Investment Commentary

Winter 2013

Market and Performance Summary

The Kovitz Investment Group® (KIG®) Equity Composite increased in value by 2.2% during the fourth quarter (net of fees), compared to a loss of 0.4% for the Standard & Poor's 500 (S&P 500). For calendar year 2012, the KIG Composite gained 19.1% versus a rise in the S&P 500 of 16.0%.

While pleased with the absolute return generated by our equity portfolios in 2012, we are even more satisfied with the relative outperformance versus our benchmark. In a significantly rising market, we are more than content to be average, knowing that our management approach is better suited to outperform in down markets (which is how we prefer it to be). Our goal is for the value of our holdings to consistently decline less than the overall market when the market declines while participating fully, but not necessarily more so, when the market rises. Therefore, we consider outperforming during a year like 2012 where the market experiences an above-average return as gravy.

On a separate but related note, it is common for any self-respecting value investor to feel the opposite of how a client feels. When we perform well, we get nervous and sense fewer opportunities; when times are miserable, we feel the excitement of searching for bargains. Trust us - there will be periods in the future when the general investing public feels miserable, and we hope that, instead of experiencing dread, you will join us in feeling energized.

As 2013 begins, however, we are less nervous than we were during past periods where the market experienced above-average performance. Our outperformance over the last year was primarily driven by above-market returns in companies we own in the financial sector. We have been substantially overweight in this sector versus the S&P 500's weightings since the reverberations of the financial crisis caused the valuations of many financial companies to contract to levels we felt were unsustainably low. Even after the strong gains realized in 2012, we feel most of our financials, as well as the stocks we own in other sectors, continue to be undervalued relative to our estimates of intrinsic value. While we never know how the trajectory of returns will manifest itself over periods as short as the coming year, we are relatively confident that decent gains should be realized in the context of what could be considered a longer-term time frame.

We must note that there's nothing magical in looking at a performance period consisting of the time it takes the earth to revolve around the sun once. Therefore, the results for our complete history, now covering sixteen such revolutions through December 31, 2012, along with corresponding benchmark returns are provided below. Our goal is to outperform the S&P 500, which serves as a proxy for the total U.S. equity market, over the long term – a goal we have thus far accomplished since the beginning of our track record on January 1, 1997. Since this inception date, our results have exceeded our benchmark on an annualized basis by approximately 4% per year after deducting all fees and expenses. On a cumulative basis, $1,000,000 invested with us sixteen years ago would now be worth approximately $4,755,000, while the same $1,000,000 invested in the S&P 500 would now be worth $2,533,000. We view these results as further confirmation that our focus on longer time horizons (as compared to most of our peers) continues to be a strategy worth pursuing.

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

	1-Year	3-Year	5-Year	10-Year	Since Inception (16 Years)
KIG	19.1%	12.0%	4.7%	8.0%	10.2%
S&P 500	16.0%	10.9%	1.7%	7.1%	6.1%

Positioning for the Cliff

While most of the talking heads in the financial media were frightening investors into adopting a defensive stance as the fiscal cliff negotiations waxed and waned, we did not alter our portfolio positioning one iota. This was not because we felt a deal was imminent. In fact, we had little confidence an agreement would be reached before the imposed end of year deadline. We live in a polarized age. Each party holds tightly to its ideals, unable to compromise until reality, or the markets, forces them into an acceptable course of action (but only after seemingly trying all the others first). Yet we were (and are) content to hold our companies throughout this period of political uncertainty even though the probability of a severe downward market reaction increased with each passing day. Why? Because we felt confident that, regardless of the near-term outcome, the intrinsic values of the businesses we owned would not suffer irreparable harm. The fact of the matter is that it is extremely difficult for public servants to inflict any long-term damage to our economy and, hence, business values. The market moves up and down but businesses with solid fundamental strengths endure.

