Kovitz Investment Group
Intrinsic Values®

Investment Commentary
Winter 2015

Market and Performance Summary

The Kovitz Investment Group® (KIG®) Equity Composite (the "Composite") increased in value by 4.3% (net of fees) for the quarter ending December 31, 2014. For all of 2014, the Composite returned 6.4%.

Many other money managers typically leave their discussion of performance right there. Positive returns should equal happy clients. However, as we've articulated over the years, investment results cannot be analyzed on a stand-alone basis; they are only meaningful in the context of how they measure up relative to a benchmark. On this score, we had a poor year as the Composite performance significantly lagged behind the S&P 500's return of 13.7% during 2014.

It is relatively easy to write these letters when we have outperformed our peers and benchmark. Fortunately, we have been in that position an overwhelming majority of the time. We now find ourselves in the opposite position with the need to explain the degree of underperformance that we have experienced over the past year. While uncomfortable, we will not shy away from our responsibilities in communicating to our client partners. We have always attempted to undertake a critical diagnosis of ourselves, including mistakes we have made, what we have learned from them, and how we plan to avoid repeating them.

As much as we'd like performance to come in smooth consistent arcs, it generally does not work that way. We accept the fact that there is a certain amount of randomness, particularly in the near-term results of businesses and the market's perception of such, and that returns are likely to be lumpy. It's not an indictment of our process as no successful investment strategy exists that can consistently generate market-beating returns. Just as last year's strong performance didn't lead us to believe we got smarter, this year's underperformance does not make us believe our process is broken. As investors running a fairly concentrated portfolio, you have to be able to psychologically accept there are going to be times when you're completely out of sync with the rest of the world. At the end of the day, our performance is the result of the success or failure of our strategy of identifying financially strong businesses with durable competitive advantages selling at significant discounts to our estimates of intrinsic value. We believe the framework of this strategy is sound and has worked well historically, not just for us, but for many other successful, like-minded investors.

The single most important thing we can do is to have the necessary resolve to stick with the process regardless of what the market is doing or how well or poorly our short-term results appear. That sounds simple, but the crux of our value proposition is being comfortable disagreeing with the market consensus. When the market tests us, as it has done recently, we feel comfortable relying on our disciplined process, which allows us to make rational, thoughtful decisions. Our process plus having the patience necessary to wait for opportunities to come to us (i.e. not to try and force it) are the primary ways we will reverse the recent underperformance.

For now, we remain focused on the careful and patient application of our investment criteria and valuation requirements. We are more concerned with the risk of suffering a permanent loss of capital than about the risk of missing opportunities, especially those that are short-term in nature. Our bottom-up research emphasizes business quality, industry structures, growth opportunities, management skill and corporate culture. It is further augmented by our assessment of the company's ability to sustain earnings power over the long haul through an understanding of its competitive advantages, business model and management's skill in the allocation of capital. We use absolute, rather than relative, methods to estimate companies' intrinsic values and we use the movement of market prices around these intrinsic value estimates to construct and manage a portfolio of high-quality businesses that have the potential to create sustained shareholder value over many years. One of the challenges we have faced over the last twelve months is that there has been very little stress, very little fear and very little volatility in the markets as a whole. Losing the opportunity to take advantage of large price swings doesn't play to our strengths and has most likely attributed to at least some of the recent poor relative performance.

Short-term periods of underperformance are expected to happen somewhat regularly when we choose to invest using the methodology we do. Fundamental, value-based investing is predicated on a long-term time horizon. We have had similarly miserable periods before (the third quarter of 2002 and the second half of 2007 immediately come to mind) and we have always recovered from these dips. As our long-term results demonstrate, our process generally works well over long periods of time. Since the inception of tracking our equity performance (January 1, 1997) our Composite has returned 572%, or 11.3% per year, versus a gain of 287%, or 7.9% per year, for the S&P 500. One of the main reasons we have been successful is because, emotionally, it is very difficult to pull off. Enduring short periods of underperformance, even if it is a necessary ingredient in generating long-term outperformance, is no easy thing. To that end, we are very grateful for a client base that shares our focus on the long-term, thus allowing us to deviate from a benchmark over short time periods. It is a very meaningful advantage.

Below is our standard performance report for the KIG Equity Composite, which now encompasses 18 full calendar years. The chart summarizes both annualized and cumulative performance results from January 1, 1997 through December 31, 2014 for the Composite and the S&P 500. We manage your portfolio for long-term results, and we encourage you to evaluate its performance over a multiyear timeframe.

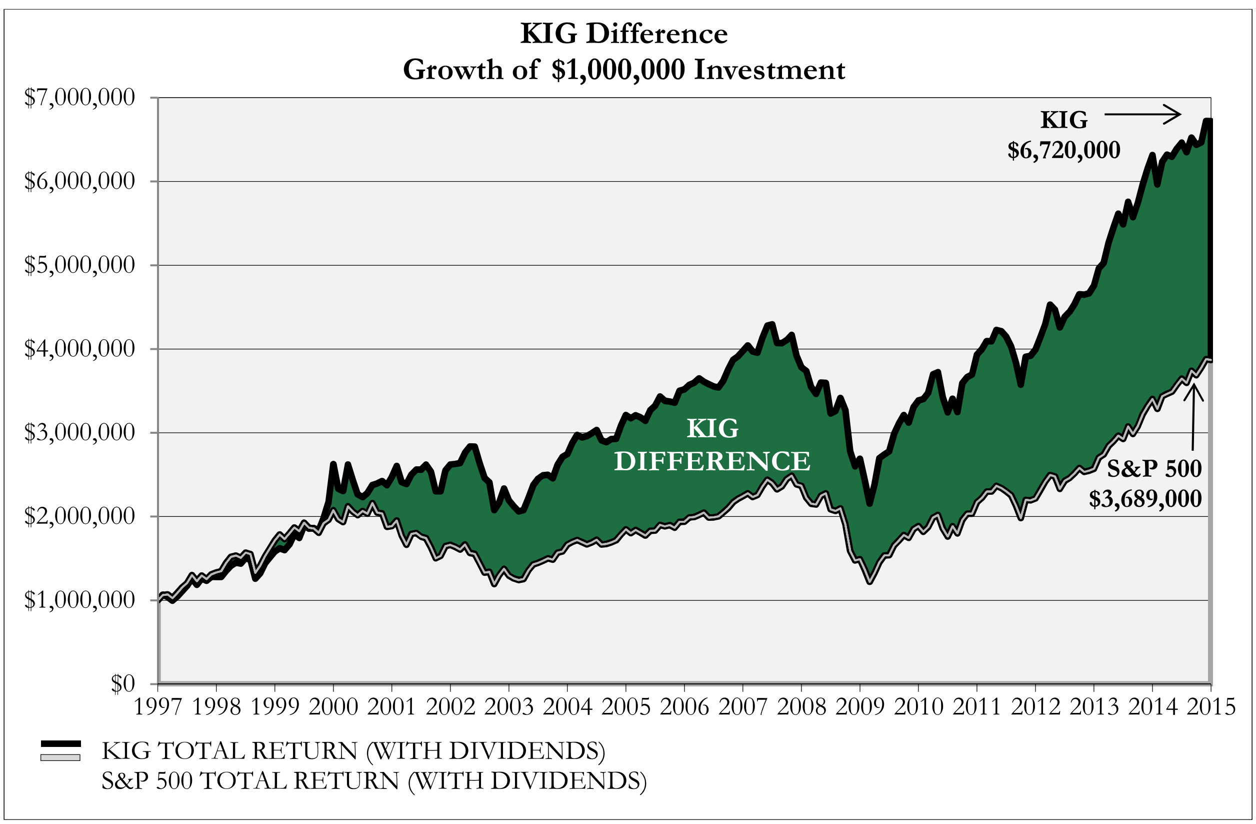
KIG vs. S&P 500
Annualized Equity Performance (Net of Fees)

