KOVITZ INVESTMENT GROUP
Intrinsic Values™

Investment Commentary
Summer 2013

Market and Performance Summary

The Kovitz Investment Group® (KIG®) Equity Composite increased in value by 4.2% (net of fees) during the second quarter, while our primary benchmark, the S&P 500, increased 2.9% for the quarter. Year-to-date through June 30, 2013, the KIG Equity Composite has returned 15.4% versus 13.8% for the S&P.

Even after a strong, double-digit gain in the first quarter and seemingly every market commentator calling for a correction, investors continued to put a strong bid under stock prices in the most recent quarter. There was a minor hiccup towards the end of the quarter following comments by the Federal Reserve relating to when it would end its bond buying program (more on this later) and fears of a severe economic slowdown and liquidity crunch in China, but it could hardly be classified as a bona fide "correction" as the S&P 500 closed the quarter less than 4% from its all-time high reached on May 21st. The only certainty in the future is that there will be a correction. We just don't know when that will occur and neither does anyone else. Trying to predict the timing of a correction may be a fascinating parlor game, but it is of no practical use to a real investor. Pragmatic investors accept the fact that correctly calling turns in investor psychology is a guess at best and has ultimately proven to be a poor substitute for an investment strategy. Instead of engaging in such games, our approach seeks to minimize risk of permanent loss of capital by selecting equity investments on the basis of value and the underlying economics of the business and shuns the timing of purchases and sales based on an expectation of where the market may be heading. In other words, our opinions are tied to the long-term prospects for specific companies and are not based on guessing short-term movements in the equity markets.

In our opinion, investors have taken a familiar stance in terms of post-market drop behavior. That is, they are fighting the prior battle (the 50% drop in the S&P experienced in late 2008/early 2009) that they weren't prepared for the first time around. With this experience still fresh in their memories and determined to not be caught unprepared again, investors continue to "chase the ghost" of that great financial crisis. To that end, they see Armageddon around every corner and believe every rally is a head fake.

Many have yet to grasp that the current economic recovery is very likely real, albeit moving slowly. Though inconsistent, GDP growth has been positive for fifteen quarters in a row. Well-managed corporations are resilient entities that can adapt to the circumstances at hand. If the events during 2009 to 2011 proved anything, it showed that companies can be managed to even the direst of situations. Importantly, we believe that the fundamentals of the companies we currently own are particularly strong as they possess sturdy balance sheets, steady cash generation, and durable competitive advantages. Regardless, market conditions will vary from period to period as the cycles of fear and greed ebb and flow. Yet, the core tenets of our investment discipline and approach remain the same. Starting with the premise that owning stocks represents fractional ownership in real businesses, we seek to purchase enduring businesses at attractive prices and hold them until they reach our intrinsic value estimates. In the interim, we are content to monitor our business franchises as they continue to create, grow, and intelligently allocate their free cash flow. Investing in this manner has been a reliable method for building wealth over long time horizons.

Ostensibly, all eyes are on the Fed looking for clarity on when it may begin to ease off its monetary stimulus. The recent mid-June FOMC (Federal Reserve Open Market Committee) meeting provided some clues as to what economic milestones would trigger "tapering" (easily the most overused word of the quarter) of its aggressive bond buying program. Both the equity and bond markets reacted negatively as investors interpreted the comments as being indicative of an earlier withdrawal than had been assumed. It also could have just been a knee-jerk reaction to the reminder that the eventual easing of Fed stimulus is inevitable. Who knows? We don't claim to have any particular insight into the Fed's actions or the timing thereof. What we can speculate on is what investment strategy will work best when that moment arrives. We believe a "tapered" world would reward companies with strong fundamentals over theme investing where a rising tide tends to lift all boats. This could provide a major tailwind to our performance (relative to the S&P 500) given our roster of fundamentally sound and financially strong companies. Only time will tell if our theory on this subject proves true, but in the meantime, we are more than content to continue to hold our portfolio of high-quality businesses through whatever interest rate environment the future may bring.