Operating in constant fear of day-to-day catalysts is in many ways exactly the opposite of how investing should be pursued. The negative case for the stock market is always more compelling than the bullish case. Pessimism always seems to sound more articulate and rational than optimism. This will always be the case because fear is a much more powerful and motivating emotion than joy. As James Grant recently wrote, "No one foresees tailwinds, only winds in their face." Yet, successful long-term investing in quality businesses must be based upon how the individual companies that you're invested in will perform in the future, not how the stock market might perform tomorrow. We choose to focus our energies on dissecting and analyzing company and industry-specific factors which provide the foundation for our investment decisions. Attempting to anticipate macroeconomic issues may prove futile, but company fundamentals, when correctly evaluated, remain the most durable way of ascertaining business values. We protect against worrisome events by investing in well-managed, financially strong, and competitively-advantaged businesses when they are selling at large discounts to our assessment of value and patiently waiting for the gap between price and value to close. Fortunately, companies such as these are built to weather most storms.

In our opinion, the most dependable way to consistently make money is to buy something for less than it's worth. Buying at a discount from intrinsic value and having the asset's price move towards that value doesn't require serendipity; it just requires sound reasoning, patience and a mindset that value exerts a magnetic pull on price over time. Negative shocks in the overall economy may prolong the ultimate payoff, but they will not permanently impact returns. This is the core of what we do and it will never be held hostage by politicians in Washington.

Portfolio Activity

Compared to many recent quarters, volatility in the market was fairly subdued over the last three months of 2012. We tend to embrace volatility as it can provide attractive entry and exit points for individual securities, and higher levels of volatility generally leads to more portfolio activity. On the other hand, tighter ranges in market pricing generally leads to lower activity, which is what occurred during the last quarter. We remain mindful that when there's nothing particularly clever to do, the potential pitfall lies in insisting on being clever. Sometimes (perhaps most of the time) doing little has more of an impact on portfolio returns than doing a lot. That said, we established two new positions during the quarter and we added to a handful of existing names which fell into our buy range primarily to newer client accounts. We also sold our position in **Cemex (CX)** and trimmed **CarMax (KMX)**. As we will discuss below, we admire CarMax's business model and continue to believe in its ability to create wealth for its shareholders. However, with CarMax's strong performance in 2012, prudent portfolio management compelled us to reduce its weighting in accounts where the position had grown disproportionately large.

One of the two new positions we added was **American International Group (AIG)**, a company that was effectively nationalized at the height of the financial crisis when the government cobbled together a $182 billion rescue package. Fast forward to today: the government's stake has been all but eliminated (at a profit of over $20 billion) and the company bears little resemblance to the complex, unwieldy mix of businesses it once was. AIG has slimmed down to the point where it has two primary lines of business, property and casualty insurance and life insurance, and we consider both to be leaders in their respective markets.

However, it appears as if the market is still punishing the company for its old ways as its current price is roughly 50% of tangible book value. A valuation this low implies that the company will earn no more than a 3-4% return on equity, an estimate that we believe to be overly pessimistic. With the company rationalizing its non-core operations and executing an operational turnaround, we consider it a cheap restructuring play.

We believe AIG's continued optimization of its portfolio of businesses should free up additional excess capital that, subject to regulatory approval, can likely be returned to shareholders primarily through share buybacks. With the company's shares selling below tangible book value, share repurchase activity would be highly accretive. In December, the lockup of AIG's interest in the stock of AIA Group, its listed, non-core Asian life insurance business, expired, which allowed the company to monetize its unencumbered 13.7% interest for $6.4 billion. Further, the recently announced sale of 90% of ILFC, AIG's aircraft lessor subsidiary, will not only generate $4+ billion in excess capital but also simplify the company's structure and reduce its cost of capital. Also, we think that the recently announced government's sale of its remaining stake in AIG will serve as a critical catalyst for the company, because it will allow the initiation of a dividend, a change in management's compensation structure to more closely align management's incentives with shareholders' interests, and the removal of the "overhang" of U.S. Treasury ownership. Given these multiple paths to value creation, we believe the price of AIG shares will ultimately trend towards book value, if not higher, over time.