	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (18 Years)
KIG	6.4%	19.0%	14.7%	7.7%	6.5%	11.2%
S&P 500	13.7%	20.4%	15.4%	7.7%	4.2%	7.8%

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

	1-Year	3-Year	5-Year	10-Year	15-Year	Since Inception (18 Years)
KIG	6.4%	68.4%	98.6%	109.3%	156.1%	572.4%
S&P 500	13.7%	74.6%	105.1%	109.4%	86.4%	286.9%

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



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We appreciate the faith that our clients have placed in us. This faith in part 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.

Portfolio Activity

For the past several quarters we have lamented the stark lack of opportunities for us to put money to work in new names. Just about every sector of the market had elevated valuations and very few companies were trading at significant discounts to fair value. This latest bull market has seen almost no meaningful corrections and had not delivered any industry or sector declines that are normal even in a market that is rising overall. This set of circumstances had made it difficult for investors like us who tend to be opportunistic in building portfolios.

During the quarter, however, the price of crude oil swooned, and shares of companies in the energy sector and those in the industrial sector with energy-related businesses underwent a major correction. Historically, we have had very low exposure to these names. In recent years, with the price of crude trading near $100 per barrel and market sentiment that it would remain there, our feeling was that most stocks in the energy group provided little margin of safety. Our preference was to wait until valuations were more favorable, and, with oil prices having collapsed approximately 50% since mid-June, we believe that day is here.

To be clear, we are not making a call on where we believe oil will trade over the next several months or quarters. In the short run, we don't know if the current plunge in the price of a barrel of oil will continue, stabilize, or even trend upward. Looking out over the next several years, however, our feeling is that oil prices will likely be higher. We say this not out of any sense of clairvoyance but from an understanding about how commodity markets generally work and our comprehension of how marginal cost economics typically play out. In a sense, commodity prices are self-correcting – the interaction between supply and demand in setting prices at the margin makes this so. Commodity prices will decline if demand decreases or if there is too much supply. Conversely, prices will rise if demand increases or supply falls. In the current case of oil, the drop has largely stemmed from oversupplied conditions caused by increased production in Northern Iraq and Libya coinciding with huge gains in production in the United States due to the "shale revolution." Even more fuel was added to fire on Thanksgiving Day when OPEC announced they would not cut current production levels. The most common interpretation of this decision was that it was meant as a shot across the bow warning U.S. shale producers that the Saudis are determined to not be the first to blink in the face of falling oil prices.

The recent surge of U.S. oil and natural gas production has been nothing short of astonishing. This transformation is the product of advances in oil and natural gas production technology—notably, a new combination of horizontal drilling and hydraulic fracturing. (Hydraulic fracturing, or "fracking," is the process of injecting sand, water, and chemicals into shale rocks to crack them open and release the hydrocarbons trapped inside.) These technological advances combined with high oil and gas prices have enabled increased production of the abundant oil and natural gas resources in the United States.

In the past five years, this technological revolution in the oil patch has made the United States the world's fastest-growing hydrocarbon producer. In 2000, shale gas provided only 1% of U.S. natural gas production. By 2010, it was over 20%, and the U.S. government's Energy Information Administration predicts that 46% of the United States' natural gas supply will come from shale gas by 2035. U.S. natural gas production has risen by 25 percent since 2010, and the only reason it has temporarily stalled is that investments are required to facilitate further growth. Having already outstripped Russia as the world's largest gas producer, the United States will become one of the world's largest gas exporters by the end of the decade, fundamentally changing pricing and trade patterns in global energy markets. U.S. oil production, meanwhile, has grown by 60 percent since 2008, growing at a clip of around 1 million barrels a day annually for the past several years. To put this in context, OPEC member Libya's production is currently about 900,000 barrels per day.

While the supply glut is the major factor contributing to the fall in the price of oil, other factors have been at work as well. On the demand side, slowing Chinese economic growth and a sputtering European economy have helped to keep demand growth under wraps putting little pressure on the surging supply of oil. Even geopolitical tensions, which heretofore served as a buttress for high oil prices in the form of a perceived risk premium, seemed to lose its sway on oil's pricing mechanism. Oil had rallied into midyear, buoyed in part by geopolitical tensions surrounding Russia's annexation of the Crimea, civil war in Syria, and broad advances by Sunni insurgents across northern Iraq. But the risk premium soon dissipated as oil investors came around to the view that none of the scenarios posed an imminent danger to supply. Finally, the strength in the U.S. dollar (up 10% vs. a basket of foreign currencies since the beginning of May), which is generally inversely correlated to dollar-priced commodities, has added to the oil price woes.

So why are we confident that oil prices will ultimately move higher? There is an old adage in the world of commodities that "low prices are the cure for low prices." Around the world, the cost of drilling oil varies widely. Ultimately, when the price of oil falls below a particular breakeven level (typically referred to as the marginal cost of production), then a drilling project becomes unprofitable and it makes sense for the driller to just shut down the particular project. These actions decrease supply, bringing it more in line with demand. We also don't discount the possibility that demand may increase as cheaper prices stimulate more use. The simultaneous lowering of supply and increasing demand serves as a natural buoy to reinforce higher prices. (There is a lot of talk that with slow global economic activity currently, it may take time for the demand side of the equation to increase. This is likely true, but keep in mind, we are looking out several years for this to play out.)

