KOVITZ INVESTMENT GROUP
Intrinsic Values™

Investment Commentary
Winter 2014

This quarterly installment of our investment commentary follows a Question and Answer format. We attempted to include a wide range of issues, from our equity performance to our thoughts on risk, as well as a discussion of various aspects of our investment philosophy. We tried to address what we'd want to hear about and what questions we'd want answered if our positions were reversed. If we left out a question you would have liked answered, please contact your Kovitz Investment Group (KIG) advisor and we will do our best to respond.

Q. How did the KIG equity composite perform in the final quarter of 2013?

KIG. For the quarter ended December 31, 2013, the KIG Equity Composite (the Composite) increased in value by 9.9%, while our primary benchmark, the S&P 500, increased 10.5% over the same period.

Q. And how about for the full year?

KIG. For all of 2013, the Composite increased 32.7%, which was slightly better than the 32.4% increase exhibited by the S&P 500. While we are thrilled with these strong absolute results, we'd like to remind everyone that our style doesn't typically lead to outperformance during periods of broad market gains. 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. Our goal is for the value of our clients' 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.

Note to our clients about 2013 performance: When you receive your personalized performance reporting package from us in the coming months, you may notice that the performance of the equity portion of your portfolio may be as much as 2-3% higher than what we reported above. This is due largely to a number of new large accounts that funded in cash this year. In situations such as this, we retain our disciplined approach of only purchasing a stock if the price we can buy it at provides an adequate margin of safety relative to our estimate of the value of the underlying company. During 2013, the cash balances in these accounts were invested gradually in accordance with our philosophy, thus, due to the unusually large gain in the broader market, they created an unusually large drag on our reported performance. Seen in this light, we are extremely pleased with our relative performance versus our benchmark.

Please understand that although we know there is an interest in how our clients perform over the short time periods mentioned (and yes, we believe even one full year is considered short) and are happy to present it in order to be fully transparent, it is just not something on which we focus. We are of the belief that being preoccupied with short-term outcomes will not lead to above average long-term results.

Besides, there is nothing necessarily informative in looking at performance over a short period of time as there's far too much noise in financial markets to place any meaningful value on it. Luck, both good and bad, can have significant impact on results over short periods of time. Performance over longer time spans is a much preferable benchmark to gauge the skill of an investment manager and the value added for the client.

Q. Understood. So how has performance been over the longer term then?

KIG. Our stated goal is for the Composite to outperform our benchmark by 2-3%, net of fees, on an average annual basis when measured over long time periods. The Composite now has an investment performance record that spans seventeen years (1997-2013). Over that time period, it has an annualized return of 11.5%, exceeding the S&P's return of 7.5% over the same period by 4% per annum. We are extremely happy to be exceeding even our own heightened expectations.

The charts below summarize both annualized and cumulative performance results from January 1, 1997 through December 31, 2013 for the Composite and the S&P 500.

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

	1-Year	3-Year	5-Year	10-Year	Since Inception (17 Years)
KIG	32.8%	17.1%	18.6%	8.7%	11.5%
S&P 500	32.4%	16.2%	17.9%	7.4%	7.5%

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

	1-Year	3-Year	5-Year	10-Year	Since Inception (17 Years)
KIG	32.8%	60.6%	134.8%	129.9%	531.5%
S&P 500	32.4%	56.8%	128.2%	104.2%	240.3%

Q. What do you feel has contributed to this long-term out-performance?

KIG. There are most likely several factors, some of which are related to our investment process and others that are due to the unique firm structure we have developed.

Probably the biggest factor is that we have what we believe to be a sound intellectual framework for making decisions and, even more importantly, the ability to keep emotions from corroding that framework. The market is really just a pendulum that forever swings between unsustainable optimism, which makes stocks too expensive, and unjustified pessimism, which makes them too cheap. Our process allows us to keep a level head regardless of the market environment, which, in turn, allows us to sell to optimists and buy from pessimists.