The second position initiated during the quarter was **Leucadia National (LUK)**. Leucadia can be described as somewhat of a quirky company. It is a diverse holding company that makes direct investments in publicly traded companies and also holds an eclectic mix of operating businesses that includes beef processing, plastic and lumber manufacturing, gaming entertainment, and real estate. The company recently announced that it would acquire the remaining shares of the investment bank **Jefferies Group, Inc. (JEF)** in an all-stock deal. During 2011, Leucadia had made a significant investment in Jefferies (28% of Jefferies' shares for roughly $1 billion). This was an opportunistic purchase at a time when Jefferies was under pressure for amassing a portfolio of European sovereign debt. The companies have had a long history of collaboration and, because of that intimate relationship, Jefferies' CEO, Richard Handler, will become CEO of Leucadia after the deal closes. This solves a succession issue for the outgoing co-CEOs of Leucadia, although both will remain involved with the surviving company - one as Chairman and the other as a board director.

At the time of purchase, shares of Leucadia were trading at a 15% discount to book value, a level we thought to be far too low for the quality of Leucadia' assets and its long track record of compounding book value at above market rates. Instead of buying shares of Leucadia directly, we purchased shares in Jefferies (its acquisition target) for which we will receive Leucadia shares upon completion of the deal. We initiated our position in this manner because Jefferies was trading at a 6% discount to the terms at which Leucadia had agreed to purchase the company. This gap will necessarily close when the deal is finalized, at which point we will directly own shares of Leucadia. While we can never be 100% certain that the deal, which is expected to close in the first quarter of this year, will come to fruition, we have a high degree of confidence that it will.

In order to fund these new positions where cash was unavailable, we trimmed positions in **Markel (MKL)** and **Goldman Sachs (GS)** in order to maintain our exposure to the financial services sector at its existing level.

The Year in Review

Against a backdrop of continued macroeconomic and political uncertainty, we feel confident that the individual holdings that make up our portfolio have both the durability and resilience to weather the inevitable shocks, as well as a proven record of adapting and growing through different types of economic and business environments. The portfolio is filled with competitively entrenched, financially strong, and attractively valued businesses with positions that are appropriately sized to our convictions. As a group, they are underleveraged, generate more cash than they need to fund their operations, and actively return this excess cash to shareholders in the form of dividends and stock buybacks. Yet, even after strong price appreciation in 2012, most of the stocks in our portfolio still have valuations that range from severely to modestly undervalued.

Of the stocks we owned during 2012, seventeen were up 20% or more for the year, while only two declined. For a complete breakout, the chart below illustrates the number of holdings whose performance fell within each of the listed ranges.

Summary of 2012 Performance, by Number of Holdings*

2012 Performance**	# of Holdings
Up 30% or more	10
Up 20% - 29%	7
Up 10% - 19%	9
Up 0% - 9%	12
Down 1% - 10%	1
Down more than 10%	1

**Includes all "core" portfolio positions held in the Equity Composite throughout 2012; appreciation is measured from 1/1/12 or the date of purchase in 2012, as applicable, to 12/31/12 or the date of sale in 2012, as applicable. Not all of KIG's client portfolios are part of the Equity Composite. Individual client experience may vary, and not all clients held all such portfolio positions for the time periods referenced in this newsletter. Please refer to page 11 for additional disclosures.*

***Includes dividends received throughout the year.*

Based on position size and return, the following stocks had the largest impact on our performance during 2012 relative to our benchmark, the S&P 500. Keep in mind, certain positions listed below under "detractors" may actually have been up for the year, but their positive return was less than the return of our benchmark, thus negatively impacting our *relative* performance.