Importantly, drilling projects can't just be turned off like the flip of a light switch. In general, oil production is a high fixed cost, capital intensive business with low variable production costs. Current well and rig infrastructure will likely continue to be used for pumping oil from the ground. Most new drilling, however, is likely to be curtailed until such time as internal rate of return hurdles can once again be cleared. While the daily news reports contain lots of headlines and a great deal of noise, we believe there is a salient data point: capital expenditure budgets for many oil exploration and production companies are already being slashed with a focus on cancelling the projects to drill new wells. In other words, the supply response has started. It may take several years for these actions to help the oil market regain its supply and demand balance, which is a timeframe many investors find too long to participate in. On the other hand, we like buying businesses with a margin of safety where the primary cost to earn the outsized return is a willingness to wait.

In order to prepare for this eventuality, over the past couple of months our research process has focused on preparing a "wish list" of energy and related companies we would want to own. In early December, with the price of oil and related companies continuing to fall, we firmed up our list. Toward mid-month, with prices seemingly in freefall, we implemented the purchase of a basket of high quality stocks at valuations that imply oil will stay at or near the current price forever. We may be early (we usually are), but we feel these stocks provide risk/reward characteristics we are extremely comfortable with over a sufficiently long time horizon.

Our basket focused on oilfield services companies, including **Halliburton (HAL)**, **Baker Hughes (BHI)**, **Schlumberger (SLB)**, and **FMC Technologies (FTI)**, and engineering and construction companies, including **Jacobs Engineering Group (JEC)** and **Quanta Services (PWR)**. These are the companies that provide the proverbial picks and shovels to the 49ers of the energy industry. All of these companies have substantial exposure to oil and gas production activity, but none have their revenues directly determined by the fluctuating price of oil.

Schlumberger, Halliburton, and Baker Hughes are three of the largest and most globally diversified oilfield services companies in the world. These companies provide services and solutions to independent exploration and production companies and integrated oil and gas companies at every stage in the process of production. These services range from exploring for and locating hydrocarbons under the ground to completing wells drilled to access oil and gas to enhancing and optimizing the recovery of these commodities from deep below the surface of the Earth. The three firms function effectively as an oligopoly in many parts of their business, which keeps pricing rational, and their breadth of offerings and strength in those areas provide meaningful barriers to entry against smaller players taking market share.

Schlumberger is the largest player in the industry and has the most exposure to producers outside the U.S., including long relationships with many national oil companies. Halliburton, long removed from any involvement in government-contracted engineering and construction that made headlines during the Iraq War, provides their services globally, but with more of a focus inside the U.S. Baker Hughes is a solid third place in terms of size and efficiency behind Schlumberger and Halliburton, but the company agreed to be acquired by Halliburton in a cash and stock deal shortly before we initiated our positions. Due to this pending transaction, we view our position in Baker Hughes as part of our position in Halliburton where the cash portion of the deal will provide a buffer against further downside should oil prices continue to slide in the short run. The substantial $3.5 billion termination fee owed to the company by Halliburton should the deal fall apart will also provide additional protection from loss in that scenario.

Our combined position in Halliburton and Baker Hughes is the largest position in our energy basket because the combination of falling oil prices and the market perception that the announced merger was poorly timed – also due to falling oil prices – has caused the stock price to deviate the most from what we consider the company's intrinsic value. Schlumberger also saw its share price decline substantially, although not to the same degree as Halliburton. Nevertheless, the stock was trading at a below-market multiple on depressed near-term earnings despite our opinion that Schlumberger's business deserves to be valued at a premium multiple on normalized earnings – an opinion that the market has generally agreed with for at least the last decade.

FMC Technologies is also classified within the oilfield services industry, but they are primarily engaged in providing subsea "trees" used in offshore oil and gas production. These "trees" are individual or multiple structures that reside on the sea floor that allow the teams operating the well at the surface to regulate pressure in the well and optimize the stimulation of the well. These structures are highly complex as they are intended to operate up to two miles below the surface under incredible amounts of pressure and at widely varying temperatures between the water at those depths and in the well itself. FMC dominates this industry and offshore oil production can't function without these types of products. As long as offshore production of oil and gas continues, and we believe it must to meet global demand in the intermediate- and long-term, FMC's business is well-positioned while the company's share price seems to be pricing in a permanent decline in offshore drilling that doesn't seem like a viable assumption to us over the long-term.

Jacobs Engineering and Quanta Services are both engineering and construction firms, but with very different areas of focus. Jacobs is one of the largest diversified engineering and construction firms in the world that engages in the design and building of structures and infrastructure related to oil and gas, chemicals, government projects, infrastructure, and various other industrial sectors. The new construction projects Jacobs takes on are typically large scale and take place over multiple years. Projects can include oil refineries, chemical plants, light rail stations and tracks, water reclamation facilities, office buildings, and the list goes on. Despite the oil and gas-related portions of their business representing only about a quarter of revenue last year and the prospects for most of the other sectors they are exposed to remaining the same, or even improving with lower oil prices, the shares are trading at a level implying that most of their oil and gas-related business will disappear and never return. While some projects could easily get pushed out or delayed, cancellation of most or all of these projects, many of which have been planned for years and are designed to meet demands of the industry looking out decades into the future, seems like an extreme and unlikely assumption. We believe the shares are priced attractively with downside risk further reduced by the diverse nature of their business and competitive position outside of oil and gas projects.

Quanta Services is a similar company, but about 70% of their revenue is derived from power generation and transmission projects with most of the remainder related to oil and gas pipeline construction. Quanta's revenues from power and transmission have been growing nicely over the past decade as utilities have increased capital spending on such projects in an effort to upgrade and expand the often inadequate state of the electric grid in the United States. Their involvement in oil and gas pipelines was the cause of the recent decline in the price of the company's shares that provided the opportunity for us to initiate the position, but even this seems overdone to us. Quanta's near-term pipeline projects are predominantly located in areas that produce natural gas as opposed to oil, and the price of natural gas, which plummeted several years ago when shale drilling created a supply glut in that market, has been relatively stable since that time. This means that the prospects for a natural gas pipeline are unlikely to be reassessed because of what is going on in the oil market and we expect Quanta to retain much of their currently booked business in this area. If that is the case, returns on Quanta's shares from these levels should be quite satisfactory and there is a comfortable margin for error in our assessment given what today's price is implying.