Over the years, we have also been rewarded by ignoring "conventional wisdom," which we believe to be a true oxymoron. In our experience, by the time something becomes conventional, there is rarely wisdom in pursuing it. The late Sir John Templeton once preached that "it is impossible to produce superior performance unless you do something different than the majority." To implement this concept fully, however, requires discipline and the ability to suffer pain in the short run. Most investors are psychologically ill-prepared to deal with negative information flow on a daily basis. We have investment personalities that allow us to accept and exploit that information flow. Incidentally, we can only conclude that these types of strategies have worked well for us over time *precisely* because they can hurt a great deal in the short run and thus are hard to apply consistently.
While our decisions may be at odds with the conventional wisdom of the market, they will always be consistent with our longer term goal of achieving the highest possible returns while attempting to protect our clients' capital from permanent losses. The goal is simply to make solid decisions on the basis of justifiable premises, valid logic and hard evidence, and avoid decisions based on market sentiment, popularity or emotion.

Many investors have turned investing into an exercise in mass psychology, trying to guess better than the crowd as to how the crowd will behave. That type of thinking, besides not being very intellectually stimulating for us, would leave too much of the ultimate success of our investment performance out of our control. We believe we should spend our time focusing on the fundamentals of the underlying businesses in which we invest (or are considering investing in) by tracking cash flow, making sure their competitive advantages remain sustainable, and keeping an eye on how management is allocating capital. In this way, our ultimate success, or lack of it, rests squarely with us and is based on our own ability to analyze industries and businesses.

Q. How does your longer investment horizon factor into this?

KIG. What we just outlined is somewhat of a blueprint for how we think about making decisions, but the only way we believe that blueprint can work is if it is applied with a long-term mindset. The investing public is surrounded by a culture obsessed with short-term thinking. It's endemic to our entire society, but nowhere is it more obvious than in investing. A stark example of this comes from an interview we read with BlackRock CEO Larry Fink. Fink relayed the following exchange from a lunch with the head of one of the largest pension funds in the world.

"We're investing for the next generation," the pension manager said.

"So how do you measure your returns?" Fink asked.

"Quarterly," the manager said.

That's a problem. Most think they're investing for the long run, but they measure success in the short run, which affects how their investment managers behave. Investors need to get over this mental roadblock in order to realize the value of thinking and behaving long term. We were able to learn this early on.

However, in order for us to truly be in a position to think and invest this way, we must have the investor client base that allows for it. Fortunately, we do. Because we have enjoyed high client retention over the years, and our clients generally appreciate our philosophy, we are able to view the assets we manage as a form of semi-permanent capital. In other words, this asset base acts as an anchor that allows us to make investment decisions using a three to five year horizon, which in our opinion is a meaningfully longer time horizon than is employed by many of our peers. We see value where others don't, invest in businesses others won't, and pay meaningful lower prices as we are operating in a less crowded space. So our investment management success is actually owed in part to our clients, who have provided us the platform by which we are able to invest this way.

By stretching our investment time horizon, the returns of the portfolio are more heavily dependent on the actual company fundamentals than changes in perception affecting stock prices in any given quarter or year. For example, management's capital allocation decisions regarding share repurchases may not have a visible effect on stock performance in any given year, but they can have a large impact on skewing the risk/return probabilities in our favor over a multi-year period. Additionally, many of our holdings are purchased while lacking a near term "catalyst." We believe being indifferent to the timing of returns affords us opportunities to establish positions in stocks trading at highly depressed prices, thus lowering the overall risk of the portfolio.

Making decisions in this light affords us additional flexibility in pursuing our capital allocation strategies (i.e. what we invest in). We believe it gives us 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 near-term stock price movements, rather than on the underlying values of the businesses in which they are investing. Focusing our energies on unearthing values, as opposed to guessing where markets or individual stocks are going, while not necessarily easy, is an exercise that we believe holds a higher probability of success.

Q. How does this view square with Efficient Market Hypothesis and the idea that markets are generally efficiently priced?

KIG. We're not sure that they are reconcilable. Efficient market acolytes tell you that financial market pricing finds its equilibrium as investors swiftly integrate all relevant information into stock market prices. In an Internet-driven society where information is so freely and quickly available it seems that investment decisions are being made, well, more freely and quickly. This is borne out in the numbers - over the last fifty years, the average holding period of stocks listed on the New York Stock Exchange has compressed from about seven years to about seven months.

