Investment Commentary

Fall 2013

Market and Performance Summary

The Kovitz Investment Group® (KIG®) Equity Composite increased in value by 4.7% (net of fees) during the third quarter, while our primary benchmark, the S&P 500, increased 5.2% over the same period. Year-to-date, through September 30, 2013, the KIG Equity Composite has returned 20.7% versus 19.8% for the S&P.

Another quarter in the books and still without the most forecasted correction in recent history. Not to suggest that an equity market that's up almost 40% since the beginning of 2012, in almost straight line fashion, will not correct. To the contrary, about the only thing we can be certain of in an uncertain future is that it will. However, we'll refrain from participating in the "guess the timing of the correction" game, and more importantly, we won't engage in wholesale portfolio changes in anticipation of one. Our investment philosophy is based in part on a simple premise: although stock prices often react to emotion in the short term, they generally trade toward fair value over the long term. If you can identify stocks of quality companies that are significantly undervalued, and have the fortitude to stick with them over the inevitable swings in sentiment, you will likely do better than trying to jump in and out of the market in hopes of correctly timing its pullbacks and advances. In other words, our investment decisions are governed by the fundamentals of the business, not by our short-term market outlook.

Thinking of the equities market as a pendulum that swings back and forth between periods of general cheapness (usually driven by fear) and overvaluation (usually driven by euphoria), we believe the pendulum is currently fairly close to the middle. We don't consider stock prices so expensive that we want to sell off our holdings, nor are they cheap enough that we're finding bargains left and right. One thing we've learned over the years is that it is much easier to have conviction when the pendulum is at the extremes and more difficult when equity valuations seem closer to fair value. Environments such as these are typically described as "stock-picker's" markets and we welcome the challenge.

Regarding performance, there is nothing magical – or even informative – in looking at it over a three or nine month period. Randomness alone can produce just about any outcome in the short run. In order to give a broader perspective, we provide the results for our complete history, which now covers more than 16 years. The following charts summarize both annualized and cumulative performance results from January 1, 1997 through September 30, 2013 for the KIG Equity Composite and the S&P 500.

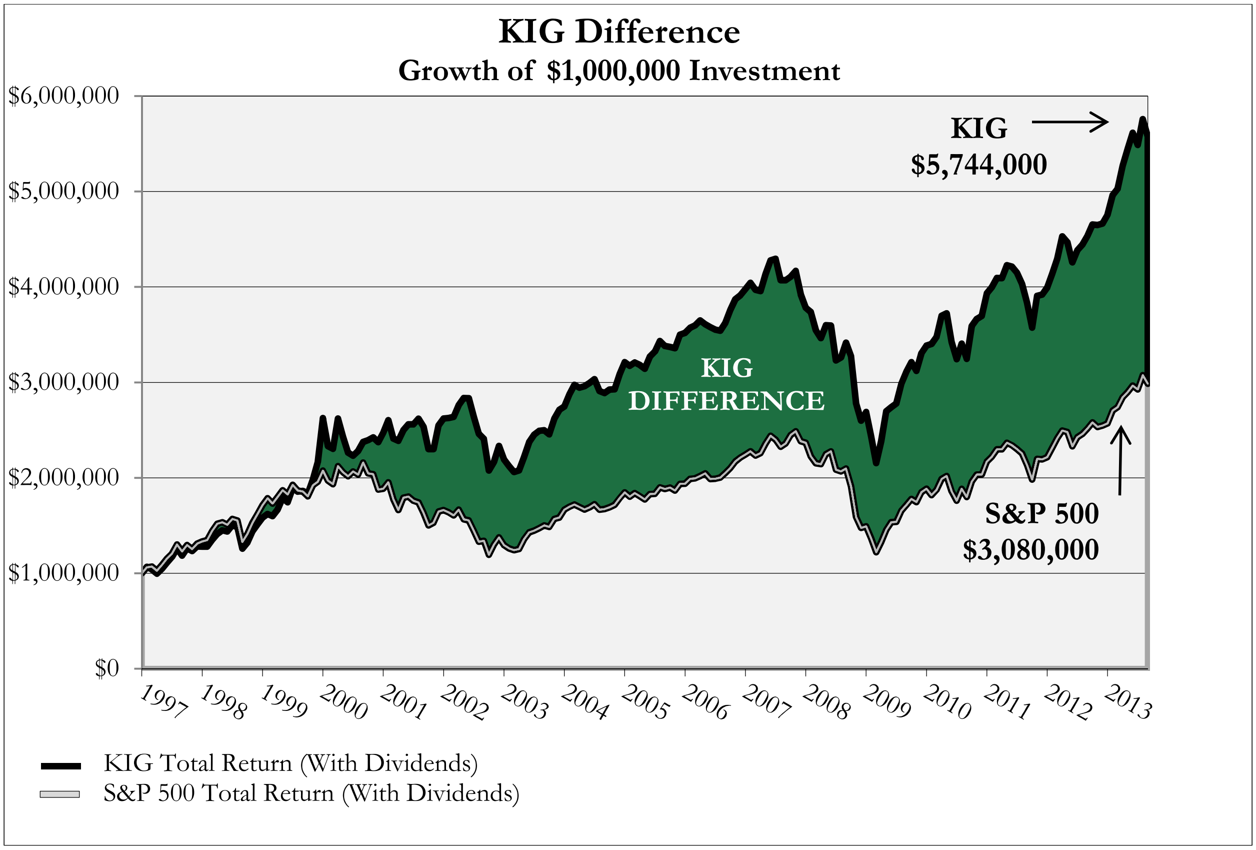
KIG vs. S&P 500
Annualized Equity Performance (Net of Fees)