Top Contributors/Detractors from Relative Performance

Top 5 Contributors to Performance	Top 5 Detractors from Performance
Lowes	Bed Bath & Beyond
Goldman Sachs	Kohl's
Wells Fargo & Company	Boeing
Bank of New York Mellon	United Parcel Service
Bank of America	Biglari Holdings

As mentioned previously, a large portion of our outperformance for 2012 was attributable to our holdings in the financial services sector. In stark contrast to 2011, where all but one of our financial holdings declined, each had positive returns in 2012 with many returning over 20%. We wish we could say we had a great explanation of why returns in this sector were as strong as they were in 2012, but we don't. Then again, we had no plausible explanation as to why they were down as much as they were in 2011. Our suspicion is the toned down rhetoric relative to a collapse of the European Union helped along with comparatively fewer headlines predicting the next financial crisis. We further suspect that the passage of time since the late 2008 financial crisis has caused the stigma of owning financials to slowly fade. In addition, valuations in this sector had been suppressed to such low levels, it seemed like the only direction possible was up.

In an effort to avoid permanent losses of capital, our analytical process typically places more emphasis on the downside of an investment versus its upside. A probabilistic endeavor, we weigh negative scenarios against positive ones and will invest only if the expected return is firmly positive. In the case of **Bank of America (BAC)**, we believe investors are placing too high of a probability on what might go wrong and too low of one on what might go right.

Even though we only owned Bank of America (B of A) since roughly mid-2012, it was our portfolio's best performing financial stock with a 51% gain (performance based on the weighted average price of our two separate purchases on April 23, 2012 and July 27, 2012). B of A was squarely in the spotlight during the financial crisis, and, despite the stock price's improvement during the past year, the company's balance sheet is still viewed somewhat skeptically. However, the bank has made steady progress rationalizing its operating units and streamlining its cost structure, and contrary to popular opinion, the bank is extremely well-capitalized. Despite B of A's continuing difficulties in settling mortgage-related lawsuits stemming from its ill-timed acquisition of Countrywide Financial, potential liabilities are largely provisioned for on its balance sheet already. In fact, we think B of A has built a balance sheet capable of withstanding all but the direst of economic circumstances. Although we place a low probability on this outcome, we believe B of A would fare better than most financial institutions even under strained economic conditions because we believe it could raise additional capital on reasonable terms if such a situation were to arise.

We believe the bank's current stock price implies that current earnings are normal. However, even though provisions for loan losses have come down dramatically from prior years, they are still much higher than levels achieved pre-crisis. Therefore, current earnings are significantly understated and considerable earnings growth is attainable without heavy dependence on robust economic growth. We believe earnings should soon start accelerating, thus enabling the company to distribute a much larger amount of cash to shareholders. Despite its quick start, we continue to feel good about owning a business that is most likely underpriced based on normalized earnings and/or book value and, at worst, fairly priced based on current earnings.

Wells Fargo & Company (WFC) was another financial sector holding that had a standout year in 2012, up 27%. Wells Fargo's superior management and strong balance sheet allowed the bank to raise necessary capital and to acquire rival Wachovia at the depths of the financial crisis. Today, the combined enterprise originates approximately one out of every three mortgages in the U.S., a fact which finally seems to have resonated with investors as perceptions of the housing market have shifted to the positive. Although the economy is less than robust 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% higher than the earnings it is currently reporting. Even after last year's run-up in price, we don't feel that this earnings power is fully reflected in its stock price. Wells Fargo is trading about where it was in 2006 when the bank was earning about one-half the level of what we believe its normalized earnings are currently.

When discussing **Lowes (LOW)** in last year's review, we wrote, "We believe that while price performance has been uninspiring, it is likely a situation of deferred gratification as opposed to mistaken analysis." With Lowe's share price increasing 43% for 2012, some of that gratification has been realized. We're not looking for a pat on the back: the takeaway is that focusing on business fundamentals and not being swayed by the pricing mechanisms of other investors is the most appropriate framework for making investment decisions. Patience is a necessary tool in order to invest this way and the appropriate perspective is essential to remain steadfast in obtaining a suitable multiple of normalized earnings before we exit a position. That ability to be patient and to maintain the appropriate perspective comes from you and the trust you have in us. Thank you.