However, it's certainly not clear to us that this has led to more efficient markets. If one's investment horizon is literally (and figuratively) a couple of quarters long (i.e. about seven months), it would seem long-term earnings power, and thus long-term value, wouldn't be a factor in an investment decision. But how could an investment be efficiently priced if it's not being valued on the basis of all its discounted future cash flows?

Investments that are unlikely to deliver immediate impact would surely be of no use to such fleet-footed investors and should, in turn, create opportunities for those seeking long-term value. Consequently, we believe being in a position to invest on a multi-year time frame offers a distinct competitive advantage. Our experience is that outcomes are more reliable over the long run as share prices capture the fundamentals of a business.

Q. Do any other advantages come to mind?

KIG. One last factor we'd mention is that Kovitz is not a marketing organization. It is run by investors, not salesmen. Performance is central to everything we do, with our overriding concerns being the stewardship of our clients' investable assets, minimizing the risk of permanent loss of capital, and continuation and protection of our successful investment track record. As a result, there is never a sales or marketing-based decision that takes precedence over our investment decision making process. We believe this differs substantially from many of our peers, and furthers our ability to focus on the performance of our assets under management. It is our belief that growing our firm is merely a byproduct of favorable investment performance.

Q. From what I'm hearing, your philosophy is mostly common sense and you have no special information sources or trading methods. So how has the Composite beaten the index (the S&P 500) by 4% per annum for the last 17 years?

KIG. The Composite has outperformed the index because we have ignored the index. Good investment outcomes happen over time when you search for great companies selling at reasonable prices and forget about the crowd. If you find unappreciated opportunities and avoid disasters, the by-product of that process should make it relatively easy to beat an index populated with a full range of securities.

Q. Can you describe the portfolio activity for the most recently completed quarter?

KIG. Our activity during the quarter slightly favored the sell side as we eliminated two holdings and trimmed four others, while initiating three new positions. As previously mentioned, absolute returns in the greater marketplace have been strong this past year and, as a result, many stocks within the portfolio have approached, and in some cases exceeded, our reasonable estimate of intrinsic value. Position changes are simply the result of applying our investment process, which is to buy businesses at a substantial discount to our estimate of value, and to sell when that discount goes away due to price appreciation or a reevaluation of our value estimate due to new information.

Of the two positions we eliminated this past quarter, we utilized each of the two just described reasons we sell. In the case of **Becton Dickinson (BDX)**, the company simply reached our estimate of value. While the company had been performing well, our discipline demands that we move on whenever price and our estimate of intrinsic value converge.

Our discipline also demanded that we part ways with **Sysco (SYY)** after we acknowledged that our original intrinsic value estimate may have been too aggressive. We had expected Sysco's earnings to normalize at a higher level as information technology spending waned and the economic environment for its core restaurant customer improved. Neither of these scenarios has played out quite like we had postulated. The good news is that we initiated our position at a price that we believe incorporated a large margin of safety, even though we readily recognize it as a mistake.

We also trimmed back our exposure to **Goldman Sachs (GS)**, **Johnson & Johnson (JNJ)** and **Robert Half (RHI)** as each approached our company specific value estimate. We also reduced our relatively large **Wells Fargo (WFC)** position in order to initiate a new position in **JPMorgan Chase (JPM)**.

Q. What were the new positions initiated during the quarter?

KIG. We took a position in JPMorgan because we felt negative headlines and litigation risks surrounding potential mortgage settlements had caused the market to unduly penalize the valuation of the bank's shares. We believe JPMorgan is a strong franchise that trades at an extremely attractive multiple on our projected normalized earnings.

We also purchased shares of rental car company **Hertz Global Holdings (HTZ)**. We have been following the rental car industry for a long time, but had always felt it was far too competitive for any participant to generate strong returns on capital. However, the industry began to consolidate over the last few years and what were eight separate brands eight years ago are now controlled by three companies, which account for approximately 90% of industry revenues. While still highly competitive, an oligopoly structure such as this tends to be very positive from a pricing standpoint and allows participants to earn returns above their cost of capital. Hertz's contribution to the consolidation was the purchase of Dollar/Thrifty Group, and we believe acquisition related synergies will contribute meaningfully to earnings growth over the next couple of years.