Of course, there is nothing magical or informative in looking at performance over a 6-month period. For an investment manager to add value, the manager must earn a return in excess of a benchmark (and after subtracting fees) over a much longer time frame. To that end, we provide the results for our complete history, which now covers more than sixteen years. The charts below summarize both annual and cumulative performance results from January 1, 1997 through June 30, 2013 for the KIG Equity Composite and the S&P 500.

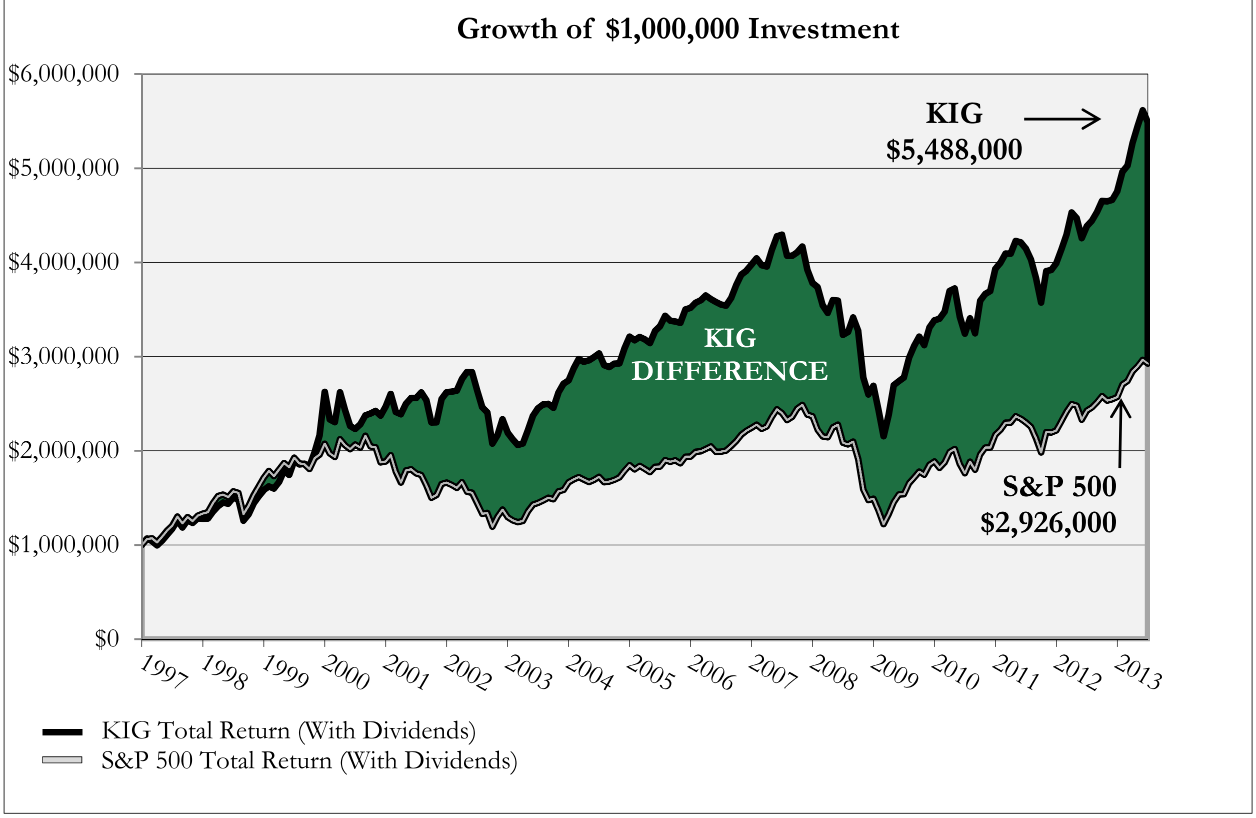
KIG vs. S&P 500
Annualized Equity Performance (Net of Fees)