CBS (CBS) is the only new addition to the portfolio during the quarter unrelated to the energy sector. CBS is a household name to many people because they operate the highest rated broadcast network in the United States. They also own a number of cable networks, including Showtime and CBS Sports, production and syndication companies that produce content for network and cable television, the Simon & Schuster publishing business, 30 local broadcast CBS affiliates, and over 100 radio stations. Currently, about half of CBS's revenues are generated from advertising on their networks, while the other half is generated by licensing and distributing content and affiliate and subscription fees paid by cable and satellite companies to carry their networks. Over time, however, CBS's aggressive stance with the multi-channel video providers and local broadcasters in boosting retransmission and reverse retransmission fees, respectively, will likely make it less reliant on advertising.

Because of the recent tumult in the media industry with content creators, broadcasters, cable/satellite companies, and companies that stream content over the internet all jockeying over how big of a slice of the media dollar pie they each will ultimately lay claim to, CBS and many similar companies have seen the price of their shares fall. The intense competition among these different groups of companies has created worries that CBS's business model, which currently relies heavily on paid advertising, will be left behind in the new age of media consumption that is perceived to be just over the horizon. We tend to think a decline in advertising revenue is more than baked into the current price and that companies with desirable content and innovative operating histories, such as CBS, will end up retaining significant pricing power no matter how the media landscape evolves. Our entry price at a below-market multiple of about 13x next year's earnings estimate for a good business like CBS offers a substantial margin of safety against future unfavorable developments in the media industry and attractive upside should the future bring nothing more than the status quo.

We also increased our position size in two current holdings, **Boeing (BA)** and **General Motors (GM)**. Shares of Boeing came under pressure as the slide in oil prices caused investors to speculate that orders for its new fuel-efficient planes will slow and/or that its healthy backlog will dwindle due to cancellations. To us, this is short-termism at its finest. While the price of fuel is certainly a key input to an aircraft acquisition decision, it's seldom based on where prices are currently. The decision is based on the range of prices that are likely over the useful life of the aircraft, which is measured in decades, and how large an improvement in fuel burn the new asset provides. It wouldn't surprise us to see some orders cancelled or deferred, but we don't think it would cause a meaningful deterioration to our business value estimate.

More importantly, regardless of what happens to the price of crude, cash flows will continue to build as the 787 first moves toward break-even on a cash basis and then gush cash thereafter. In fact, we estimate that Boeing's free cash flow will likely eclipse earnings starting in 2015. Speaking to management's confidence in future cash flow, in December 2013, Boeing shareholders received a dividend increase of just over 50%. This past December, the company tacked on another 25%, and the shares now yield almost 3%.

General Motors' results from a sales perspective continue to impress. There is no sign that the massive recalls issued over the past year are tempering the demand for new GM vehicles. In the United States, industry-wide auto sales will approach 17 million units in 2014. While this may be the high water mark, we expect that sales could continue near this pace for several more years as the replacement cycle for aged vehicles remains intact. Its European business is still in a loss position (like it is for many other car makers), but management has taken steps to improve the cost structure and, at some point, the continent will see its economic fortunes improve. Meanwhile, sales in China remain strong. To be sure, liabilities from the ignition switch issues continue to grow, yet we feel they are easily manageable as the company's net cash position is extremely strong. In our opinion, the stock is severely undervalued and an upward adjustment to its multiple seems warranted. In other words, good things typically happen to cheap stocks.

We eliminated two holdings, **Abbott Laboratories (ABT)** and **DirecTV (DTV)**, which approached our fair value estimates. The acquisition of DirecTV by AT&T has not yet been consummated, but what little upside we would stand to make did not seem enough to compensate for the deal risk (i.e. the risk that the transaction is delayed or terminated) we would be taking.

We also trimmed three positions that have performed very strongly this year: **CarMax (KMX)**, **CVS Health (CVS)** and **Walgreen Company (WAG)** (now **Walgreens Boots Alliance (WBA)** as of January 1st). Financial results for each have been strong and that has been reflected in the share price. As they now trade closer to our intrinsic value estimates, we felt compelled to reduce our exposures.

Bonds Unplugged (again)

Like many investors, we were happy to see bond prices fall/rates rise during the second half of 2013. We figured that it was likely the beginning of the end of the low interest rate environment we have been in since the financial crisis. The continued improvement in the economy, culminating in the strongest year for new job growth in the last 15 years, seemed to support a return to a more normal rate environment. However, throughout 2014, even while the stock market and the economic data seemed to be pointing to an improving US economy, bond rates continued to fall. In the fourth quarter they declined back to similar levels at which we suspended new purchases of traditional municipal and corporate bonds in 2012. Though it wasn't fun waiting until mid-2013 for more attractive rates, we're glad that we didn't lock in sub-2% rates for 8 years in 2012 and we suspect we will be glad waiting for more rational rates to return this time as well. For IRAs, charitable foundations and other tax deferred accounts, we continue to buy non-agency mortgage backed securities. While the prices on these have risen as well, we are still able to find them at prices that should allow clients to earn reasonable returns over a 4-6 year average life, without adding what we believe is a material amount of credit or interest rate risk.

Year in Review

We use this space at the end of each year' communication to review some of the companies that contributed the most to performance during the year while not shying away from detailing which companies detracted most from performance.

Some of the best…

Apple (AAPL) was our single best performing stock in 2014. It wasn't long ago that market sentiment toward the shares of Apple was exceptionally grim. As the stock reached its nadir in mid-2013, to the outside world, it looked pretty dumb for anyone to still be holding shares in what was considered a former rising star. Apple appeared to lack any semblance of its former innovation prowess, margins were declining, and analysts were busy slashing their price targets. However, our investment thesis was much less focused on product innovation (and analysts' opinions) and more so on its low valuation in relation to its earnings, its cash-laden balance sheet, and its cash-generating business model (low capital intensity/high recurring revenues), which continued to flourish even as the stock price moved lower.

Our longstanding belief was that Apple's cash hoard could be deployed in ways which would substantially benefit current shareholders. Fortunately, the company felt this way as well. Over the last couple of years, management has deployed over $70 billion towards share repurchases and dividends and has authorized at least another $100 billion of the same through the end of 2015. We don't think it was coincidental that sentiment around the shares brightened just as the market came to the realization that a torrent of cash was coming to Apple shareholders. Innovation concerns have also ebbed as the current iteration of the iPhone has been well received, the company introduced Apple Pay (an innovative way to pay using your iPhone), and Apple Watch will debut next year (we have no opinion on its success). Analysts are now busy ratcheting up earnings estimates. Meanwhile, the cash continues to grow.