	1-Year	3-Year	5-Year	10-Year	Since Inception (16.75 Years)
KIG	23.4%	16.9%	11.9%	8.9%	11.0%
S&P 500	19.3%	16.3%	10.0%	7.6%	6.9%

KIG vs. S&P 500
Cumulative Equity Performance (Net of Fees)

	1-Year	3-Year	5-Year	10-Year	Since Inception (16.75 Years)
KIG	23.4%	59.9%	75.4%	133.9%	474.4%
S&P 500	19.3%	57.1%	61.2%	107.3%	208.0%

Since inception, our results have exceeded our benchmark by over 4% per year on an annualized basis. Compounding these annual differences over sixteen and three-quarters years has a significant effect on wealth accumulation as the ending dollar values in the graph on the next page illustrates.



Please refer to the disclosure on the last page of this newsletter for additional discussion regarding the performance of KIG's Equity Composite.

One of KIG's biggest advantages is the long-term time horizon that we and our clients share. As a result of this aligned orientation, we have been rewarded with a stable capital base that affords us additional flexibility in pursuing our capital allocation strategies. This puts us at a huge advantage over those who work with fleet-footed capital, where demands for consistent quarterly or yearly returns force them into a capital allocation strategy based on perceived stock price movements instead of underlying value. Focusing our energies on unearthing values, as opposed to guessing where markets are going, while not necessarily easy, is at least an exercise that we believe holds a higher probability of success.

Contributors/Detractors

Gains were fairly broad based in the quarter with roughly three stocks in our portfolio gaining for every one declining. On an individual security basis, the largest contributors to our relative performance for the quarter were **Apple Inc. (AAPL)**, **Walgreen Company (WAG)**, **Robert Half (RHI)**, **Expeditors International (EXPD)** and **Boeing (BA)**. These more than offset the results of our largest detractors, which were **Target Corp (TGT)**, **Wells Fargo & Company (WFC)**, **International Business Machines Corp (IBM)**, **Berkshire Hathaway (BRKB)** and **Coach (COH)**. Though Wells Fargo and Berkshire each managed positive performance in the quarter, that positive performance was less than the benchmark's, and their large weightings hurt our relative performance.

While the price of Walgreen's stock rose strongly in the quarter, we discerned no noticeable change in its operating fundamentals. There were, however, several analyst upgrades that most likely propelled the stock. Why there is sudden excitement in a company which we've felt has been undervalued for quite some time is unclear. However, this is a textbook example of why we believe valuation can act as its own catalyst when we buy undervalued companies and patiently wait for the market to agree.

Apple benefitted from the disclosure that activist investor Carl Icahn took a stake in the company and will likely agitate for deployment of the company's massive cash balance to fund share buybacks – something we have advocated in past *Commentaries*. Apparently, Icahn's message resonated a little more strongly than ours. Apple's stock price was also helped by a strong rollout of its latest iPhone iteration. To us though, at the current price, Apple remains much less a product story than a balance sheet story, and it seems that management may be more open now than in the past to exploring ways of returning capital to its shareholders through more aggressive balance sheet management. While we are generally leery of utilizing financial engineering as way to boost the value of a company's equity, we have never seen a balance sheet stronger than Apple's, which limits much, if not all, of the risk in doing so.