	1-Year	3-Year	5-Year	10-Year	Since Inception (16.5 Years)
KIG	25.2%	19.2%	11.2%	8.4%	10.9%
S&P 500	20.6%	18.4%	7.0%	7.3%	6.7%

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

	1-Year	3-Year	5-Year	10-Year	Since Inception (16.5 Years)
KIG	25.2%	69.2%	69.9%	123.8%	448.9%
S&P 500	20.6%	66.2%	40.3%	102.2%	192.6%

Since inception, our results have exceeded our benchmark by over 4% per year on an annualized basis. Compounding this annual difference over sixteen and one-half years has a significant effect on wealth accumulation as the graph below represents. The difference (shaded portion) demonstrates graphically how KIG has outperformed the market over the long run.



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.

Uncertainty vs. Risk: An Update

Two years ago, in our *Summer 2011 Investment Commentary*, we wrote about certain behavioral tendencies of investors that cause good companies to become mispriced. We postulated that oftentimes investors confuse uncertainty and risk, and that we could capitalize on specific situations where uncertainty is high, but risk (defined as the chance for a permanent loss of capital) is low. It's a variation of a consistent theme: by looking through short-term concerns and focusing instead on longer-term fundamentals and valuation, we believe we can put ourselves in a position to earn above-average returns.

At the time we wrote,

> "An uncertain situation does not necessarily mean it's risky. For example, a company with an uncertain *near-term* outlook and an already depressed price may have a very favorable investment profile where downside risk is low and upside potential high. The probability of minimal downside is inherently not risky and could even be considered "safe" as compared to investment alternatives with clearer outlooks and higher current valuations."

In order to avoid uncertainty or ambiguity, an investor's typical first reaction is to sell or hold off buying until the situation looks clearer. The problem with this approach is that, by the time the uncertainty dissipates, stock prices will be higher and returns from that point will be demonstrably lower. The correct calculus, in our opinion, is to eschew an emphasis on short-term uncertainty and focus instead on fundamental research that attempts to derive long-term business values.

That an asset will be attractive at some price might seem intuitively obvious, but many investors consistently ignore the possibility. Investors feel better when prices are going up and tend to move to the sidelines when prices are going down. In contrast, we have always believed that it is difficult to find a compelling bargain when everything appears rosy. We prefer to find companies that are facing a challenge, but have proven over time their ability to compete, execute and, ultimately, make money in the face of such challenges. In these situations, the uncertainty is likely already embedded in the stock price, and valuations will expand if our assessment that prospective results will improve proves to be correct.

We thought it would be useful to revisit the company situations we wrote about then and provide an update of what has transpired over the last two years. At the time, all of these companies' stock prices were trending lower amid uncertainty. We also added updates on **Boeing (BA)** and **Wells Fargo (WFC)**. While these were not discussed in our *Summer 2011 Commentary*, they were in highlighted in our *Winter 2011 Commentary* in a section titled *"Variant Perceptions,"* a discussion with a similar theme.

Note: Italics represent what we discussed in the *Summer 2011 Commentary* under the section entitled *"Uncertainty vs. Risk,"* with an updated section titled *"What Happened?"* for this Commentary. (Please also note that the "Total Returns" shown below represent the performance of the companies' stock during the past 24 months, and do not necessarily represent actual client experience.)