The only real concern we have with Apple is that, at this point in its life-cycle, it may become a victim of its own success. This inference refers to the fact that, with annual sales expected to pass the $200 billion mark and a market cap approaching $700 billion, it is becoming tougher for new products to move the proverbial needle. Valuation is inextricably linked to growth and a slower growth rate will cap further expansion of the multiple on earnings at some point. We don't think we are near this inflection point just yet, but we will continue to monitor the situation in the coming year.

Shares of **Berkshire Hathaway (BRK.A/BRK.B)** also had a strong year. Berkshire has been our single largest position in the Composite since September 2005. Over this time it has been among the strongest contributors to our long-term investment results, rising 175% (9/30/05- 54.62) versus a gain of 104% for the S&P 500. Perhaps surprisingly, we still think the stock represents a good value at current prices. During 2014, the company reported robust quarterly results highlighted by double-digit growth in operating earnings, solid cash flows, and an estimated 10% percent year-over-year growth in book value per share. In its primary insurance subsidiaries, Berkshire continues to grow premiums while maintaining healthy underwriting profits. In the noninsurance operations, Berkshire has benefited from the gradual economic recovery and good execution in the railroad, utilities, manufacturing and services businesses. The company's investment portfolio has risen alongside the broader equity market and fixed income markets, further contributing to growth in book value per share.

Other developments during the year included Berkshire's announcement of a preferred stock investment to facilitate the proposed acquisition of Tim Hortons by **Burger King Worldwide (BKW)**. Berkshire along with 3G Capital, a private equity shop, had collaborated on the previous acquisition of H.J. Heinz in 2013. Berkshire will invest $3 billion in preferred shares yielding 9%. In the latter half of the year, Berkshire announced the purchase of one of the nation's largest privately owned car dealership networks, and they also bought the Duracell battery business from Procter & Gamble using Procter & Gamble shares that they already owned. This unorthodox transaction had the added benefit of saving the company from recognizing substantial unrealized capital gains taxes. Each one of these investments by itself is not particularly substantial when considered in the larger context of Berkshire's balance sheet, but they do highlight an attribute that is key to our positive investment thesis on the company. Specifically, Berkshire's unique culture, sizable cash flows, and substantial cash balance, approximately $60 billion at the end of the third quarter, make it a favored buyer of entities whose owners care about finding a good, permanent home for their businesses and the perfect partner for transactions that require speed and discretion.

CVS Health continued what has been a multi-year move upward in the price of its shares. Once maligned for its acquisition of the Caremark PBM (pharmacy benefit manager) business, analysts are now praising the move. The company has been taking meaningful PBM market share with its unique integrated retail/PBM model. The retail segment has also performed well as prescription drug sales have benefitted from increased generic penetration and has largely offset weaker front-end sales, which reflected the impact of discontinuing sales of tobacco products. Pharmacy sales have also been somewhat insulated from reimbursement pressure due to its symbiotic relationship with Caremark. All of this has been reflected in an expanded multiple, which has caused us to reduce our exposure slightly as mentioned above.

Some of the worst…

Ocwen Financial (OCN) was our worst performing holding during the year. Ocwen is the fourth largest mortgage servicer, the largest subprime servicer, and the largest non-bank servicer. Mortgage servicing is a good business that provides a steady stream of cash flow and Ocwen has taken a variety of approaches to reduce the amount of capital needed to generate that cash. Complementing their business, new capital rules for banks made it unattractive to continue to hold mortgage servicing rights (MSRs), so Ocwen appeared to have a clear path to growing their business.

When we originally bought the stock in the high-$30s, it had fallen from the mid $50s at the beginning of the year. This drop seemed to mostly be a reaction to a settlement with the CFPB and the authorities in 49 states (every state except New York) agreed to in late 2013 and an initial indication of interest by the New York Department of Financial Services of investigating the company for its dealings with affiliated companies and other operational issues. We estimated normalized earnings around $4 at this time and thought the regulatory issues were more than priced in. Fast forward to today and regulatory costs have been higher than anticipated, acquisitions of additional MSRs have been put on hold, and Benjamin Lawsky of the NYDFS has proven to be very effective at issuing press releases lampooning Ocwen's operations on topics ranging from how they contract with an affiliated company to force-place insurance on delinquent loans and the latest accusations of "back-dating" letters to borrowers.

While a margin of safety concept is the backbone to our investment philosophy, it is not to say the quoted prices in the market cannot wildly diverge from the underlying value of the business over short periods of time. It is simply that over long stretches (years) the value of the underlying business and the price other market participants are willing to pay generally converge. Therefore, while we make every effort to buy seventy-cent dollars, there is nothing to guarantee against a seventy-cent dollar turning into a fifty-cent dollar, before ultimately approaching fair value one hundred-cent dollars. We believed this would ultimately prove to be the case in regard to Ocwen.

Unfortunately, in December, the NYDFS and Lawsky dropped the guillotine. As part of a settlement related to various, loosely defined infractions, the NYDFS forced Ocwen's longtime chairman Bill Erbey to resign, assessed fines and restitution of $150 million (relative to $100 million Ocwen had previously estimated and reserved for), installed an Ocwen-funded outside monitor for two years with an option for a third year, and formally declared that Ocwen could not acquire additional MSRs until the company met some yet-to-be-determined performance benchmarks. As a further reaction to this settlement and potentially also at the request of the NYDFS, Ocwen announced that they would no longer service mortgages held in GSE (Fannie Mae, Freddie Mac, Ginnie Mae, etc.) securitizations. This currently amounts to about half of their servicing book by outstanding principal balance, and the company is currently exploring options to sell these MSRs. After the terms of this settlement were announced, the share price subsequently dropped into the mid-teens.

This was unequivocally the worst case scenario short of Ocwen's license to conduct business in New York being revoked and this outcome is much worse than we anticipated. To give some indication of the severity of the NYDFS penalties, the first settlement between Ocwen and the CFPB and the other 49 states called for, among other things, $125 million to be paid to 185,000 borrowers who had been foreclosed on by Ocwen which averages $675 per borrower. In the New York settlement, Ocwen was ordered to pay $50 million to about 5,000 New York borrowers who had been foreclosed on which averages $10,000 per borrower.

You may ask, "You were wrong, so why not just sell?" In this case, the stock is currently trading at or potentially below our estimate of liquidation value, so we believe further downside should be limited from here. In fact, it appears Ocwen's sale of its GSE servicing book may be able to garner an amount equal to the company's current market capitalization. While it is difficult to determine how much of their cost structure they can shed by shrinking the business in this way, normalized earnings could amount to $1.00 or more. If this is the case and the company uses the proceeds from the sale of their agency MSRs wisely, the current price is, at worst, fair or, more likely, cheap.