Target shares sold off after it disclosed disappointing results in its Canadian store rollout. While somewhat discouraging, Target's Canadian foray is still in its early stages and we are prepared to endure some hiccups for what we believe is a natural market extension. While we think it's unlikely the Canadian stores won't ultimately be profitable, as the start-up costs for the Canadian expansion dissipate, earnings will normalize at higher levels even if the stores merely run at a break-even level. As stewards of capital, it's extremely satisfying to own a high quality, growing company with this type of margin of safety.

Giving Up the Ghost

If pressed, how many readers of this *Commentary* would have known the market was up as much as it was so far this year, or that it was even up at all? If one confined themselves to just reading the headlines (Washington D.C. infighting, Fed tapering, Egypt, Syria, China, etc.) or watching financial network media, the angst is so palpable that one might reasonably conclude that stock prices could not be up much, or are likely even down. The fact that they're not may mean that investors have finally given up the "Armageddon Ghost" we discussed in our last *Commentary*, where any negative news precipitates a major market sell-off and every market rally is deemed a "head fake." Investors, it seems, have become desensitized to the media's constant barrage of doomsday propaganda.

While this may generally be considered a healthy development for a well-functioning market, be aware that it may not be as beneficial for *our* long-term wealth in that it may inhibit our ability to purchase undervalued stocks. For with this more tolerant attitude comes a market with more muted volatility. While many investors erroneously equate volatility with risk and therefore shy away from it, we equate it with opportunity and embrace it. Our long-term results have been bolstered by taking advantage of temporary price swings to pick up securities on the cheap or sell them when dear. Maybe we're wrong and the current even-temperedness of market participants is not a new normal but a short-lived phenomenon. We can only hope.

Active Share

We are an active manager. By this we mean that we construct portfolios using individual securities in an attempt to outperform our benchmark index over a multi-year period. A passive investor, on the other hand, utilizes one or more low cost index funds with the goal of capturing as close to the market return as possible. Passive investors sacrifice the opportunity to earn more than the applicable index, knowing that they also forgo the risk of earning less.

In order to justify their existence, active managers must add value. To do that, the manager must earn a return in excess of the benchmark net of the fees charged (we'll leave for another day a discussion of the significant value the manager may add by instilling the investment behavioral discipline so many investors lack). The value added by outperformance does not necessarily have to be achieved over each and every measured time period, but certainly over longer periods of time. By definition, an active manager can outperform only by holding positions that deviate from those in its benchmark. There are only two ways to do this: stock selection or factor timing. Stock selection involves active bets on individual stocks whereas factor timing, also known as tactical asset allocation or market timing, involves varying bets based on broader groups of stocks (i.e. sectors), or varying the timing of those bets based on an opinion of how those factors will perform in the short-run.

Given that we're on record that market timing doesn't have a lot to offer the serious investor, our deviation from the benchmark comes exclusively through stock selection, which we accomplish in a combination of three ways:

1. We select securities from our benchmark that we believe have better-than-average prospects, and weight them significantly higher than their respective benchmark weighting (explicit overweighting),
2. We choose not to own securities in our benchmark that we believe have less-than-average prospects (implicit underweighting), and
3. We own some securities outside the benchmark (typically, a small percentage of our portfolios).