CVS Caremark (CVS)
Price (June 30, 2011): $37.58

> *<u>Source of Uncertainty</u>: The Caremark Pharmacy Benefit Management (PBM) business has lost some major accounts and has struggled to consistently win new business.*
>
> *<u>KIG Assessment</u>: We ultimately believe that the PBM's marketing message will produce positive results. However, even if the unit's performance continues to stagnate, we don't feel that much downside risk exists given its current low valuation, and substantial upside could be captured if business trends improve. Heads we win, tails we don't lose much.*

What Happened?
Shortly after we had penned the above, CVS Caremark's PBM business began to gain traction. The loss of business slowed while new business wins accelerated. CVS's integrated model (combined retail/PBM offering), which we had been strong believers in, began to resonate with plan sponsors as a formidable way to improve medical outcomes and lower drug spend. In our view, the retail pharmacy/PBM model allows CVS to offer unique programs, such as Maintenance Choice (90 day supply, mail order or retail pickup) and Pharmacy Advisor (chronic illness consulting), which should help drive greater share of the total pharmacy dollars and positively contribute to overall enterprise profitability. CVS's future earnings should also continue to benefit from the generic drug tailwind, which provides for lower revenue, but higher gross margin dollars, strong growth in its MinuteClinic business (in store walk-in medical clinics), and the retention of prescriptions gained from the **Walgreen Company (WAG)**/Express Scripts dispute. Beginning in 2014, healthcare reform could also provide opportunities as the company's broad set of services leaves it well positioned to be more than just a retail distribution point for health insurance exchanges and their members.

- **Price (June 30, 2013): $57.18**
- **CVS Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 56.7%**
- **S&P 500 Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 27.2%**

Johnson & Johnson (JNJ)
Price (June 30, 2011): $66.52

> *Source of Uncertainty: The McNeil over-the-counter drug business has had significant product recalls due to inadequate and deficient manufacturing processes.*
>
> *KIG Assessment: We find it somewhat surprising and regrettable that a company whose name was once synonymous with quality could find itself in this situation. However, many of the recalled products will potentially be making their way back on the market in the near future, and we believe they will ultimately win back a large amount of the market share that has been sacrificed. To the extent that these gains prove elusive, any deficiencies may be more than offset by success on the branded pharmaceutical side. J&J's pharma business is at the front end of a rebirth, driven by new products acquired and in-licensed over the last several years and an increase in internal R&D productivity.*

What Happened?
The JNJ story continues to be a mixed bag. The over-the-counter business has recovered, albeit slowly. JNJ management expects about 75% of the recalled products to be back on the shelves by the end of this year. As the products come back, the company plans to invest accordingly to win back market share, thus tempering profitability. Medical device sales have recently come in below expectations. However, as postulated, the pharmaceutical business has been strong. JNJ has been extremely productive, launching eight new drug products since 2011. New product launches introduced since 2009 now account for 17% of total sales (up from just 9% in 2011) and could approach 40%+ of revenues a few years from now.

Despite the business still having a somewhat muddied future, JNJ's price-to-earnings multiple has expanded meaningfully since mid-2011 as investors recognized the power of JNJ's diversified business model. As such, we have trimmed backed our position size accordingly.

- **Price (June 30, 2013): $85.86**
- **JNJ Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 38.4%**
- **S&P 500 Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 27.2%**

Lowes (LOW)
Price (June 30, 2011): $23.31

> *Source of Uncertainty: Housing, housing and housing. The housing market continues to wane, hampering new construction and home improvement sales. Stubbornly high unemployment has contributed to dampened home-related sales.*
>
> *KIG Assessment: To us this is not a question of "if," but "when." Housing will improve, but at a pace closer to that of the tortoise than the hare. Downside price risk is minimal as current earnings in a bad housing market have been priced in, while the upside is substantial as earnings power in a "normalized" housing market will be significantly higher. The real risk is one of opportunity cost: Will the capital be better utilized elsewhere because the upside we envision may take too long to materialize? Patience is a virtue that has historically rewarded us well and we are therefore comfortable with this risk.*

What Happened?