Even in situations like this, where we have absorbed substantial punishment and market sentiment towards a company couldn't be worse, we believe our clients are best served by sticking to our process. This means assessing whether a company's shares are trading at, above, or below our estimate of intrinsic value at a given point in time and acting accordingly without regard for what decisions were made previously.

Coach (COH) was another major underperformer. Near-term earnings guidance has been slashed as the company attempts to rejuvenate its brand in North America by investing in marketing, store renovations and product. The company is also reducing promotions in full-price and outlet channels while further rationalizing its retail store count. Increased competition has pushed Coach to undertake these initiatives, which leads us to believe we may have overestimated the strength of Coach's moat. While Coach works through these issues, the company will be aided by its practically debt-free balance sheet and strong cash position. This should provide some flexibility during this transition, particularly in preserving its dividend, which now provides a 4% yield on the current stock price. So far, we have been impressed with management's actions to reposition the brand. While customer response will not be evident overnight, we will be watching results closely to determine if we believe these actions will ultimately gain traction that will manifest itself in increased earnings power.

Bed Bath & Beyond (BBBY) could be on both the "Best of" and "Worst of" lists. After a difficult first half of the year (down 21%), shares of Bed Bath & Beyond rebounded sharply through the end of the year (up 20%). In our last newsletter (*Fall 2014*), we wrote extensively about how the retail industry is in the throes of what is likely a once-in-a-generation change with the emergence of omni-channel retailing, the seamless approach to the consumer experience through in-store, online, and mobile shopping channels. Bed Bath had fallen behind in this area, but has since devoted significant resources and capital to enhance its omni-channel offering. Investments have included an updated website, in-store technology capability, data centers and back-end fulfillment. In its latest quarterly report, year-over-year e-commerce revenues grew at a rate greater than 50%. Admittedly, this increase was coming off a low base, but it highlights that ongoing initiatives seem to be gaining traction. An advantage brick and mortar based retailers have over their online-only rivals is that its physical stores can act as fulfillment centers that can ship online orders or hold goods for pickup. This has not gone unnoticed by Amazon, the largest U.S. online seller, who, in a twist, has begun opening traditional retail stores.

Our last letter also highlighted that we believed, based on a severely discounted share price, a pristine balance sheet and a low interest rate environment, that a massive share buyback could be a prime driver of shareholder value. Recognizing this opportunity as well, company management issued funded debt for the first time in its history and used the proceeds to support an accelerated repurchase plan which will retire about 9% of its outstanding shares.

Recently, **PetSmart (PETM)**, which was thought to be another victim of the new world order of online shopping, agreed to be taken private by a consortium of private equity sponsors at a valuation of approximately 19x trailing earnings. This deal may remind investors that there is still an underlying value in high quality, service-oriented retail franchises with underleveraged balance sheets and superior vendor relationships in healthy demand categories. Perhaps companies grappling to make the shift to an omni-channel model are better suited to undertake this task out of the gaze of the public markets. A similar valuation placed on the shares of Bed Bath would equate to price of $90-$100, well above its current price of $76.

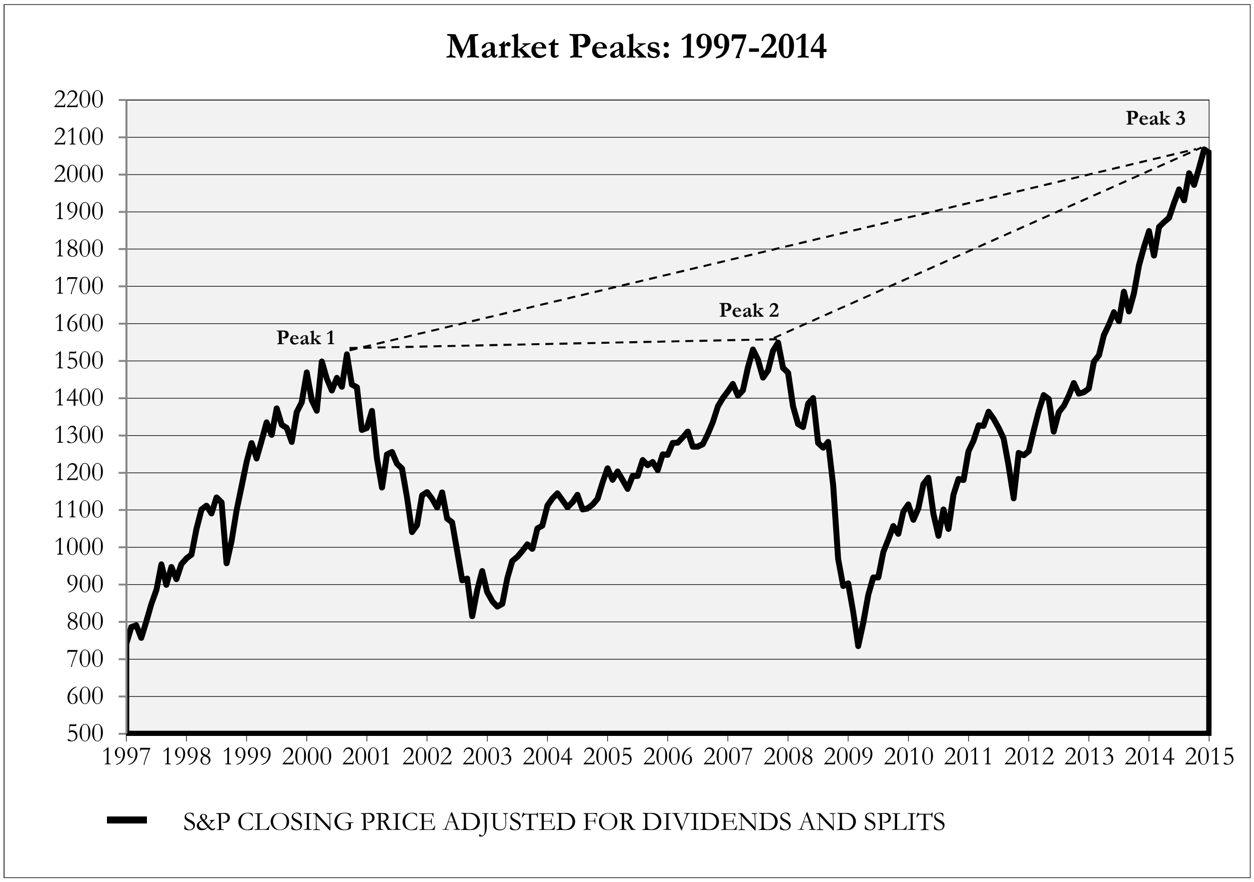
Our investment philosophy is predicated on taking a private business owner approach and to match valuation with expectations. In mid-2014, our analysis suggested that Bed Bath's shares were priced for declining earnings from that point forward, something we believed didn't hold much validity. While the end hasn't been written, this serves as a primary example of why we don't just sell a stock because it has been going down and investor sentiment poor.