Lastly, we took a new position in **Corning (GLW)**, which primarily manufactures specialty glass for consumer electronics, such as TVs, monitors, notebook computers, and smart phones. We feel the valuation appropriately discounts the potential cyclicality in the business while its strong balance sheet affords further protection. Corning recently announced a deal to buy out joint venture partner Samsung in its TV screen business which we believe will be highly accretive to earnings.

Q. How would you characterize your performance this year and what helped and hurt your returns relative to the benchmark?

KIG. Often times when the market is up powerfully, it tends to be driven by a few sectors that pull up the overall returns and masks the relatively poorer performance in other sectors. This year, however, gains were much more broad-based as every S&P sector produced positive returns. Gains across our clients' portfolios were generally in line with the breadth of the broader market. Also, quality tends to lag in rapidly rising markets as speculators typically come out of the woodwork to seek and push up more speculative stocks. For whatever reason, that phenomenon was more muted this year and high quality stocks, of which our clients' portfolios are full, displayed a semblance of market leadership.

The Composite benefitted from its over-weighted exposure to the Financials sector where **American Express (AXP)** and **American International Group (AIG)** had particularly good years, up 58% and 45%, respectively (individual company performance is based on price return only- i.e. dividends are not included). **Boeing (BA)**, our largest gainer in 2013, was up 81% and seemed to have finally put to rest the uncertainty surrounding its new Dreamliner plane. Accordingly, investors finally began to take into account the company's large, multi-year order backlog. Our two pharmacy-related holdings, **Walgreen Company (WAG)** and **CVS Caremark (CVS)**, contributed decidedly to our relative performance with gains of 55% and 48%, respectively.

International Business Machines (IBM) was the only "core" holding in the Composite that experienced a price decline in 2013. We initiated a position early in the year, and added to it over the rest of the year as the price fell, but the stock ended the year down 1% versus our average purchase price (although the return was slightly positive when dividends are taken into account). While IBM's recent results have been relatively lackluster, we believe its low valuation discounts much of this bad news and are therefore very comfortable continuing to hold it. **Apple (AAPL)** turned in positive performance for the year, but owning this stock actually hurt the Composite's relative performance because its 5% return was so far below the benchmark's return (and the Composite owns more than its index weight). We continue to believe that Apple is a very misunderstood story and that the hardware/software ecosystem it has developed will continue to drive market share while its fortress-like balance sheet should help protect it from further downside.

Q. You mentioned that you still have a large weighting to the financial services sector. What is the rationale given how far most of the stock prices have come?

KIG. We are still substantially overweight financials despite how well they've (generally) performed in our clients' portfolios over the last several years. Recall that because many financials were at ground zero of the financial crisis, panic drove valuations to levels that were unsustainably low. As far as our bank-related holdings go, we believe they are still undervalued based on our assessment of normalized earnings, which are higher than the current earnings that are still somewhat depressed due to legacy home mortgage losses and legal expenses. One thing many investors fear is that new regulations will crimp future earnings, but it appears to us that the market has more than priced in that risk already. Another fear many investors have is that growth will be hard to come by for this industry in a slowly growing economy with little lending demand. However, even under this scenario, we believe financials should be able to return almost all their income to shareholders in dividends and share repurchases, which we think would be viewed favorably.

Regardless of our positive views on the financial industry as a whole, we have reached somewhat of a self-imposed limit to our financials exposure from a portfolio management standpoint. This is why we felt it necessary to scale back our Wells Fargo position in order to take on the new JPMorgan position.

Q. With the market having done as well as it has, are you looking to lower your exposure to the market and build up cash levels?

KIG. Investment decisions are made solely on the merits and valuation levels specific to each company. In other words, we are business/valuation-focused and not market-focused. As such, the amount of cash in our accounts will largely be a function of the opportunities that we identify that are trading at an appropriate discount to our estimate of their private market value. Cash balances will grow if more companies reach our target values than we can find available for purchase at appropriately discounted levels. In absence of that, we will stay more or less fully invested.

Another thing to keep in mind in relation to our disciplined approach to investing is our disciplined approach to portfolio management. For those clients with a bond allocation, as the equity market has moved up and bonds have been mostly treading water, we have been actively rebalancing these portfolios to keep them aligned with client-specific target asset allocations. In most client situations, we have likely sold more stock in 2013 than we have bought.

