KIRR, MARBACH & COMPANY, LLC
KM &Co

Investment Managers
www.kirrmar.com

David M. Kirr, CFA · *Gregg T. Summerville, CFA* · *Mark D. Foster, CFA*
Mickey Kim, CFA · *Darrell H. "Kip" Wright, CFA* · *Richard H. Hummel, CFA*

October 7, 2003

THIS ISSUE

The Stock Market

Interest Rates and The Bond Market

Integrity and Stewardship

Summary

Integrity and Stewardship

"Integrity without knowledge is weak and useless, and knowledge without integrity is dangerous and dreadful."

– Samuel Johnson (Eighteenth century English writer)

Dear Clients:

The U.S. equity market continued to grind higher during the third quarter of 2003, with the rate of advance slowing as the market consolidated its gains from the torrid first half. Stock market volatility similarly declined during the third quarter, as the pyrotechnics shifted to the bond market. Stocks have clearly come a long way as investors mark the anniversary of the October 9, 2002 bottom. Our outlook for the stock market is essentially unchanged from our last quarterly letter; **we expect gains in the second year of the market's recovery to be tougher to come by and more modest.** Similarly, our invested level in both equities and bonds remain on the "light" side as we continue to reduce or eliminate positions as they reach our price targets and refrain from investing in situations not meeting our quality and risk/reward criteria.

The Stock Market

The stock market continued its recovery from the low reached on October 9, 2002. For the period ending September 30, 2003, the bellwether S&P 500 Index had a total return 14.7% for the year-to-date and 30.5% from the October 9, 2002 low. The Leuthold Group recently published a study examining stock market recoveries back to 1900, which showed the average and median first-year recovery of 47% and 38%, respectively. Similarly, ISI Group looked at S&P 500 performance in the third-year of presidential terms (which is the year we are in) dating back to Calvin Coolidge in 1927 and determined the average total return was 19.7%. Thus, although the market has come a long way over a short period of time, its advance is not out of line with similar periods in history.

Periods ending September 30, 2003
(Total Returns – Cumulative-Bloomberg)

	S&P 500 Index	NASDAQ	Russell Midcap Index
3-months	+2.65%	+10.22%	+6.43%
9-months	+14.71%	+34.26%	+22.89%
One-year	+24.38%	+53.16%	+32.63%
Two-years	-1.08%	+20.24%	+20.71%
Three-years	-27.40%	-50.78%	-6.28%

The U.S. equity market has been strong because U.S. and foreign economies have improved. Although the rate of change in the U.S. has been choppy and uneven, corporate operating earnings have been strong. As you can see from the chart published by ISI Group on the following page, the third quarter of 2003 is expected to mark the sixth consecutive quarter of double-digit gains in S&P 500 operating earnings per share, a robust recovery from the recession that began in early 2001.

S&P 500 Operating EPS

	2001	% Change	2002	% Change	2003	% Change
Q1	$10.73	–23.0%	$10.85	+1.1%	$12.48	+15.0%
Q2	9.02	–39.0%	11.64	+29.1%	13.03E	+11.9%
Q3	9.16	–36.0%	11.61	+26.8%	13.69E	+17.9%
Q4	9.94	–24.0%	11.94	+20.1%	14.30E	+19.8%
YEAR	**$38.85**	**–31.0%**	**$46.04**	**+18.5%**	**$53.50E**	**+16.2%**

As we've stated, we expect gains going forward to be both tougher to come by and more modest. On the positive side, the Leuthold Group study referenced on the preceding page showed a *cumulative* gain *two-years* from the low of 61% (average) and 59% (median). This implies the gain from the market low of October 9, 2002 thru September 30, 2003 is roughly half the average two-year gain from the lows experienced since 1900. Similarly, ISI Group calculated returns during the fourth-year of presidential terms have been more modest than third-year returns, but still averaged 13.6% since 1928. On the negative side, the twin trade and fiscal deficits continue to soar, putting downward pressure on the dollar and upward pressure on interest rates. Finally, as we mentioned in our last quarterly letter, pockets of speculative fervor have become apparent. The New York Times published an article in the September 26, 2003 issue that examined returns by Standard & Poor's stock rating category, which are based on 10-year records of earnings and dividends. For 2003, stocks rated "A" (S&P's highest rating) were up half as much as those rated "B." Further, stocks rated "C" (indicating doubtful financial condition, but short of actual default) were up twice as much as those rated "B." Morgan Stanley Research looked at the performance of S&P 500 stocks from the low through the end of August 2003, based on their closing price at the October 9, 2002 low. Investors' enthusiasm for low-dollar priced stocks has clearly been unbridled.

Performance by Stock Price Level

Price @ 10/9/02	Average Price Performance (10/9/02–8/31/03)
Sub-$5	+208%
$5-$10	+101%
$10-$15	+73%
$15-$20	+54%
$20-$30	+39%
$30-$40	+31%
$40-$50	+19%
$50-$60	+13%
Over $60	0%

Interest Rates And The Bond Market

We posited in our last quarterly letter the bond market had reached the point where investors were possibly looking at "return-free risk" instead of "risk-free return." We assure you we're not that smart, but our posit turned out to be prophecy as The New York Times reported Merrill Lynch's broad domestic bond index fell 3.36% in July alone, more than any *full year* since 1976. The yield on the 10-year Treasury increased from its 45-year low of 3.1% on June 13, 2003 to 4.6% on September 2, 2003, an increase in yield of almost 50%. Readers of KM quarterly letters know higher bond yields equate to lower bond prices (and vice-versa) and, indeed, the price of the 10-Year Treasury (3.625% due 5/15/2013) plunged from about 104.3 to 92.8 over the same period. Another way of looking at this is the **three-*month* decline in price would have more than offset three-*years* of income.** The bond market subsequently staged a rally through the end of the third quarter, which mitigated some of the pain. Though interest rates have backed-up, they remain at historically low levels. The economy is improving, the trade and fiscal deficits continue to surge and the cost estimates for Iraq climb almost daily. This leads us to believe interest rates are more likely to move higher than lower. Combine our outlook for rates with the fact that corporate spreads have continued to compress and you can see why our invested level and maturities both continue to be less than normal.