Peaks and Troughs

While we've had some poor outcomes this year on individual positions, this has also been a psychologically difficult year for us because the characteristics we typically emphasize in our stock picking, such as high quality franchises, sturdy balance sheets, and low valuations have been completely ignored by most other investors in 2014. Investment strategies that performed the best last year include buying the stocks with the highest price-to-earnings (P/E) ratios or simply buying what has been going up. Among the worst strategies has been to own low P/E stocks or anything that has been going down. In sustained market rallies, history has shown that investors tend to chase returns and sacrifice safety in order to do so. We hesitate to believe that strategies such as these can deliver sustainable benefits as gains achieved in this manner are usually fleeting. Soaring stock prices based on rosy future expectations have a tendency to evaporate when results fail to meet unrealistic prospects. Recent examples include technology/internet stocks in 2000, homebuilders in 2005, and energy/commodity stocks in 2008. Already, Ebola-related companies (vaccine makers and even hazmat suits manufacturers), which were all the rage in October, have seen their prices tumble 50% or more in some cases as fear over the pandemic subsided. Euphoria-induced prices have historically had short runways. In general, we have always been of the belief that low valuations favor the optimist, while high valuations favor the skeptic.

In contrast, we believe our process of buying businesses in the manner discussed above has immeasurable staying power; the basis for which includes staying focused on our process and building a culture that continuously learns and improves. However, it doesn't work over all time frames, especially short-term ones. This is not an excuse, but a reality. We're looking at a peak-to-peak cycle and trying to protect and grow our clients' capital through the whole cycle.

Since the inception of our performance record in 1997, there have been three distinct market peaks as indicated in the graph of the S&P 500 below.

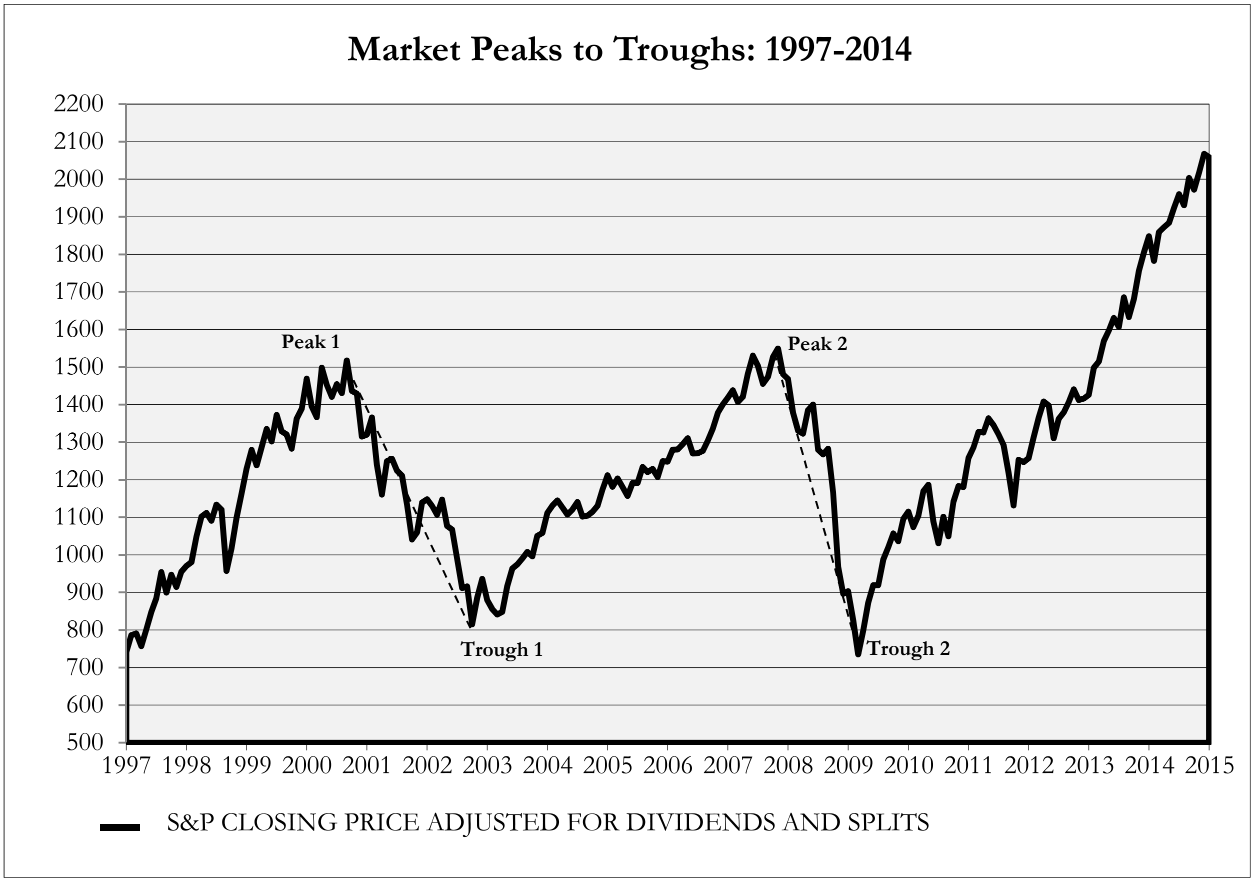


Our Composite performance vis-à-vis the market (S&P 500) over these periods is shown below. We seem to be meeting our goals here.

