higher than the earnings it is currently reporting. Over the last several years, though, Wells Fargo's progress in earnings power has not been reflected in its stock price, which is trading about where it was in 2000. Again, with a company of this stature, we are prepared to wait until the views of other investors come around to match ours.

American Express, the lone financial to be up for the year (by 12%), continues to show improvement in its credit card portfolio as net charge-offs have steadily declined. The company is reinvesting a large portion of its earnings back into its industry leading rewards programs which we believe will continue to attract and maintain its more affluent membership base and lead to solid future earnings growth.

Red Robin Gourmet Burgers (RRGB) was our largest percent gainer for the year with a 29% gain. When we initiated our position at the end of 2010, we believed Red Robin was in a position to use its strong free cash flow to repurchase its shares and pay down debt, which they began doing in 2011. We were also of the mindset that their cost structure was somewhat bloated and they have made significant progress in bringing down store level expenses. We think they still have more room to go in this area and will be watching closely to make sure management is achieving this goal. While we would have liked to see them stop opening new units altogether, they have slowed their store growth markedly, thus increasing their already high levels of free cash. The company is in the process of rolling out a smaller, higher return format (fast-casual) which will feature a streamlined menu ordered at the counter top, as opposed to its current sit down table style. If successful, it will provide a nice avenue for growth at a lower cost than its traditional restaurants.

Another strong gainer in the consumer discretionary sector was Bed Bath & Beyond, which increased 18% for the year. Same store sales have continued to show strength as it has captured and maintained market share gains that resulted from its largest competitor's (Linens 'n Things) liquidation in 2009. The company's balance sheet is pristine with no debt and over $1.5 billion in cash and short-term investments. Ex-cash, Bed Bath is trading at around 13x current earnings, a multiple well below where we believe this stalwart retailer should be trading.

The two leading decliners in the consumer sector were **CarMax (KMX)** and **Biglari Holdings (BH)**, down about 4% and 10% for the year, respectively. CarMax continues to reinvent the used car business to make it more user friendly, including no haggle pricing and a commitment to offer to buy a customer's vehicle even if the customer doesn't purchase one sold by CarMax. The latter practice ensures new inventory flow and also allows them to sell lower quality cars into the wholesale market, which is becoming a large part of recurring revenues. We believe CarMax is significantly undervalued, particularly so when viewed in light of its meaningful growth opportunities. CarMax currently operates 107 used car superstores in 52 markets. We believe that they can add a meaningful amount of stores in current and untapped markets as a value-conscious public continues to embrace their brand. This is one holding where our thinking about time frame may be even longer than usual. It's rare to find a business where we see such a long runway to compound capital at an above average rate.

Biglari Holdings' principal brand, Steak 'n Shake, continues to put up restaurant industry leading results. Same store sales have increased eleven quarters in a row as guest traffic has increasingly been drawn towards its value menu. Sardar Biglari, the Chairman and CEO, is also continuing to implement his holding company concept where he utilizes cash flow from the company's restaurant subsidiaries to make investments, in whole or in part, in outside companies. For instance, he recently built up a 10% stake in restaurant rival Cracker Barrel, but lost a proxy contest to be placed on the board of directors. While disappointing that he won't be able to directly influence Cracker Barrel's operations, the investment has appreciated as his battle highlighted an unappreciated asset. Restaurants will continue to be fertile ground for his activist endeavors while he also attempts to break into the insurance market, where the float generated by premium dollars is particularly suited to his investment style.

We should also highlight Lowe's which increased over 3% for the year. The company has made a great deal of progress in regaining lost sales due to the crack in the housing market. Management has taken all the right steps, in our opinion, as the company slowed new store development, closed unprofitable stores and spent its considerable free cash flow on sprucing up existing stores, buying back stock ($3 billion worth over the past twelve months), and increasing its dividend payout by 55% since 2009. We believe that while price performance has been uninspiring, it is likely a situation of deferred gratification as opposed to mistaken analysis.

In the consumer staples sector, top gainers included CVS Caremark, Costco, and Wal*Mart, which increased 19%, 17% and 14%, respectively. CVS is finally showing that its merger with pharmacy benefit manager (PBM) Caremark was strategically important. The company stands to benefit as a huge number of the world's most well-known and widely used prescription drugs will be coming off patent over the next couple of years. They also may be the beneficiary of **Walgreen Company (WAG)** contract dispute with rival PBM Express Scripts (discussed below) as prescription volume should increase handsomely.

Costco's ability to lead with attractive values in food and consumables has kept its stellar record of increasing traffic and same-store sales intact. Its loyal members continue to trade out of the other retail channels and into Costco. Over the last several years, the company has expanded its fast growing international operations, particularly in Asia, to 25% of sales. We took some profits in Costco during the year as its multiple has expanded to over 20 times earnings, but continue to hold our smaller position. We strongly believe that Costco's gains in traffic and membership are sticky and that it will retain these grocery shopping trips as the economy recovers. The company's earnings growth will also benefit from the operating leverage generated by Costco members adding more big-ticket, discretionary merchandise to their Costco purchases.