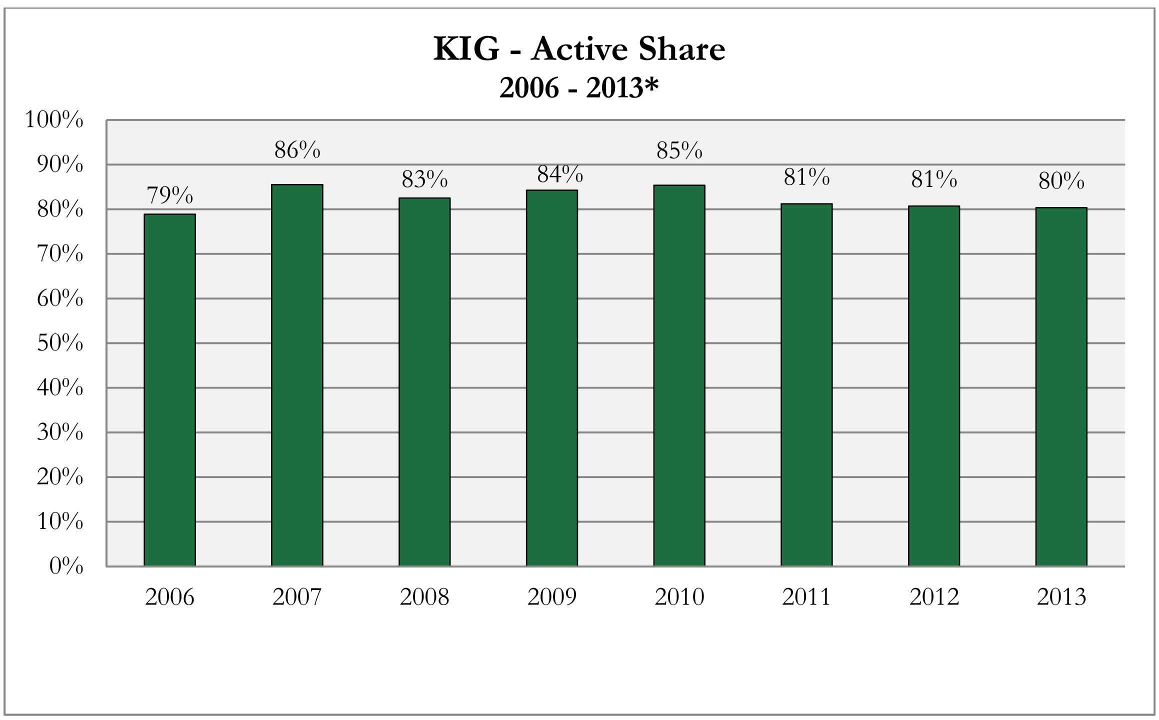
While our portfolio deviates from the benchmark, we make sure it does so in a diversified manner. Diversification is one of the few tenets of Modern Portfolio Theory that actually resonates with us. Diversification is achieved by compiling uncorrelated assets in order to diversify away idiosyncratic (company specific) risk, thus leaving portfolios with only systemic (market) risk. Generally, it has been demonstrated that holding 10 well-chosen securities mitigates much of the diversifiable risk and holding 20 securities eliminates the vast majority of idiosyncratic risk. Therefore, we consider our typical 30-35 stock portfolio to be well-diversified.

This approach differs from many active managers who allow the fear of underperforming their benchmark to motivate them to take steps to ensure their portfolios "act" more like their benchmark. Generally, this takes the form of diversification beyond its logical function. Over-diversification may reduce the short-term business risk of the active manager (i.e. not getting fired), but the strategy virtually assures long-term underperformance as over-diversified managers become "closet indexers" (i.e. managing portfolios that closely resemble the benchmark while charging active manager fees). Under such circumstances, adding value, defined as market-beating performance after fees, is a virtual impossibility.

This begs the question: how can clients who are paying for active management know if their manager is truly active or simply a closet indexer? In 2006, two finance professors from Yale devised a method to measure the extent of active management called Active Share. While the formula is somewhat complex, Active Share expresses the percentage of stock holdings in a manager's portfolio that differ from the benchmark index. Intuitively, after taking into account both the holdings and the percentage weighting of those holdings, the more a portfolio's composition differs from its benchmark, the higher its Active Share.

For an all-equity portfolio that has no leveraged or short positions, the Active Share of the portfolio will always be between 0% and 100%, with a 0% reading suggesting the holdings are identical to the index, and a 100% reading indicating a portfolio that is completely different than the index. (We would argue, however, that if one is too close to 100% there's a good chance the benchmark is a poor fit.) It is generally agreed that an Active Share reading below 60% implies closet indexing. While not definitive, data we've seen seems to suggest that the average actively managed mutual fund has an Active Share in the low-70% range.

The graph below presents the Active Share of the KIG Equity Composite from 2006 through the present. As indicated in the graph, our active share has remained relatively consistent over this period, averaging in the low-80% range. Keep in mind; this is a byproduct of our consistent investment approach, rather than an objective to which we manage.



