

October 12, 2004

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"Being president is like being a jackass in a hailstorm. There's nothing to do but to stand there and take it."

– Lyndon B. Johnson

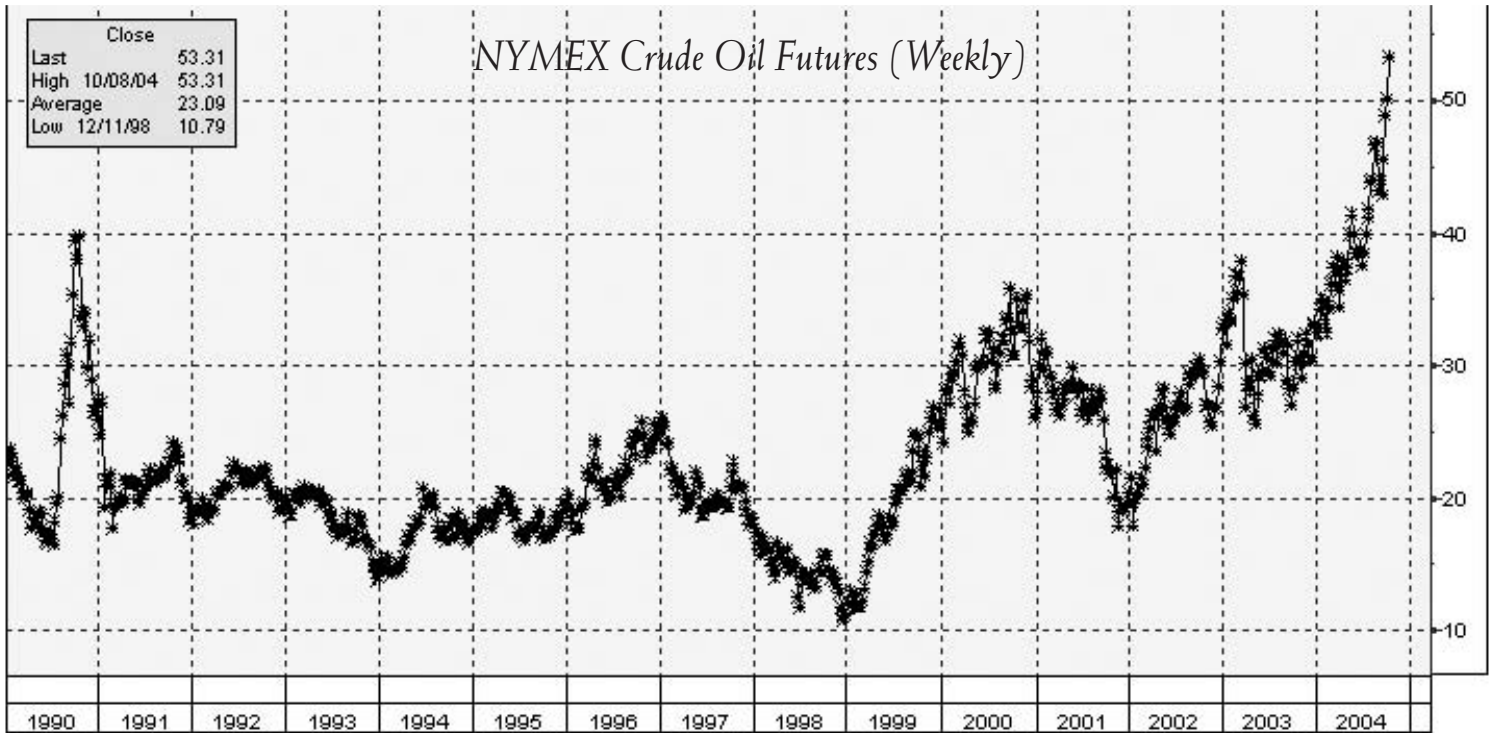
DEAR CLIENTS:

The U.S. equity market stumbled in the third calendar quarter of 2004, as the headlines blared all the "bad stuff" that was happening. Crude oil futures continued their relentless ascent on the New York Mercantile Exchange, reaching \$49.90 per barrel just prior to the end of September, which *The Wall Street Journal* reported was the highest in the 21-year trading history of the contract. The price has subsequently eclipsed \$53 per barrel in early October, with no end to the rise in sight. As promised, the Federal Reserve started raising short-term interest rates, moving from the emergency level of 1% to 1.75% over three consecutive meetings, in 25 basis point (0.25%) increments, starting June 30, 2004. The Fed suggested after the most recent increase, on September 21, 2004, they intend to keep gradually increasing rates over the next year. We mentioned in our last quarterly letter the September quarter had started poorly, with a number of negative earnings pre-announcements, particularly in the technology sector. This trend continued and spread to other sectors, with negative pre-announcements running 2:1 over positives. Finally, a number of key economic statistics released during the quarter pointed to slowing growth in the economy.

