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THIS ISSUE

The Stock Market

The Economy, Interest Rates and the Bond Market

Summary

General

Securities and Exchange Commission/ Form ADV–Part II

"Not everything that can be counted counts, and not everything that counts can be counted."

—Albert Einstein

Dear Clients:

We closed our most recent quarterly letter to clients by re-emphasizing our outlook that gains going forward in U.S. stocks and bonds were likely to be both more modest and much harder to come by. Nothing occurred during the first quarter of 2004 to alter our outlook and, indeed, total returns during the period for stocks and bonds were mostly positive, but relatively modest compared with recent history.

The U.S. equity market started the year strongly, but experienced a mild correction in late March, with the S&P 500 Index dropping about 5.6% from its early February high. We attribute a good portion of this decline to an increased risk factor being priced into the market, as the terrorist attack in Spain and the escalation of hostilities in Iraq served to remind investors that constant danger will be an uncomfortable fact of life for the foreseeable future. Similarly, bond yields staged an impressive rally during the quarter, as surprisingly weak *reported* employment numbers gave investors confidence the Federal Reserve would not be boosting interest rates anytime soon and turmoil around the globe drove investors to the "safety" of U.S. Treasury securities. As we'll discuss in further detail, a report issued by the Labor Department in early April caused an immediate and violent reversal to the bond market rally.

We quote Warren Buffet because we like how he looks at the world and his observations make such good investment sense. In his most recent annual letter to shareholders of Berkshire Hathaway Inc., released on March 6, 2004, he said, "Our capital is underutilized now, but that will happen periodically. It's a painful condition to be in—but not as painful as doing something stupid. (I speak from experience.)" We noted in our January letter to clients that with valuations becoming more extended, it was more difficult to find securities with both the quality and risk/reward characteristics we seek, resulting in lower than normal invested levels in client equity and fixed income portfolios. We took advantage of the correction in the equity market to complete some positions that had run away from us to the upside and establish new positions.

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Similarly, we purchased a significant amount of the 10-Year Treasury bond following its collapse in price in early April. Client equity portfolios now have a more normal invested level, while bond portfolios continue to be have a lower than normal invested level, as we await the opportunity to take advantage of any further weakness in Treasury securities and/or increasing spreads in corporate bonds we have identified as solid credits.

The Stock Market

As shown in the chart below, although U.S. equity indices had mostly positive, but modest, total returns for the first quarter of 2004, the one-year returns (dating to the early stages of the war with Iraq) remained strongly positive. However, we'd point out given the pounding the S&P 500 endured during the bear market of 2000-2002, an investor in that index would still have experienced a negative return for the five-years ending March 31, 2004.

Periods ending March 31, 2004
(Total Returns – Cumulative – Bloomberg)

	S&P 500 Index	NASDAQ	Russell Midcap Index
3-months	1.69%	-0.36%	5.14%
One-year	35.12%	49.38%	50.83%
Two-years	1.66%	9.09%	18.40%
Three-years	1.91%	9.76%	30.14%
Five-years	-5.85%	-17.55%	49.79%

With interest rates more likely to move higher than dramatically lower, there is not much room for the overall market's P/E ratio to expand. Therefore, a reasonable expectation for the U.S. equity market for the near-to-intermediate term is for gains to roughly track the increase in corporate earnings. Baseline's reported consensus among Wall Street investment strategists they polled is for S&P 500 operating earnings to increase 10% for 2004. Although we think this is a reasonable *expectation*, we obviously can't predict the future. On the positive side, the economy is strong, corporate earnings are increasing, inflation and interest rates remain low and the fourth year of a presidential cycle (which we're in) is typically good for the stock market. On the negative side, sentiment remains bullish (see the $40.8 billion inflow into equity mutual funds in January—what scandal?), speculation is alive and well (see the frenetic level of trading activity and price action of stocks on NASD's OTC Bulletin Board, the "Wild West" of U.S. equity trading), commodity prices are increasing rapidly and, as the March terrorist attack in Spain brought into all too clear focus, the risk of an "out of left field" event is ever present.