Housing has recovered more quickly than we anticipated. Over this time, Lowe's operating performance has been satisfactory, but still lags rival **Home Depot (HD)** in many key metrics, including same-store-sales and sales per square foot. Importantly, Lowe's signaled its intention to markedly reduce new store openings highlighting management's commitment to wringing additional productivity out of its existing assets to drive returns on invested capital higher. The primary byproduct of slowing store growth is enhanced free cash flow, which Lowe's management has wisely allocated to share repurchases. Since June 2011, Lowe's has spent approximately $9.5 billion buying in its own stock, resulting in a 20% decrease in shares outstanding. As we have often commented, when a good business is selling for less than intrinsic value, share buybacks represent the best course of action to enhance per share value. Based on the market's recent warm reaction to many of the companies associated with housing (my, have things changed), Lowe's has begun to approach our fair value estimate, and we reduced our position size during the quarter commensurately.

- **Price (June 30, 2013): $40.90**
- **LOW Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 83.0%**
- **S&P 500 Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 27.2%**

Wal*Mart (WMT)
Price (June 30, 2011): $53.14

> *Source of Uncertainty: Wal*Mart's U.S. retail division has suffered from eight straight quarters of negative same-store-sales. The company may be losing share to the dollar stores.*
>
> *KIG Assessment: We can't really sugar-coat this as the company has had several merchandising missteps and has lost*

*some market share at the fringe. Wal*Mart will learn from its mistakes and continue to leverage its cost leadership to maintain its price leadership. Downside risk is hard to envision as its balance sheet strength and cash generation characteristics are powerful counter-measures to weak sales. If the company can regain some of its lost traffic, which we believe it will, margins are set to expand, fueling further earnings growth.*

We also believe the company gets little credit for astute capital management. Management has bought back approximately $45 billion in stock over the past five years (current market capitalization is $190 billion) and has recently authorized another $15 billion to be completed over the next year. Importantly, it is not levering the balance sheet to do this as it can be funded with cash flow from operations. Deploying capital in this manner can have a large impact on increasing sales and earnings on a per-share basis, which is what we're focused on.

<u>What Happened?</u>
Up until its most recent quarterly report (ending April 30, 2013), Wal*Mart posted six straight quarters of same-store-sales increases. Traction from price leadership investments (EDLP- Everyday Low Prices), strategic merchandising initiatives (assortment add-backs, improved on-shelf availability) and sharper marketing efforts ("Local Basket Compare") is helping to win back and maintain customers. That said, the impact from higher payroll taxes and rising gas prices on WMT's core lower income customer could provide some headwinds in the months to come.

While its supercenters remain the best vehicle to capture market share, Wal*Mart management accelerated the rollout of smaller format stores in 2012 in the United States. Wal*Mart has had solid initial success opening 80+ small/medium-format stores aimed at taking share within smaller/urban markets and combatting the dollar store intrusion. International acquisitions in new/existing markets could continue to complement organic growth, but we are pleased that management has chosen to slow new store growth in emerging markets to focus on profitability and returns. Management has also outlined plans to further unleash its productivity loop (price investments offset by expense leverage). This creates a virtuous cycle: lower prices increase store traffic, which leverages expenses, which in turn enables even lower prices.

Most importantly, plans for lower capital expenditures (i.e. fewer new stores) suggest free cash flow acceleration. As we hoped, the board recently authorized a new $15 billion buyback, which will likely be completed in the next twelve to eighteen months. Combining stock buybacks with dividends, we project Wal*Mart will return approximately $15 billion of cash to shareholders this year.

- **Price (June 30, 2013): $74.49**
- **WMT Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 47.4%**
- **S&P 500 Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 27.2%**

Boeing (BA)
Price (June 30, 2011): $73.93

<u>Source of Uncertainty</u>: Troubles surrounding the introduction of its newest airplane, the 787 Dreamliner, for which initial deliveries have been delayed several times over the last couple of years.

<u>KIG Assessment</u>: Historically, launching a new plane has not been easy. Boeing has compounded its problems with the

787 by its decision to outsource 60% of the design and manufacturing. Originally intended to shift risk to the suppliers and speed up development, working with over 40 suppliers and contractors has proved challenging to say the least. The price of innovation is always high but the rewards are high as well. The reality is that the 787 is coveted by its airline partners for its fuel efficiency and range, and they are more than ready to take delivery whenever it's ready to fly.