Wal*Mart, which we discussed above, looks to be making strides in regaining lost customers due to prior marketing gaffes. In its most recent quarter, Wal*Mart posted a small gain in same-store sales, its first such increase in over two years. We're confident that this momentum will continue as the company has added back many products it had cut in an effort to further increase its already efficient working capital utilization and has moved back to an everyday low pricing strategy that had been its hallmark.

A notable decliner was Walgreens, down 13%, as its aforementioned spat with Express Scripts turned sentiment towards the pharmacy chain negative. The quarrel, which first surfaced over the summer, involved prescription drug reimbursement rates that Express Scripts pays when one of its members utilizes a Walgreens' drug store. While the uncharacteristically public dispute had both sides claiming the other was acting irrationally, most (including us) assumed that a deal would be brokered before year-end. It did not happen. As it stands now, beginning January 1, 2012 Walgreens will no longer be an Express Scripts' network provider and will stand to lose out on tens of millions of annual prescription sales. While disappointing in the short run, we side with Walgreens' management that chose to forgo what they considered to be uncompetitive and substandard reimbursement rates. While earnings will take a temporary hit, we believe Walgreens will find a strategy that makes the company increasingly relevant to payors who know and value the convenience and consistency of its stores and can achieve sustainable earnings growth, albeit from a slightly lower base. The company has engaged in active discussions with health plans and employers in an effort to ensure that WAG remains in their pharmacy networks. To date, over 100 health plans, employers, and related parties, representing about 10 million annual prescriptions, have informed WAG of their intention to change PBMs, or exercise contractual provisions to maintain access to WAG pharmacies in 2012. At its current price, we believe lower earnings are already discounted and that multiple expansion will ensue once investors see that Walgreens' earnings power has only been slightly diminished.

In the health care sector, Abbott was up 22% as the company reported strong growth in its rheumatoid arthritis therapy, Humira, and announced its intention to split the company in two. While the diversification of a combined company has its benefits, Abbott became convinced that its medical products division and branded pharmaceutical division were headed down different paths, the former being a growth-driven business with a heavy emphasis on emerging markets and the latter being a slower–growing, cash generating business. With the split still a year off, we will take the time to analyze each business separately, but we will not know the valuations or balance sheets of each until we get closer to the effective date. At such time, we may keep both businesses or sell off one to reinvest in the other.

St. Jude Medical (STJ) was the biggest health care decliner, down 18%. The subdued economic recovery has kept pressure on many types of health care procedures, including many of the cardiovascular-related ones in St Jude's domain. In addition, ICD sales have lagged historical levels as doctors have been more discerning when screening for appropriate candidates due to studies that have shown that past prescription policies may have been too liberal. Regardless, St. Jude has a strong product portfolio with several newly approved product applications from the FDA. At its current valuation of less than eleven times earnings we, believe the stock remains significantly undervalued.

Boeing (BA) was up 15% and had the largest gain of the stocks we own in the industrial sector. The third quarter marked the company's first delivery of its revolutionary jet, the 787 Dreamliner. Three years behind schedule, many thought this plane may never realize its expectations as a fuel–efficient, mid-size jet with long-haul ranges. However, Boeing is finally in a position to capitalize on its backlog of 800+ orders worth a total of approximately $145 billion. Concerns also abated about its 737 program as it announced its intentions to build its new-engine variant of the plane in Washington State. The company also came to terms on an early contract extension with the International Association of Machinists & Aerospace Workers (IAM), keeping sound labor relations with its union intact.

Robert Half (RHI), the temporary and full-time staffing company, lost 7% for the year. The company continues to ramp its revenues and earnings that were devastated during the financial crises. Key to its resurgence was that the company had the requisite balance sheet (no debt) to continue investing in its business during the downturn as many of its competitors were ill-equipped to do the same. With its competitive position enhanced and the labor markets appearing to turn the corner, we believe the company is poised to regain the level of earnings it had prior to the recession. If that happens upside from here may be substantial.

All of our representatives from the information technology sectors had positive stock performance in 2011. Apple led the group with a 24% gain from the date of our purchase earlier in the year. Apple remains one of the cheapest companies we own despite reporting robust revenue and earnings gains from its popular suite of products, including the iPhone, iPad, and Mac computers. Investors may be concerned that the death of Steve Jobs will have a permanent impact on future innovation, or they may be concerned that revenues have grown to such a size that further large increases will not be attainable. Our focus is on valuation and the huge cash pile ($80 billion) building on its balance sheet. Regarding valuation, we are confident that slowing earnings are more than discounted at current prices. To the extent that doesn't happen as soon as the market is implying, significant upside exists. As for the cash, we would be an advocate of a massive share buyback, but our feeling is that the company may pay out a large special dividend and initiate a smaller regular payout. Either way, it will likely appease investors who are worried that the company may spend the cash on an expensive, value-destroying acquisition.

Automatic Data Processing (ADP) and Accenture rose 20% and 12% for the year, respectively. Both companies, ADP in payroll processing and Accenture in IT consulting, had very solid years that saw their competitive positioning enhanced. If and when interest rates rise, ADP's earnings power will increase substantially as the money it earns on the float from its customers will be able to be invested at higher rates than available today. Accenture's consulting business is well situated for the current environment as companies look to technology to lower costs and improve productivity.