We can't dispute the fact a lot of bad stuff happened in the quarter. However,

some of the negatives are not as bad as the headlines would lead you to believe. Further, in the interest of balance, we'd point out a lot of potentially *really* bad stuff didn't happen at all. Terrorists *didn't* attack the Olympics or either party's convention. Inflation *didn't* surge, the rapid rise in commodity prices notwithstanding. Similarly, intermediate to long-term interest rates not only *didn't* ratchet higher in the face of Fed tightening, they actually decreased.

Overall, corporate earnings remain strong and the economy continues to grow. Like most investors, we're more than a little frustrated by the market's lack of progress this year. At the beginning of the year we thought corporate earnings would increase about 10% and a reasonable expectation was for the market to approximate the gain in earnings. Fast-forwarding nine months, despite the recent negative tenor, corporate earnings will *far* exceed a 10% gain. The fundamentals support higher valuations, but a 10% return for 2004 now appears to be a stretch. Still, if we can get past the elections without a terrorist attack or the bad stuff getting materially worse, 2004 can still be a reasonably good year. Nobody ever said being a long-term investor is easy and sometimes we *do* feel like the proverbial jackass in a hailstorm.



Source: Bloomberg

THE STOCK MARKET

The U.S. stock market hit its low on October 9, 2002, but investors had decidedly mixed emotions as the bull market reached its second birthday. As you can see from the table, U.S. stocks enjoyed a strong run over the past two years, most of the increase occurring in the first year. Further, the advance has been fairly broad-based, in stark contrast to the late 1990s, when anything technology or dot-com related went through the roof and everything else languished. Then, there were large pockets of investment ideas with compelling merit. These pockets have now been hunted and the overall market has reached "fair value." The upshot is it's harder to find ideas meeting our quality and risk/return criteria and returns going forward are going to be more modest.

Periods ending September 30, 2004
(Total Returns – Cumulative – Bloomberg)

	S&P 500 Index	NASDAQ	Russell Midcap Index
3-months	-1.87%	-7.24%	-0.84%
9-months	1.51%	-4.98%	+5.77%
One-year	+13.87%	+6.71%	+20.55%
Two-years	+41.61%	+63.43%	+59.88%
Three-years	+12.62%	+28.30%	+45.52%
Five-years	-6.38%	-29.63%	+48.71%

Stock prices follow earnings, over the long-term. We discussed in our most recent quarterly letter how investors appeared to be focusing on expectations for a *deceleration* in corporate earnings. We pointed out 1) after four consecutive quarters of 20% plus growth for S&P 500 earnings, a slowing of the *rate* of increase was a mathematical certainty and shouldn't surprise anyone and 2) there's a big difference between a slowdown in profit growth because the economic cycle is maturing and a decline due to an economy heading into recession. Negative earnings pre-announcements for the third quarter have been running at twice the rate of positives, yet the *aggregate* First Call consensus estimate for S&P 500 earnings for the quarter has decreased only slightly, from +14.8% year-over-year at the start of the quarter to +14.3%. Further, the First Call consensus estimate for 2004 earnings for the S&P 500 still calls for a +18.7% year-over-year change. (Source: ISI Group) The deceleration in earnings and recent spate of negative pre-announcements has caused investors to become overly pessimistic on the outlook. The stock market is an anticipatory mechanism and tends to overshoot on the upside and downside. It may seem counterintuitive, but expectations have been ratcheted-down to the point where the odds now favor more positive earnings surprises and a better market going forward. Finally, *The New York Times* published an article on September 26, 2004 citing a study by Ned Davis Research, which identified only seven instances since the end of World War II when S&P 500 earnings increased by more than 20% for four consecutive quarters. In the 12-months following the end of such streaks, the S&P 500 rose an average of 8.3%, with the median increase about 15.3%. The conclusions were 1) periods when S&P 500 earnings have increased by 20% for four consecutive quarters have been pretty rare birds and 2) the market typically performed fairly well following the end of these periods, even after earnings gains started to cool.