<u>What Happened?</u>
After several more setbacks, including a temporary grounding earlier this year due to battery issues, Boeing has begun deliveries of the 787. While there were a few airline order cancellations, the number was significantly less than the market had feared. Production levels of the 787 should begin to ramp up steadily allowing Boeing to work down its order book of approximately 800 planes ($160 billion at list prices).

With the 787 issues largely behind the company and several new plane designs forthcoming in the next six to twelve months, Boeing should be able to refocus on its cost structure, leading to more robust cash flow growth. Incidentally, Boeing's outlook at this juncture is far from uncertain and has probably never looked so good. While prevailing conditions such as this typically signify an exit signal, the valuation remains reasonable, so we are not yet ready to book profits.

- **Price (June 30, 2013): $102.44**
- **BA Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 45.4%**
- **S&P 500 Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 27.2%**

Wells Fargo & Company (WFC)
Price (June 30, 2011): $28.06

<u>Source of Uncertainty</u>: "Bank" is still a four-letter word in most investors' lexicon due to the lingering taint from the financial crisis. Scarred investors continue to be worried about the state of financial service firms, including concerns about retained bad (toxic) assets, the potential for a "double-dip" in the housing market, uncertainty over earnings levels and the evolving regulatory landscape. Specifically for Wells Fargo, its significant exposure to the mortgage market (increased significantly by its acquisition of the faltering Wachovia at the height of the financial crisis) is enough to scare off potential investors. Also, for today's investor who is seemingly obsessed with high dividends, many shun Wells' paltry 0.7% dividend yield.

*<u>KIG Assessment</u>: Lingering stresses are often ripe for investment opportunities. Cognizant of the ability for bad assets or higher than expected loan losses to wipe out significant chunks of shareholders' equity, we perform our own "stress tests" on financial institutions as part of our research process. With Wells, we note that it has raised significant amounts of equity through the sale of new shares. While dilutive to existing shareholders, we believe it was the right thing to do as it not only ensured Wells' survival, but demonstrated a strength many other banks lacked. It will also allow Wells to work its way through any additional balance sheet "surprises." Our conservative stress test also demonstrated that even if an unrealistically high percentage of troubled loans all defaulted **tomorrow**, Wells would still be adequately capitalized. In reality, defaults are spread out over longer periods allowing Wells to book substantial amounts of earnings (that increase shareholders' equity) to cushion any blow.*

Our secondary source of optimism with respect to Wells is that we believe its current earnings are significantly below *what we calculate as a normalized level. Our conservative assessment of normalized earnings assumes that at some point in the not too distant future loan losses will return close to their historical average, that total interest earning assets (loans) don't grow at all, and that non-interest income experiences only modest growth from its currently depressed level. Based on these assumptions, we arrive at normalized earnings per share of $4.00-$4.30 (vs. an expected $2.70 for 2011). If instead we assume interest earning assets grow moderately our normalized earnings per share estimate is closer to $5.00.*

What Happened?

Acquiring Wachovia, a bank that was laid low by a large book of subprime mortgage assets, has paid off extremely well and is just one illustration as to why we believe Wells Fargo has among the savviest management teams in banking. At the time of the acquisition, Wells took what appear in hindsight to be ample write-offs of the risky portion of Wachovia's balance sheet, and because few other banks (if any) were strong enough financially to do so, bought a *high quality* deposit base and branch network at a *distressed* price. As projected, earnings have ramped up and we expect Wells to earn approximately $3.70 per share in 2013. Within the next year, we believe Wells will hit our conservative normalized earnings level of around $4.00 per share.