Our goal in the above company narratives is to emphasize that investors have a choice. You can focus on company-specific fundamentals, decide to invest in a business as an owner, and share in the profits generated. Or, you can focus on macro issues and try to gauge how these may influence short-swing trading results. As no one can know the duration or magnitude of the impact (if any) of any particular macroeconomic or political occurrence (or perceived occurrence) on the long-term profitability of a particular company, dissecting such macro or political events often proves futile in predicting market movements. We'd rather be right over the next three years as opposed to the next three weeks.

KIGball

With the recent box office success of Michael Lewis' "Moneyball", we thought we'd resurrect our take on the book that we wrote about in our Fall 2006 newsletter. We couldn't help but notice the similarities between the way the Oakland Athletics contrarian general manager, Billy Beane (fascinatingly portrayed by Brad Pitt in the movie version), built his team with the same principles we utilize to build our portfolios. For us, while we were enthralled as sports fans with the subject material, we were more fascinated with its relevance in reinforcing our investment ideology.

The story itself could be Hollywood material. A small market team with one of the lowest payrolls in the league somehow manages to become a perennial fixture in baseball's playoffs- typically the realm of large market teams with big payrolls. But the book resonated with us primarily because Beane's theories about what is important in creating a successful baseball team run completely counter to conventional wisdom. His team's achievement proved that traditional yardsticks of success for players and teams were fatally flawed. Home runs? Overvalued by the market. Speed? Overrated. Defense? Not worth paying up for. Find players that get on base a high percentage of the time (walks are as good as hits) and scoring takes care of itself. If you're a regular reader of these letters it probably wouldn't surprise you that our thinking about investments is about as opposite from Wall Street's as can be. We believe that some of Wall Street's traditional yardsticks are faulty. Earnings growth? Overvalued by the market. Hot sectors (momentum)? Overrated.

To illustrate how Billy Beane's managerial principles parallel our investment ideals, we've pulled some passages from the book and compared them to some of the tenets of our philosophy.

Beane: "I get excited about a guy when he has something about him that causes everyone else to overlook him and I know that it is something that just doesn't matter."

KIG: "We get excited about a stock that the market marks down for reasons that just don't matter to long-term business value."
Beane: "The hardest thing is… [to] take a guy high (in the draft) no one else likes… it makes you uncomfortable."

KIG: "You need confidence in your analytic ability, and a thick skin, to buy a stock that the market perceives to have issues. Typically, those issues, though, are more than adequately discounted in the share price. Investors tend to hate uncertainty. We're not crazy about it either but have learned to live with it."

Beane: "We don't get the guys who are perfect there has to be something wrong with them to get to us."

KIG: "We don't buy the market darlings- they tend to be overpriced by the market. We prefer to buy the stocks of quality business where there are low expectations built into the share price."

Beane: "Every deal you do will be publicly scrutinized by subjective opinion… you have to ignore the newspapers."

KIG: "An unwritten word does not sell newspapers. Journalists, and often times analysts, in their quest to create the sensational, often focus on things that are tangential or even unrelated to business value. You can't let yourself get scared out of a position because the tide of opinion is temporarily against you."

Beane: "When we stop trying to figure out the perception of guys [i.e. what others think of them], we've done better."

KIG: "Most investors pretty much engage in an exercise in mass psychology, trying to guess better than the crowd how the crowd will behave. Sticking to the fundamentals of the business- tracking cash flow, making sure competitive advantages remain sustainable and keeping an eye on how management is allocating capital- and pretty much ignoring everything else- is a recipe for longer-term out performance."

Beane: "The day you say you have to do something you're screwed. Because you're going to make a bad deal."

KIG: "Sometimes inaction is the proper course, if it has been taken after measuring all the measurable options. You may recover from the stock you don't buy. You may never recover from the stock you bought at the wrong price."

Billy Beane has been successful because he is able to see something in baseball players his fellow general managers don't or can't. Other GMs don't think a player will help their team, Billy Beane says he will. By investing in stocks you believe to be undervalued you're also making a contrarian bet. The market is saying these stocks are cheap for a good reason. You say they're not.

Does this qualify us to run a major league franchise? Probably not. Does it qualify Billy Beane to run money? Probably so. Regardless, contrarian thinking has served both us and the A's well.

Quotes of the Quarter

"I think the future of equities will be roughly the same as their past; in particular, common-stock purchases will prove satisfactory when made at appropriate price levels. It may be objected that it is far too cursory and superficial a conclusion; that it fails to take into account the new factors and problems that have entered the economic picture in recent years — especially those of ... the movement towards less consumption and zero growth. Perhaps I should add to my list the widespread public mistrust of Wall Street as a whole, engendered by its well-nigh scandalous behavior during recent years in the areas of ethics, financial practices of all sorts, and plain business sense."
– Excerpt from June 1974 speech by Benjamin Graham

"History doesn't repeat itself, but it does rhyme."
– Mark Twain

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