INTEREST RATES AND THE BOND MARKET

The bond market continued its roller-coaster ride in the third quarter, as the 10-year U.S. Treasury Bond went from a yield of 4.585% on June 30, 2004 (down from its 2004 high of 4.874% reached 6/16/04) to 4.123% on September 30, 2004 (after reaching 3.982% on 9/22/04), in the face of *three interest rate increases* by the Fed. Stronger economic data and fears of inflation led to a weak bond market in the June quarter, while weaker data and positive news on the inflation front led to a strong market in the September quarter. We also think some investors sold stocks and redeployed the funds into bonds, further pushing up prices and depressing yields.

The Fed expects the recent "soft patch" in the economy to end and be followed by renewed growth. We are also in the economic recovery camp, but concerned about the near-term impact of surging energy costs rippling through the economy. We don't see anything happening in the current quarter that will send yields to their 2004 high or low (3.683% on 3/16/04) and our best guess is for yields to end the year plus or minus 50 basis points (0.50%) from current levels.

On the corporate side, we've been saying the same thing for many months, but spreads remain very tight and we don't see much room for them to move tighter still. With a finite upside (i.e. 100) and limited spread, there is not a tremendous amount of value in corporate bonds relative to U.S. Government bonds. Our corporate bond exposure has decreased as some bonds matured/were called by their issuer or were sold because the risk/reward or fundamentals became unfavorable. We have been slow to redeploy the proceeds in the face of a surging government bond market, as our preference is to buy on weakness, not on strength.

Given our outlook of a relatively narrow range for overall yields and spreads to be flat to higher, a reasonable expectation is for bondholders to earn the coupon payment over the near- to intermediate term.

SUMMARY

These are difficult times for investors, but we are reminded uncertainty and pessimism are the friends of the long-term value investor, assuredness and optimism the foe. Although we expect returns going forward to be modest, we still view the glass as half-full. The next several weeks should bring some clarity to some of the unknowns weighing on the market. The presidential election will be settled in the next couple weeks. We'll soon know if estimates for corporate earnings for the September quarter came down too much or not enough. Finally, investors and the Fed will examine upcoming economic data to determine if the recent soft patch was just a temporary pause, after which robust growth will continue, or a more lasting slowdown. The implications for interest rates and earnings are potentially significant, so we expect the market to seize upon any nugget of information. It promises to be an interesting period!

As always, we thank you for the trust and confidence you've placed in us and for your business.

KM PRIVACY POLICY NOTICE

Under Securities and Exchange Commission Regulation S-P, KM is required to deliver its Privacy Policy Notice to each client prior to the establishment of an account and updates annually. We are delivering our 2004 annual update to each client account with this letter. In addition, given the



"It's just a correction. The fundamentals are still good."
(Son to father, reading report card)

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increasing importance of protecting clients' personal information, we have implemented a policy whereby KM personnel will *not* release any information about a client's account without specific authorization from the client. If you would like KM to release information about your account to your CPA or other service provider, please contact Kip Wright, CFA, Senior Client Service Officer (812-376-9444, 800-808-9444 or kip@kirmar.com).

IMPORTANT INFORMATION FOR TAXABLE CLIENTS

We want to alert taxable clients that, as a result of a number of portfolio holdings reaching price targets and being sold during 2004, realized capital gains will be larger than normal. Briefly, a taxable portfolio realizes a capital gain or loss in the year it sells a holding, regardless of when the holding was purchased. Realized capital gains and current year performance are somewhat unrelated. For instance, if a stock was purchased three years ago, the appreciation or contribution of that stock to performance occurred over the entire period, with only a portion contributing in the current year. However, *all* of the capital gain from the three-year period is realized in the year the stock is sold. We generated very strong performance in 2003, but we did not realize a lot of capital gains because many stocks had not yet reached our price targets. We are likely to generate much more modest returns for 2004, but will realize more capital gains because more stocks reached our price targets and were sold. We will review taxable portfolios between now and year-end to determine if it makes good investment sense to realize some offsetting capital losses. It's both fortunate and unfortunate the list of possible candidates for generating capital losses is fairly limited.

This larger than usual realized capital gain does not reflect any change in the way your portfolio is being managed; it is purely a matter of timing. In fact, our portfolio turnover has been trending lower over the past couple years.

Regards,

Kirr, Marbach & Company, LLC