Q. So how do you think about a market that's near its all-time highs?

KIG. We don't think about the "market" much at all. We tend to focus strictly on the individual companies that make up the market and take our cues from the valuations of each. We mainly look at the market as giving us opportunities to buy certain companies at reduced prices or sell at full prices. If we were to have an outlook, it would be driven solely by the number of opportunities we find that meet our stringent qualitative and quantitative parameters. On that score, while stocks may be less undervalued than they were a year ago, we believe they are still reasonably priced. If Goldilocks were an investor, she might be saying, "Stock prices aren't so high that I'd be worried or too low that I'd be aggressive. They're just about right." Keep in mind that a fairly valued market doesn't imply zero future return. Technically, it means the market should produce future returns in line with the rate used to discount all the cash flows (i.e. the discount rate) in determining the current valuation, for this is the return demanded to compensate for the inherent business risk. We use different discount rates for each security we value based in part on our estimate of the riskiness inherent in the cash flows. Typically, these discount rates fall between 8% and 10%. Given current market levels, we would be a bit more conservative and say the market can return somewhere between 6% and 8% on a compounded average annual basis from this point forward. Since we focus our process on finding and holding undervalued, rather than fairly valued, securities, we would hope to do better than this for our clients.

One portfolio metric we track closely is what we call our Price-to-Value (P-V) Ratio, which measures how fully valued our portfolio is in the aggregate (i.e. a P-V of 100% would imply the portfolio was fully valued). At December 31, 2013, the portfolio's P-V was approximately 88% after having begun the year at 77%. This numerically demonstrates our earlier stated belief that the stocks our clients own are less undervalued than they were but still far from fully valued.

At worst, the strong market over the last couple of years may have pulled forward some of the future return. However, just because the market is at an all-time high does not make it overvalued or even expensive. In a newsletter published earlier this year, we looked at how many times the market had hit a new high over the last 100 years and found that, on average, it happened about once a month. Of course, it doesn't happen in any smooth or regular way. The point is that an all-time high tells you nothing about the "value" of the market.

Our promise to you is that we will continually work hard to identify new companies that meet our investment criteria - converting low return cash or more richly valued companies into (hopefully) 70 cent dollars - and will always maintain our discipline as we have in similar past periods.

Q. But doesn't it seem that the market may be due for a correction?

KIG. In an uncertain world, about the only thing we are certain of is that, at some point, there will be a correction. We just don't know when and neither does anyone else. Trying to predict the timing of a correction may be the financial media's favorite pastime, but it is of no practical use to us as investors. Pragmatic investors accept the fact that calling turns in investor psychology is a guess at best, and a poor substitute for an investment strategy. 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 over the long run than trying to jump in and out of the market in hopes of correctly timing its pullbacks and advances.

To put this in perspective, since the end of World War II, there's been an average annual intra-year decline in the S&P of about 14%. Yet here we stand with the S&P approximately 100 times, or roughly 10,000%, higher than its level back then, without taking into account dividends received over that time. Value never accretes in straight line fashion. If it did, we strongly believe that historical returns would have been lower.

There is no more powerful impulse in the human psyche (at least the part devoted to investments) than to think one can get out of the market just before it crashes and, conversely, to believe you can get back in just before it recovers. Our experience suggests that, like most such impulses, this is one usually best resisted. As Peter Lynch famously said, "Far more money has been lost by investors preparing for corrections than has been lost in the corrections themselves."

The direction of the market over the short-term is something that is out of our control. The best we can do today is to focus on companies with durable business models, sustainable competitive advantages that will be around for years to come, sturdy balance sheets to weather troubling economic times, and strong brands that give the company pricing power. Looking for these attributes in an investment is firmly within our control and will be the basis of whether we are successful over future, longer-term time frames, not whether we can guess the timing of the next correction.

Q. Discuss your approach to valuation.

KIG. We compute business valuations by using a desired cap rate to discount future cash flows assuming reasonable growth expectations and normalized earnings/cash flow base. On the surface, it's a fairly standard discounted cash flow analysis, although, as with any assumption-driven formula, the quality of the judgment used to set the parameters is what determines the quality of the output. It's also important to us that our assumptions be conservative as an additional layer to our margin of safety. The result of this analysis gives us a rough estimate of the value of the underlying business if it were to be acquired in whole by a knowledgeable buyer looking to earn a fair return.