Lowe's stock price moved up throughout the year as perceptions that a nascent recovery in the housing market has taken hold. Further bolstering the shares was the impression among investors that the company has made steady progress in closing the performance gap with **Home Depot (HD)**, which had been outpacing Lowe's in many sales and profitability metrics. Lowe's is in the second year of its strategic plan designed to drive sales and improve profitability. Year one of the transformation largely focused on building up its IT infrastructure and installing the capabilities to provide store associates with faster access to better information and the tools to improve transaction speed. The bigger issue was to refresh its merchandising approach and its pricing structure, which had become somewhat less competitive. After taking action late last year to clean up its price perception relative to Home Depot, Lowe's embarked on additional initiatives aimed at building upon the company's historic/core strength: delivering compelling products at great values. Still a work in process, signs that the company has been making headway in these areas have been evident in its results.

Our focus has been, and will remain, on Lowe's free cash flow generation and management's allocation of that cash. In our opinion, management has taken all the right steps. The company slowed new store development, closed unprofitable stores, and spent its considerable free cash flow on sprucing up existing stores. It has also bought back stock and increased its dividend payout (by 78% since 2009). Regarding buybacks, Lowe's has repurchased almost $10 billion of its own stock over the past three years, or approximately 23% of shares outstanding. Given that we believe the stock has been underpriced throughout this period, we think that this was an excellent use of the company's cash. The increase in its stock price is therefore a double-edged sword: it is good news for our portfolio's performance, but a higher price means fewer shares can now be repurchased for the same amount of dollars. As such, we have tempered our expectations and slightly lowered our fair value target, although it still lies comfortably above the stock's current market price.

Kohl's (KSS) was our biggest decliner for the year, dropping 11%. Most investors view past price weakness as worrisome. Generally, we view it as a sign that the asset has gotten cheaper. Valuation assessments should remain independent of emotions, and it is the relationship between other investors' subjective view on prices and our objective valuation that drives our outlook at any given time. Like Lowe's, Kohl's has implemented a significant stock repurchase program, and a lower share price will enable management to buy back even more shares. Since we are not participating by selling our shares, our ownership stake will increase commensurately. This is not to say all is well with Kohl's right now. Reported monthly sales have been erratic as merchandising decisions have resonated with its core customer base, but have not attracted as many infrequent shoppers as in the past. Additionally, the economic environment has not been especially conducive to encouraging spending beyond the essentials, so competition among apparel and home goods retailers has intensified and discounting remains prevalent. We view these factors as cyclical and not an indictment on Kohl's business strategy or long-term competitive positioning. (We are curious, however, why Kohl's has not picked up any meaningful share in the wake of the sales hemorrhaging at J.C. Penney, one of its primary competitors. Our research is currently focused on looking for that answer.)

Kohl's offers an attractive proposition for convenient shopping for well-known brands at relatively low prices. It combines the low cost structure of a mass merchant with the national brands of a traditional department store. Kohl's continues to introduce successful private and exclusive brands following the example of its Jennifer Lopez and Vera Wang lines. While these are positives, we concentrate primarily on the cash the company generates, which continues to be substantial. Kohl's current free cash flow yield is approximately 10%, of which nearly all is being returned to shareholders in the form of share repurchases and dividends. In other words, this equates to a 10% annual return assuming no growth in cash flow and a constant multiple. Our belief is that cash flow will grow over time and at some point investors will place a higher multiple on Kohl's shares resulting in an annual return significantly higher than 10%. With a company of this stature, we are prepared to wait until the views of other investors come around to match ours.