KIG vs. S&P 500
"Peak-to-Peak" Performance

	KIG	S&P 500
Peak 1 to Peak 2: **Mar 2000 to Sept 2007**	78.2%	26.6%
Peak 2 to Peak 3: **Sept 2007 to Dec 2014**	63.7%	58.1%
Peak 1 to Peak 3: **Mar 2000 to Dec 2014**	191.8%	100.3%

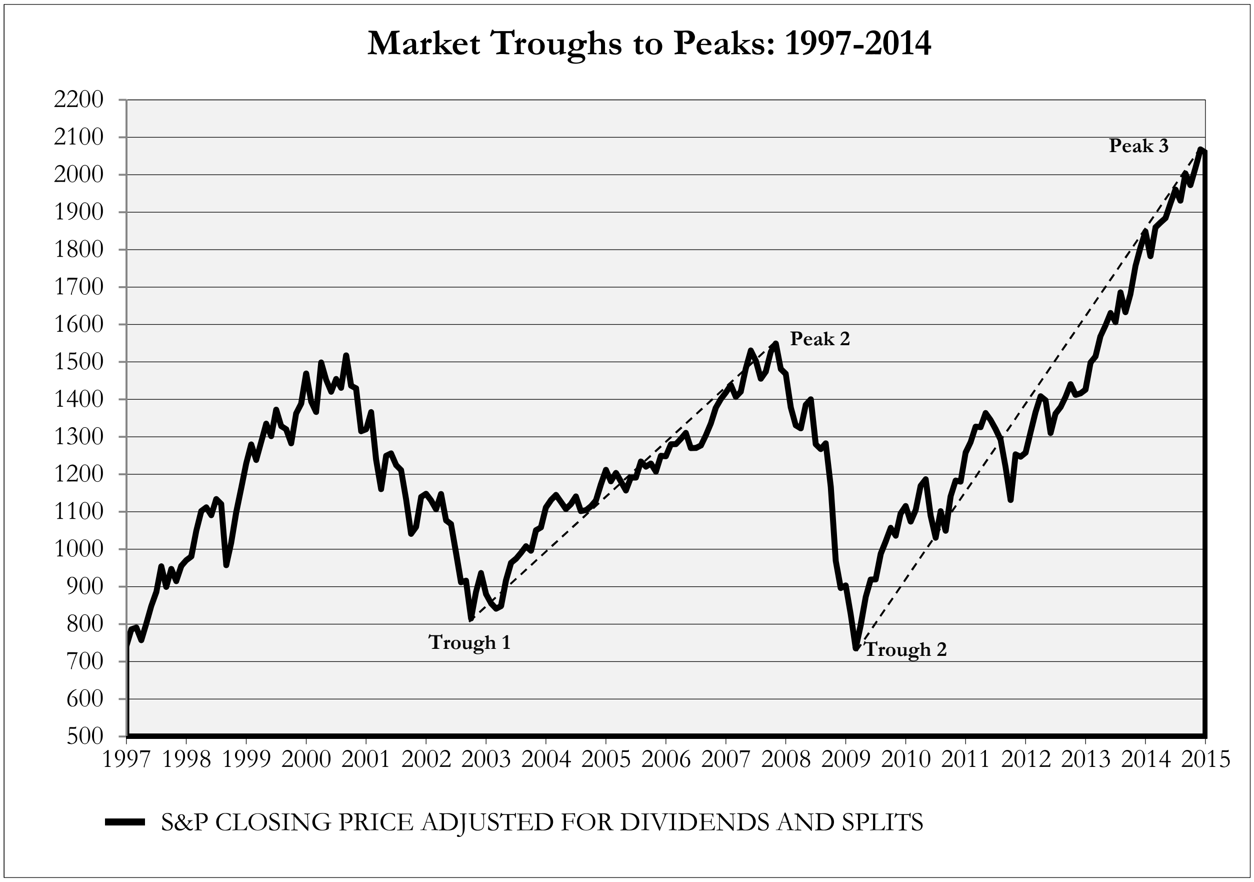
The Composite has also had strong relative performance when you look at our results from a market peak to a market trough. Over the same time period, we have seen two instances of this as indicated in this graph.



KIG vs. S&P 500
"Peak-to-Trough" Performance

	KIG	S&P 500
Peak 1 to Trough 1: **Mar 2000 to Sept 2002**	-9.9%	-38.2%
Peak 2 to Trough 2: **Oct 2007 to Feb 2009**	-47.5%	-50.1%

Where the Composite hasn't shown decent relative results is when the market moves from a trough to a peak. These periods are designated below.



KIG vs. S&P 500
"Trough-to-Peak" Performance

	KIG	S&P 500
Trough 1 to Peak 2: **Oct 2002 to Sept 2007**	97.8%	105.0%
Trough 2 to Peak 3: **Mar 2009 to Dec 2014**	212.1%	217.4%

The Composite has lagged the market in both of these interludes.

So what is the point in our detailing all of this? The first reason is to show that our value proposition isn't in keeping up with rapidly rising markets like those typically enjoyed from market bottoms. Where we add value is in preserving capital in tough markets like those experienced after a market has peaked.

The second reason is to put in perspective the position where we currently find ourselves in the market cycle and how our results may trend over the foreseeable future. Are we at a market peak currently? We don't ever make predictions like that. We're not good at it, and nobody else is either. Our general belief is that market timing is a game best sat out. It is extraordinarily difficult to make money by placing bets on market calls as the world is too complex with too many moving parts to have this be a consistently profitable exercise. Experience has taught us that we are most effective when building portfolios one security at a time by buying and selling stocks based on specific company valuation metrics and not by making wholesale changes based on our expectation of what the market may or may not do.

However, viewing the current market through the lens of an historical comparison may prove instructive. 1982 was a time in which there were very high interest and inflation rates and very low stock valuations. Sentiment towards the market was awful. Today, on the other hand, we are presented with conditions that are essentially the opposite: generationally low interest rates, tame inflation, and valuations at the high end of reasonableness. Sentiment, while not giddy, is certainly elevated. 1982 turned out to be one of the greatest buying opportunities of all time. It seems counterintuitive that current market conditions could also presage the same.

Again, this is not an explicit prediction on our part. It is only a thought experiment to demonstrate where the probabilities lie about what type of market may be on the horizon. We will not make any changes to the process because of it and neither should you. If your goals have not changed then you should not change your portfolio allocations that have been designed to meet these goals.

Managing risk is at the core of what we do. We manage business risk by looking for companies that are capable of producing solid returns on capital. We manage financial risk by requiring strong balance sheets and ample cash flow generation. We manage valuation risk by pursuing opportunities that are out-of-favor and selling cheaply. Experience has taught us that investing in companies with these characteristics stacks the risk/reward deck in our favor over the long-term. It is also instrumental in why the Composite has performed well in choppy or down markets.

Nobody cheers for poor markets, but these periods are inevitable. Of course, past performance is not indicative of future results, but should it turn out that the market is currently at, or near, a peak, we would be surprised if this time period too did not turn out to be a source of outperformance. We just need to be patient and avoid the temptation to play somebody else's game.

Best Regards,

Kovitz Investment Group

Kovitz Investment Group, LLC

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