While details vary with the type of underlying business being valued, we generally look to calculate a conservative estimate of normalized free cash flow. Combined with our analysis of the return required to compensate for the inherent business risk (the discount rate we discussed above), as well as a conservative estimate of potential free cash flow growth, we estimate the fair value for the underlying business. From this, we estimate the equity value after all outstanding company debt is considered. You've probably heard us use the term often, but this is what we refer to as the intrinsic value of the business.

Q. How is the intrinsic value utilized?

KIG. We use the calculated intrinsic value estimate to set a price at which we would be buyers of the stock. To be considered for purchase, target buy prices would generally need to be no more than 70% of our estimated intrinsic value, giving us roughly 40% upside if our valuation is accurate.

Q. Why such a large discount?

KIG. Demanding this type of discount is one of the primary ways that we manage risk in the portfolio. We have always believed that price is the most overlooked risk factor. And by price, we don't mean the absolute dollar amount, but the valuation. A high price (i.e. valuation) can turn a safe business into a risky investment, and a low price can make a risky business a safer investment. Investing in a company at a significant discount to our estimate of intrinsic value leads to potential upside if our estimate proves accurate, but, more importantly, it significantly reduces potential downside if our estimate proves too high. We refer to this discount as our "margin of safety" and it is what we consider to be the cornerstone of our investment philosophy.

Q. You just mentioned risk. Tell us how you define risk.

KIG. We define risk as the probability of suffering a permanent loss of capital. While we recognize industry standard equates volatility with risk, we believe the logic of using volatility as an interchangeable proxy for risk is flawed. Putting volatility at the heart of one's investment approach seems very odd to us. For example, it would have driven you to increase exposure in 2007 as volatility was low, and decrease exposure in 2009 as volatility was high – the exact opposite of a valuation-driven approach.

Often, extreme volatility presents the least risky time to own and acquire equities. This is the case in situations where stock prices decline meaningfully, while the intrinsic values of the underlying businesses do not change substantially. Believe it or not, this happens relatively frequently, and, incidentally, is one of the reasons we are not big believers in the efficient market theory.

On the other hand, our definition of risk is characterized by the potential for competitive, operational, or exogenous events to permanently impair the intrinsic value of a business. When this occurs, the downside volatility of a stock price reflects a decline in business value, as opposed to a decoupling of price and underlying value.

To us, risk is not a number but a mindset. We focus on the following key questions aimed at mitigating risk prior to making an investment:

- Do we believe there is at most 20% downside from the current price?
- What could cause significant impairment to this company's intrinsic value and how likely is such an impairment to occur?
- Is there low balance sheet risk (i.e. judicious use of debt)?
- Is there low risk of technological obsolescence?
- Are the cash flows of the business overstated or understated due to boom or bust conditions?
- If the stock market were closed for five years, could you sleep at night without seeing a price quotation for the business?

One of the last steps in our analysis is what we call a pre-mortem. While we routinely conduct post-mortems as part of assessing our overall decision-making process, the pre-mortem is an essential part of our company risk analysis. In this mental exercise, we fast forward a year and assume the investment decision at hand did not work out. We then try to come up with all the reasons that could have caused this negative result. Since we are most concerned with avoiding downside, we find it a great way to think about all the risks inherent in an investment. It may expose flaws in our original analysis or force us to go back and fill in any informational holes.

Q. If volatility is not risk, then what is it?

KIG. To us, volatility is not a measure of risk but merely a measure of the rate at which investors change their minds. Most market participants think that the reason you can earn greater long-term returns in the stock market versus most other asset classes is due to increased risk. But we would argue that because you can control, to a certain degree, the risk inherent in your equities portfolio, it can't be the source of these higher returns. On the other hand, volatility is something over which you have no control. While 2008 was large as far as drawdowns go, smaller ones occur with regular frequency. It's normal and what we consider to be the cost of admittance. However, extreme downward volatility is a scary proposition for most investors (nobody seems to be afraid of extreme upward volatility), likely because of the uncertainty it creates. We believe this uncertainty is the most important reason for the excess return.