Wells has been one of the best performers in the Federal Reserve's annual bank stress tests. Based on these tests, it has become evident that its capital base is strong, allowing Wells to resume dividend increases and share buybacks which had been halted for all large banks by the government since the TARP bailout in late 2008. Wells has steadily increased its dividend, and the shares currently yield 3%. Assuming Wells is able reach its historic (pre-financial crisis) payout ratio of 40-50% of earnings, its dividend yield should approach 5%. Wells has also been devoting an equal amount of capital towards share repurchases.

- **Price (June 30, 2013): $41.27**
- **WFC Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 54.7%**
- **S&P 500 Total Return, Including Dividends (June 30, 2011 – June 30, 2013): 27.2%**

Portfolio Activity

While we saw some increased volatility during the final weeks of the quarter, volatility has been relatively muted throughout 2013. This, coupled with the fact that June was the first down month in the equity markets since October 2012, does not provide the best environment for finding bargain priced securities. As such, portfolio activity on the buy side during the quarter was minimal. We did not initiate any new positions and increased our position size in just one holding – **International Business Machines Corp (IBM)**. Despite the rise in prices, we are not of the belief that valuations, in general, are overextended. Yet stocks are certainly not cheap either, and we've found the best way to improve our odds of a good investment outcome is to buy more aggressively when the valuations are favorable and less so when the opportunity set is less attractive. We remain confident that we will find additional qualifiers in time whether through general market volatility or individual company disappointments. In the interim, we believe the companies we own will grow their values.

While the downside to higher prices (from a portfolio management perspective) is fewer opportunities to deploy capital, the upside is that it gives us the flexibility to trim back exposures to certain stocks that have become more fully priced and have approached our intrinsic value estimates. As individual stocks' price-to-value ratios rise and approach our estimates of intrinsic value, we often trim, or completely exit, our holdings. Along these lines, we eliminated our interest in **Automatic Data Processing (ADP)** and trimmed our stakes in **Becton Dickinson (BDX)**, Johnson & Johnson and Lowes. We also scaled back our positions in CVS and Walgreen Company, because strong performance in each left us with an oversized combined position in the retail pharmacy sector.

Fixed Income: "Unpaused"

As many of you know, for more than a year now, we have been less than enamored with the idea of locking in today's low yields on fixed income securities. The idea of loaning a business or municipality money for an eight to ten year period at 2% or less annually didn't seem like an attractive proposition to us. In such market conditions, we knew that we were likely to lose money after inflation and taxes over that time span. As such, we implemented something of an unofficial "pause" in pursuing these unattractive maturities (i.e. a "buyer's strike"). During this period, we once again resisted the temptation to chase yield by buying high yield bonds or trying to pass off master limited partnerships or preferred stocks as substitutes for fixed income when they are no such thing. We also resisted the temptation to extend duration to obtain a better yield. As you've heard from us time and again, we believe the most important function of bonds in our portfolios is to preserve principal in times of stress. The fact that we were able to sleep soundly in 2008 knowing our high quality bonds largely held their value was as important to us as it was to you.

Yet we finally have some good news to report: Bond prices are falling, which has pushed yields higher. As a result, we have begun to more aggressively pursue intermediate maturity bond purchases as of the last week of June. For those of you who are not subject to the alternative minimum tax, we continue to find value in private activity municipal bonds, especially when we can buy in smaller lots. In some cases we have been able to purchase these bonds with a yield of up to one percent higher than the traditional municipal bonds that we purchase for our clients who are subject to the alternative minimum tax.

KIG is Growing and Welcomes a New Employee

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

Deborah Stevenson, Executive Assistant, joined Kovitz in May 2013. She works alongside financial advisors to provide client service and administrative support. Prior to joining Kovitz, Deborah worked at Harris Associates LP providing customer and administrative level support to portfolio managers. Deborah graduated from Chicago State University in 2001 with a Bachelor of Science degree in Mathematics and Computer Science. In 2009, she received her Masters from University of Phoenix in Education.

Best Regards,

Kovitz Investment Group

Kovitz Investment Group, LLC

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