**Active Share for each year is measured as of the last calendar day of the year and as of June 30, 2013 for 2013.*

Antti Petajisto, one of the creators of the Active Share metric, followed up his original work with a 2009 study (focusing primarily on mutual funds) that came to some interesting conclusions. He found that, "Although the average actively managed mutual fund has underperformed its benchmark index, both the type and the degree of active management matter considerably for performance… The most active stock pickers have been able to add value for their investors, beating their benchmark indices by about 1.26% a year after all fees and expenses. Factor bets have destroyed value after fees. Closet indexers have essentially just matched their benchmark index performance before fees, which has produced consistent underperformance after fees."

Institutional behavior in the investment management industry tends to emphasize the avoidance of embarrassment, which generally leads to over-diversification. This almost always leads to performance that is *indifferent* from the benchmark. As John Maynard Keynes famously said, "It is better to fail conventionally than to succeed unconventionally." In our opinion, successful active management strategies demand un-institutional behavior. We have always felt that succeeding as an investment management firm meant building a long-term performance record that exceeded our benchmark. Rooted in the assertion that the only way to outperform a benchmark is to be different from it, we have attempted to add value through the selection of attractive risk-adjusted investments through exceptional security analysis. We have also believed it extremely important to allocate capital to our best ideas without over-diversifying.

Although high Active Share does not guarantee outperformance – it only indicates that performance is going to be different than the benchmark – it is likely a necessary condition for outperformance. High Active Share coupled with a rigorous investment framework and disciplined and rational decision making process gives us confidence that we will continue to add value to the wealth building process.

Portfolio Activity

KIG Theorem: "There is an *inverse* relationship between the trajectory of the market (upward/downward) and the amount of qualifying investments (less/more) that are available for purchase."

Given that we've been in an upward phase for some time now, it should come as no surprise that we are finding little to do on the buy side. However, as opposed to last quarter where we did not initiate any new positions, we were able to uncover what we believe are two promising situations during the quarter, **DirecTV (DTV)** and **Vodafone (VOD)**.

Generally, qualitative characteristics of qualifying investments include the strength of the franchise, the predictability and sustainability of free cash flow, and how well management is allocating that free cash flow. Quantitatively, the valuation multiple (price to earnings/cash flow) must allow for expansion. DirecTV, which provides digital TV service via satellite to over 20 million customers in the United States and over 16 million in Latin America, fits the bill. Trading at an attractive 9% earnings yield, truly discretionary free cash flow far exceeds reported earnings as the cost to gain new subscribers, an optional investment with high long-term returns, is deducted from current profits. With a mature U.S. business, these subscriber acquisition costs are set to decline. Latin America, where satellite TV sits in an even stronger competitive position given the prohibitive cost to build fiber networks, continues to experience robust growth rates as its economies further develop. DirecTV has been an extremely aggressive share repurchaser, having retired over 20% of its shares over the last two years and with a commitment to buy in another 10% this fiscal year. Based on these factors, we believe DirecTV will produce meaningfully greater growth on a per share basis than what the market has "priced in" with respect to its current valuation.

We also took an initial position in Vodafone, a company that may be familiar with longer-term clients as we have successfully bought and sold it in the past. Vodafone is one of the world's largest providers of mobile services with over 400 million customers in 40 countries, primarily in Europe. However, its most valuable asset is its 45% ownership stake in U.S.-based Verizon Wireless. Our thesis, then and now, is simple: When you strip out the value of its Verizon Wireless stake, Vodafone's remaining assets sell at a large discount to our estimate of fair value. The last time we owned the company, this exercise was more theoretical because the range of values that could be ascribed to the Verizon Wireless piece was wide. Recently, however, **Verizon Communications (VZ)** (the parent company of Verizon Wireless) announced its intentions of buying its long-time partner Vodafone's stake in Verizon Wireless for $130 billion. Even after taking into account associated tax liabilities from the sale, this value was significantly higher than what we had assumed, thus making the remaining assets that much cheaper in our eyes.

We increased our exposure to **Coca-Cola (KO)**. Shares of Coca-Cola trended lower during the quarter most likely due to a listless quarterly earnings report that revealed volume growth below expectations. We're not sure which is worse: that analysts believe they can calibrate sales levels precisely to three-month intervals, or that investors react when the actual results differ from these estimates (also known as guesses). Regardless, we'll take our investment cues from different measures, including the quality of the company's competitive advantages, and its price in relation to our estimate of intrinsic value. Coke has the former in spades with its superior brand equity and scale, while it's trading at a price that does not reflect these attributes. Admittedly more mundane (some may say simplistic), we believe these characteristics are more important to the investment outcome than whether the company misses or exceeds a quarterly sales or earnings number.