Nick Murray, who we invited to speak at our annual luncheon a couple of years ago, sums it up perfectly. He says, *"[Investors] hold that risk and volatility are synonymous. We know that the synonym for volatility is uncertainty. And like all patient… investors, we know that uncertainty and return are correlated: the more of the former we have the emotional intelligence to embrace, the more of the latter we will capture… in the long run. Volatility is the name we give to the uncertainty of equity returns over the short to intermediate term.*

But it must be the relative uncertainty of equity returns – which can be positive 20% one year and a negative 20% the next – which causes [investors] to demand from equities an acceptable enhanced return. Thus it is the uncertainty of equities' return – it's volatility above and below a rising trendline of long-term value – which is the direct cause of the return premium."

Q. The financial media doesn't seem to support this conclusion, does it?

KIG. John Maynard Keynes once stated, "It is largely the fluctuations which throw up the bargains and the uncertainty due to fluctuations which prevents other people from taking advantage of them." We believe that the reason for this inability to take action at precisely the time one should is that the perception of investment promoted through the financial media is geared around the short term, the recent past, the narrowly focused, and the quick fix. We are told that if we pay closer attention to the day-to-day noise, we will get better results. We'd argue that all it will lead to is better ratings.

Much of the media and financial services industry wants us to be busy, but about the wrong things. The emphasis is often on the excitement induced by constant activity and chasing past returns rather than on the desired end result. Consequently, money tends to flow to investments that have done well, rather than those that will do well.

The media also short-circuits investors' ability to distinguish between temporary declines and permanent losses. It feeds into how most investors see only what's happening today and postulates that tomorrow will be much the same. They see price declines and believe them to be permanent. In contrast, we know that today guarantees little about tomorrow and we are willing to consider the possibility that price declines may be temporary. The cornerstone of rationality is the ability to see past the present and analyze possible future scenarios in a probabilistic fashion. We have always believed, perhaps somewhat counter-intuitively, that absorbing volatility may in fact create a method of ensuring a more reliable, and potentially less risky, outcome.

Q. What is the biggest investment mistake you have made what did you learn from it?

KIG. Over the years, we have made many mistakes mis-analyzing or misunderstanding the sustainability of a particular company's competitive advantage. However, as our long-term results attest, you do not need to bat 1,000 in order to generate satisfactory results. We have to accept the fact that we will make mistakes and that's OK - as long as we learn something from each one. The one mistake we would highlight was the mis-reading of many of our portfolio holdings' earnings in the 2006-7 timeframe. We did not place enough emphasis on how the exceptional economic environment during that timeframe resulted in earnings that were far above normalized levels, particularly in the consumer and financial industries. Had we accounted for this, we would have realized that valuations were more elevated than what we believed them to be. Understanding this dynamic would most likely have put us in a better position heading into the teeth of the financial crisis.

Since then, we have been much more focused on identifying companies that may be over-earning relative to our estimate of their normalized levels. To that end, we have recently embarked on a comprehensive analysis of the profit margins of each company we currently own. There has been much discussion that the higher-than-historical margins being generated in recent years are unsustainable and must eventually revert to some historical mean. We believe there are many valid reasons why margins should be higher today, including lower interest rates, a larger percentage of revenues coming from international sources, and more services-based revenue. We will look at each company's margin structure and how it has evolved over the last 10-15 years. For companies showing significantly higher than historical margins, we will need to convince ourselves that nothing unusual or unsustainable is occurring that would warrant us adjusting our estimate of normalized earnings downward. We hope to discuss these results in an upcoming newsletter.

Q. Anything else you'd like to add to wrap things up?

KIG. We appreciate the faith that our clients have placed in us. As we shared above, this faith helps us do our job and gives us an advantage as we go about our investment decision making. Managing other people's money is an enormous responsibility and we hope you take comfort in the fact that we are doing the exact same thing with our own money as we do with yours. Market conditions will vary from period to period. Sentiment has been buoyant for a while, but we are well prepared for times that may prove more challenging. The core tenets of our investment discipline and approach will remain the same regardless.

Best Regards,

Kovitz Investment Group

Kovitz Investment Group, LLC

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