Integrity and Stewardship

Clients place their trust in us when they allow us to manage their assets. Clients expect us to be good stewards of their assets and to always act in their best interest. We are in awe of this show of confidence and try to earn this trust each and every day. We understand that without the trust and confidence of our clients, we simply wouldn't have a business. We've always operated with the belief that if we did right by our clients, we would do well for ourselves. We think this is the way most investment management firms viewed their clients and approached their business, many years ago. Unfortunately, recent revelations seem to indicate some managers now view themselves as being in the business of salesmanship, not stewardship.

As you know, last month New York Attorney General Eliot Spitzer alleged actions by certain investment management firms, mutual fund companies and others that ranged from felonious to fraudulent. Spitzer's complaint cited improper/illegal trading in mutual fund shares by hedge fund Canary Capital Partners and its general partner, Edward Stern. Bank of America's Nations Funds, Bank One's One Fund Group, Janus Capital Group and Strong Capital Management were named, but not charged, in the complaint. The probe is ongoing and expanding with Alliance Capital Management, Fred Alger Management and hedge fund Millennium Partners L.P. recently in the headlines. Unfortunately, this list is likely to get much longer as a recently published study by a Stanford University professor stated *1 in 6* mutual fund families are tainted by allowing illegal late trading and/or preferential market timing trading. A detailed discussion of the charges and schemes is beyond the scope of this letter, but the heart of the matter is some investment managers were apparently willing to sell their integrity for the price of some additional fees. It's more than unfortunate the "professionals" involved lost their moral compass, which allowed an environment to exist where at least some fund companies put their own financial interests ahead of those of their shareholders.

By nature of our business, *every* investment manager has conflicts of interests with its clients. The key is how the manager *manages* those conflicts. Many managers "talk the talk" about their interests being aligned with clients. The revelations of the past month seem to indicate this isn't always the case. We try our best to take this a step further to make sure that not only are our interests *aligned* with our clients, our interests *are* our client's interests. To wit, as our August 31, 2003, KM team members, family members and related entities owned approximately 36% of the shares of the Kirr, Marbach Partners Value Fund (Value Fund--net assets as of 8/31/03 of approximately $36.2 million), which is managed in the same manner as client equity portfolios. We have referred to this in the past as "eating our own cooking." When our "cooking" is good, we benefit along with our clients. When it's not so good, we suffer along with our clients. The point is we're seated at the same table with our clients and eating the same meal. We don't think you'll find this level of commitment to one's own product at many firms. Perhaps if it was, none of this nonsense would have happened. When we say our integrity has never been "for sale," it may sound self-serving. Similarly, our anger may seem like self-righteous indignation. However, the bad actions of a few taint all of us who try to run our businesses the "right" way.

Summary

We are pleased to report our efforts and achievements have continued to receive recognition from the financial press, both locally and nationally. Our strategy of "buying straw hats in the winter" has apparently struck a chord with some writers as a timeless, Midwestern-type catchphrase that makes solid, universal investment sense. We tell you this not out of braggadocio, but to perhaps validate in your own mind that, yes, you can get world-class investment management expertise from a small firm in Columbus, Indiana!

A recent essay from Morgan Stanley said, "Successful investing ultimately is about courage and imagination. From a value perspective, courage is required to see temporary problems for what they are-temporary-and buy undervalued securities when the consensus sees things as hopeless. But tuning out the noise in the investment business that distracts you from summoning your courage or imagination can be a Herculean task. Information rules-insight is rare." This year has turned out better than we thought at the beginning of the year and much better than we thought as the market was plunging in early March, ahead of the start of the war with Iraq. Through it all we tried to stay unemotional and let our value discipline dictate our actions. Though we certainly feel good about our recent success, we pledge to work harder tomorrow and harder still the next day.

General

We are truly fortunate several clients with separate accounts and a number of our fellow shareholders in the Value Fund have either mailed or dropped-off checks to us to add to their accounts. We thank you so much! We need to ask you to do us a favor and make sure your check is made payable to either the account's custodian (for a separate account) or Value Fund. If your check is made payable to KM, we are deemed to have "custody" of your assets, which triggers additional SEC rules and regulations. We'll be more than pleased to forward your check to the custodian or Value Fund, but if you could help us out by making your check payable to the correct entity, it would be much appreciated.

As we head into the fourth quarter, thoughts naturally turn towards taxes. Most, if not all, taxable accounts will have net realized capital gains for 2003. If you'd like an update as to where your account stands, tax-wise, as we approach year-end, please contact Kip Wright, CFA at 812-376-9444, 800-808-9444 or kip@kirrmar.com. Finally, a number of clients using Salin Bank & Trust Company as custodian noted at the beginning of the year that the tax statement provided by Salin could be more "user-friendly." Specifically, although the necessary information was included in the statement, it wasn't summarized on one or two pages. We asked Salin to investigate options for improving the report. Salin did some checking and presented a solution offered by a third-party vendor as best in terms of usability and cost. We agreed and Salin informed their taxable custodial clients of the option to receive this summary of tax information, at Salin's cost from the vendor ($100). We'd note at the time we decided to name Salin as our preferred provider of custody services, Bank One was charging clients $250 for a similar report. Given our discussions at the time, that cost was likely to go up.

Regards,
Kirr, Marbach & Company, LLC