<u>Corollary to KIG Theorem</u>: "There is a *direct* relationship between the trajectory of the market (upward/downward) and the number of portfolio companies we are actively looking to sell (more/less)."

Given that we've been in an upward phase for some time now, it should come as no surprise that we are looking to be more active on the sell side. Along these lines, we eliminated our interest in **Lowes (LOW)** and trimmed our position in **CarMax (KMX)** during the quarter. While this may not constitute as much activity as our corollary suggests, several other holdings are getting much closer to price-to-value ratios where action may be required. After the large market moves over the past couple of years, the fact that we haven't sold more positions speaks more about the low valuations from which many stocks were at rather than how richly they are valued today.

After multiple years of ownership, we exited our position in Lowe's. While our enthusiasm for the company (its business model, financial strength, competitive positioning) has only grown stronger over our long holding period, its stock price reached a level we thought was more than fair. In other words, it was a great holding for us, and we continue to think it is a great business, but we no longer believe it represents a great value. We can't continue to hold a security that doesn't offer the reward of better-than-market returns with less risk regardless of how much we admire the underlying company. A successful investment outcome is typically determined by relatively few variables. In this case, Lowe's management made two important decisions that we believe drove the stock's return: slowing store expansion and using the resulting increase in free cash flow (supplemented with cheap debt) to buy back stock. And not just a little bit of stock. Over our holding period, the company bought back approximately $14 billion worth of stock, or enough to retire approximately 30% of its share count. As we have said repeatedly in these pages, when a company's stock represents good value, the best (and least risky) capital allocation decision management can make is to repurchase shares. For a mature business selling at a discount like Lowe's was, we believe it was the best way for management to maximize intrinsic value on a *per share basis*, which is what we care about most.

We may admire CarMax even more than Lowe's. Still, we thought it prudent to scale back our exposure during the quarter as the stock's price has appreciated substantially. We did not eliminate it entirely like we did with Lowe's, as the range of future outcomes for this business includes scenarios with further upside. However, its margin of safety is less than what we prefer for a position the size of CarMax's before we trimmed our holdings.

The decision between selling completely and trimming is a difficult one. Mathematically, it's based on our probabilistic scenario analysis and resulting upside versus downside projections. In non-mathematical terms, we view our options something like this: if it's a great business and is priced as such – sell; if it's a great business but priced as if it's merely a good business – trim. This all starts with the premise that, initially, we are trying to buy great businesses that are priced as average or less-than-average businesses.

KIG is Growing and Welcomes New Employees

We have added new talent to the Kovitz team to strengthen and support our growing firm.

Brandon Hinkle joined Kovitz Investment Group in September 2013. Brandon focuses on business development and portfolio management for Kovitz Private Holdings, LLC, an affiliated private equity holding company. He utilizes his vast operating and finance experience to identify and assist corporate acquisition opportunities. Previously, Brandon founded Plura Financial Solutions in 2010, an online matchmaker between banks and small businesses seeking debt. Brandon also served as CFO & COO at Chicagoland Beverage Company, a regional beverage distributor. His prior experience also includes serving time in the GE Antares workout group from 2008 – 2010, and various commercial banking and leveraged finance roles at Merrill Lynch from 2001 – 2008. Brandon earned a Bachelor of Science in Finance from Michigan State University in 2001, and an MBA in Marketing & Entrepreneurship from the Kellogg School of Management at Northwestern University in 2009. Brandon has been a frequent guest speaker at Northwestern's Entrepreneurship & New Ventures class, and made several guest appearances on MSNBC discussing financing options for small businesses.

Richard Walters, Systems Engineer, joined Kovitz Investment Group in September 2013. Rick helps manage, develop and support the firm's technology infrastructure. His prior work experience includes engineering business processes, managing network security and designing information systems. Rick studied Mechanical Engineering at University of Wisconsin Platteville, is an inventor and owns three patents on automatic transmission design.

Quotes

"The right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence." – John Maynard Keynes

"Risk means more things can happen than will happen." – Elroy Dimson, London Business School

Best Regards,

Kovitz Investment Group

Kovitz Investment Group, LLC

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Past performance does not guarantee future returns.

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