Our only other stock that lost ground during 2012 was **Bed Bath & Beyond (BBBY)**, which fell 4%. Top line trends slowed throughout the year as industry competition pressured same store sales comparisons. Increased utilization of coupons and a continuing shift mix to lower margin products has also led to year-over-year gross margin declines. These trends surely give cause for worry, yet we had no illusions that sales would continue to grow at the lofty rates of the last few years. Bed Bath garnered significant market share from the demise of Linens 'n Things in 2009, and that benefit has cycled off. We also anticipated a steady decline from its industry-high gross margins as its other store concepts (primarily buybuy Baby and Christmas Tree Shops), which have a lower margin structure than the flagship Bed Bath stores, became a larger percentage of its overall store base. Most investors automatically assume that a declining gross margin as a percentage of sales is evidence that a business is in a state of decline. Oftentimes, that is a valid assumption, but there are times when it is not. A company's goal should be to grow its dollar amount of gross margin, not necessarily its gross margin percentage. As long as a company is earning a return that is greater than its cost of capital, a declining margin percentage is acceptable if it is associated with margin dollar growth. We believe this is the case with Bed Bath.

Bed Bath's other positives include: 1) a pristine balance sheet with no debt and over $850 million in cash and short-term investments (equal to about $4 per share), 2) an intention to repurchase a significant amount of stock ($2.7 billion over three years, or 20% of its outstanding shares at current prices), and 3) a valuation that has Bed Bath trading at around 11x current earnings (ex-cash). This represents a multiple well below where we believe this exceptional retailer should be trading.

Shares of **Apple Inc. (AAPL)** appreciated 33% in 2012. Even so, the company has seemingly gone from the company everybody loves to the company everyone loves to hate. The "hating" began just as the stock began to slide from its record high of approximately $700 per share to under $600 per share. Then the negative sentiment really picked up as the stock moved down closer to $500 (current value is $532 as of December 31, 2012). Coincidence? In our experience, as stocks fall in price, investors look for reasons to explain the decline. As the cacophony increases, the explanations take on an aura of "reality" and the stock price declines deepen in a self-fulfilling prophecy. John F. Kennedy once said, "The enemy of the truth is not the lie, but the myth." Nowhere does this have more relevance than in the stock market where "conventional wisdom" is most often based on unsubstantiated rhetoric. The simple answer is no one can really explain why stocks rise or fall over short-term intervals. It's typically nothing more than random noise.

The primary "explanation" for Apple's price decline seems to be the feeling that its earnings have peaked as competition in its smartphone and tablet markets will pressure margins. We have no doubt that over time Apple's industry leading margins will soften, but we feel it will be more than offset by unit growth, which will lead to increased earnings over the foreseeable future. However, for the sake of argument, let's say the bears are right and we are wrong. Let's assume that earnings peaked in 2012 and that they decline 5% per year for the next three years. What does that imply about Apple's current stock price? To answer that question, we turn to Apple's balance sheet. Specifically, let's look at the buildup of Apple's largest asset: cash.

The table below estimates the growth of cash on Apples balance sheet over the next three years.

Growth of Cash on Apple's Balance Sheet*	
Cash as of September 30, 2012	$121.2 billion
Plus: Q4 2012 Cash Earnings	$12.2 billion
Plus: 2013 Cash Earnings (5% decrease from 2012)	$44.7 billion
Plus: 2014 Cash Earnings (5% decrease from 2013)	$42.4 billion
Plus: 2015 Cash Earnings (5% decrease from 2014)	$40.3 billion
Less: Cash Dividends Paid: Q4 2012 through 2015	($32.4 billion)
Cash as of December 31, 2015	$228.4 billion

**Based on KIG estimates*

Apple's Valuation in 2015: Bear Scenario	
Current Market Capitalization (12/31/12)	$500 billion
Cash as of December 31, 2015	($228.4 billion)
Enterprise Value (Market Cap Less Cash)	$271.6 billion

2015 Cash Earnings	$40.3 billion
2015 Price-to-Earnings Ratio	6.7 x

A large portion of Apple's cash resides overseas and under current U.S. tax law could not be repatriated without incurring certain tax liabilities (accounting for this increases the multiple slightly, to about 7.5x.) Regardless, this demonstrates that even in a bearish scenario (peak earnings in 2012), the cash-generating ability of Apple over the next three years leads to an absurdly low PE ratio if the stock price does not move up from here. Understand that while we think Apple produces great products, we are not "Appleonians," a term reserved for those who adore everything Apple, including owning its stock. No, our investment thesis is that we consider it a mis-priced stock. Of course, we will continually monitor the company's business operations to be sure that even flat earnings prove to be too pessimistic.