The Economy, Interest Rates And The Bond Market

The economic recovery continues. The government's Bureau of Economic Analysis reported real gross domestic product (Real GDP) grew 4.1% in the fourth quarter of 2003, on top of the whopping 8.2% gain for the third quarter of 2003. Economists expect Real GDP to grow by 4.6% for 2004, which would be a strong performance. Investors were perplexed by the incongruity of strong growth in Real GDP, but very weak growth in employment *reported* for January and February. Going against the conventional wisdom of the day is not generally considered a career-enhancing move on Wall Street (i.e. "don't fight the tape"), so many investors embraced the "jobless recovery" thesis and bought more bonds as yields sank and prices rose. We were equally puz-

	2002 High	June 30 2003	September 30 2003	December 31 2003	March 31 2004
10-Year U.S. Treasury	5.40%	3.52%	3.94%	4.25%	3.84%
Ba Index Spread	6.50%	3.15%	2.62%	1.52%	1.48%

zled, but confident the probabilities favored a stronger-than-expected employment report, at some point. Sure enough, on April 2, 2004 the Labor Department released a report indicating that not only had the U.S. economy created 308,000 jobs in March (more than double the consensus expectation), the previously reported figures for February and January were being revised upward. Most bond market participants were stunned by this revelation of strength in the economy and sent the yield on the 10-year U.S. Treasury bond soaring from 3.88% to 4.15%, which The Wall Street Journal reported was the *biggest single-day increase since July of 1996*.

The chart above shows the path of 10-Year Treasury yields and credit spreads, as indicated by the yield differential between the 10-Year Treasury and the Lehman Brothers Ba Index. As you can see, although the yield on the 10-Year Treasury increased by about 30 basis points (0.3%) between 6/30/03 and 3/31/04, the Ba Index Spread has continued to contract. We thought corporate bonds were a bit "rich" at a spread of 315 basis points on June 30, 2003. Clearly to us, at a spread of 148 basis points on March 31, 2004, corporate bonds are *extremely* rich. In general, an investor buying corporate bonds at these types of spread is assuming businessman's risk, but not receiving businessman's reward. Remember, a bond is a totally different security than a stock. If you're right on a stock, it can double, triple or even achieve the mythical status of the "10-bagger." If you're right on a bond, it pays you par at maturity and not a penny more. If you're wrong, watch out below. With spreads already very tight and interest rates not likely to decrease as the economic recovery continues, we would not be surprised to see investment bankers rush a slew of corporate deals to market. This increasing supply of new bonds will tend to cause spreads to widen. While our exposure to short-maturity issues and cash restrained performance as yields were dropping, it has cushioned the downside of this spike in rates and will give us the opportunity to redeploy into more attractive opportunities going forward.

Summary

Stock-picking ability and a steady hand at the helm will continue to be the keys to success for the balance of 2004. Although the economic recovery continues to chug along and surprises on corporate earnings have tended to be to the upside, it's not going to be dull. Aside from the risk factors we mentioned earlier, two important factors for the financial markets have gone from being foregone conclusions a few short months ago to far from "done deals" now. It appears President Bush and John Kerry are locked in a real horse race for the November election. In addition, it's far from clear the Fed will hold the federal funds rate at its 1958 level of 1% indefinitely. Uncertainty is the enemy of investors, so as the presidential campaign ebbs and flows and investors try to determine if the Fed will act sooner rather than later, the markets will be roiled. Again, we thank you for the trust and confidence you have placed in us by allowing us to manage your precious assets. We try to earn your business each and every day.

General

You will notice a different look and feel to the performance reports you receive from us, beginning with the first quarter of 2004. We made the decision last year to change from our proprietary portfolio information system to one provided by CheckFree/Security APL. Our proprietary system had served our business well during our first 28 years as it evolved to meet our ever-increasing needs. However, we felt our business had reached the stage where our clients would be better served by moving to a more standardized portfolio information platform. We transitioned from our proprietary system to CheckFree/Security APL effective at the beginning of 2004. Although we're all still getting used to the new system, we're confident it will be a change for the better for our clients.

Securities and Exchange Commission/Form ADV—Part II

Form ADV—Parts I and II describe an investment adviser's business and practices. Advisers registered with the Commission are required to electronically file an annual updating amendment to Part I and offer to provide to clients a copy of its annual updating amendment to Part II. KM filed its annual updating amendment to Part I in March. As a matter of practice for the past several years, we have provided each client account with a copy of our annual amended Form ADV—Part II and do so again this year.

Regards,
Kirr, Marbach & Company, LLC