Investor fancies are fickle. We choose to ignore emotional perceptions and instead focus on fundamentals and valuation. Using this approach, Apple sets up a very interesting risk/reward situation. If we are correct and earnings actually increase from here, the stock has significant upside. If earnings were to be flat from here, the stock probably has moderate upside. Most importantly, even if the bears are correct, we believe that there is little to no downside from this price. We like our odds.

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 CarMax to sell lower quality cars into the wholesale market (i.e. cars which don't meet CarMax's quality standards are sold at auction to other used car vendors), which is becoming a large part of recurring revenues. Even with CarMax's 23% gain during 2012, we believe CarMax is undervalued in light of its significant growth opportunities. CarMax currently operates just 113 used car superstores in 56 markets. We believe that it can add a meaningful amount of stores in current and untapped markets as a value conscious public continues to embrace the CarMax brand. Under this approach, marketing spend and corporate overhead will be able to be leveraged over a larger base of sales.

Despite its tremendous growth already, CarMax's market share is still under 4% of the $250+ billion used car market. This share should grow steadily as its business model continues to take hold and flourish. 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.

As stated above, we closed out our position in Cemex. Cemex was our largest percentage gainer in 2012, increasing 93% (measured from January 1, 2012 through our sale on December 20, 2012), yet it was one of our larger mistakes over the past few years. We failed to anticipate the magnitude of the demand destruction that the housing bust and ensuing economic crisis would have on Cemex's primary products, including cement, concrete and aggregates. This was compounded by the fact that Cemex was highly leveraged due to untimely acquisitions and lacked the flexibility that companies with better balance sheets enjoy in economic downturns. Cemex management was forced to spend too much energy refinancing debt and renegotiating covenants with its lenders, which left less time to focus on its struggling business. The company eventually right sized its cost structure and began to pay down debt through asset sales. Regardless, our initial analysis was flawed and we erred in our estimate of intrinsic value as a result. We should have known better.

Our goal in writing these newsletters is twofold: 1) Transparency - to provide a frank assessment of our analytical process, mistakes and all, and 2) Substantiation - to clarify our investment principles as they relate to equities, and demonstrate how we utilize them in the context of our overall money management framework. We hope we have accomplished these goals. On behalf of all of us at KIG, we thank you for your continued trust.

Clarification and Correction

Every once in a great while it is brought to our attention that some of our readership has construed a meaning from our writings other than what we intended. We believe any lack of clarity is the responsibility of the writer, not the reader, and thus we try to clear up the misunderstanding when that occurs.

Such a case occurred with our most recent newsletter issued in October 2012. The mix-up centered around our explanation of our exit from our holdings in **PrivateBancorp (PVTB)**, a regional bank located in Chicago. In the explanation, we indicated that management had not disclosed the company's significant exposure to certain real estate assets. We implied that had we known that fact we might not have made the investment in the first place, or that we may have exited the position before the substantial drop in price of the stock. (Note: we did end up exiting the position profitably because we averaged down our cost by buying more shares after the price of the stock fell.)

A few of our readers concluded that KIG's view was that management was deliberately quiet on the subject, knowing full well that the bank had exposure about which the market didn't know. Where we erred is in not fully appreciating that "lack of disclosure" has a deeply negative connotation to it in that it can imply a willful and intentional act on the part of management to deceive shareholders. We had no evidence or knowledge of that being the case and the implication was not what we intended. We simply intended to state that the information we deemed important once we learned of it was not disclosed by company management, and that we therefore based our investment decisions only on the information we had. We apologize for any confusion this may have caused.

Quotes of the Quarter

"We have two classes of forecasters: Those who don't know - and those who don't know they don't know." – John Kenneth Galbraith

"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on." - Amos Tversky

"Doubt is not a pleasant condition, but certainty is absurd." - Voltaire

Best Regards,

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