KIRR, MARBACH & COMPANY, LLC
KM &Co

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"**Doubt is not a pleasant condition, but certainty is absurd.**"
– **Voltaire,** *(Author and Philosopher)*

THIS ISSUE

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Dear Clients:

The U.S. equity market "climbed a wall of worry" in the quarter ended September 30, 2005, with the major market indices posting solidly positive returns. Investors had to deal with the impact of the catastrophic destruction wrought by Hurricanes Katrina and Rita, soaring energy prices (crude oil reaching $70/barrel and natural gas up 99% during the quarter) and the Federal Reserve's clear resolve to stay its course of policy tightening (raising its target for federal funds to 3.75% on September 20, 2005, the eleventh consecutive 25 basis point increase in this cycle, which began June 30, 2004). An optimist might view the equity market's positive performance in spite of these negatives as a signal all of the bad news is priced into the market, which is poised to respond to any positive news. The pessimist might view the market's rise as a sign that investors just don't understand the negative implications and have just postponed the pain.

We can't predict the short- to intermediate-term any better than those who profess to that ability. We're cognizant of the very real risks, but also understand the market is a *discounting* mechanism that looks far beyond the next six to twelve months. The best thing we can do for clients is to continue doing what we've done for the past thirty years plus; buying good businesses at a significant discount to intrinsic value, believing at some point down the road, the gap between intrinsic value and price will narrow, resulting in a good long-term investment.

Periods ending September 30, 2005 (Total Returns-Cumulative-Bloomberg)

	S&P 500 Index	NASDAQ	Russell Midcap Index*	Russell 3000 Index*
3-months	3.60%	4.78%	5.92%	4.01%
9-months	2.77%	-0.59%	10.07%	4.01%
One-year	12.25%	14.19%	25.10%	14.58%
Two-years	27.79%	21.85%	50.81%	30.90%
Three-years	58.95%	86.62%	100.01%	64.77%
Five-years	-7.22%	-40.03%	41.34%	-3.43%

* Beginning with our third quarter 2005 performance reports, we are changing our benchmark index from the Russell Midcap Index to the Russell 3000 Index. We are doing this because we feel the Russell 3000 better represents the stocks held in client portfolios. Much like the S&P 500 represents mostly large-capitalization stocks, the Russell

Midcap represents mostly medium-capitalization stocks. As we'll explain in further detail, we search for value in large-, medium- and small-capitalization stocks. The Russell 3000 represents 98% of the U.S. equity market's capitalization and thus we believe is the most representative benchmark of broad market performance.

KM's Outlook for the Economy and the U.S. Financial Markets

The signs point to an upcoming economic slowdown. As always, the timing is uncertain, as is whether the slowdown proves to be a temporary pause that sets the table for a resumption of growth or a precursor of further weakness. The economy has been absorbing some "body blows" lately. This led the University of Michigan's August index of consumer sentiment to match its biggest drop since the monthly survey's inception in 1978 and left it at its lowest level since the recessions of 1980 and 1990 (Source: International Strategy & Investment—ISI). Three primary negatives facing consumers are:

• **Soaring Energy Costs.** $3/gallon gasoline is headline grabbing and hurts the consumer pocketbook and psyche. Crude oil futures on the Nymex closed at $66.24/barrel on September 30, 2005, up 52.5% year-to-date and 33.4% from a year ago. Just as consumers get accustomed to $3/gallon gasoline, winter is right around the corner and home heating costs will also be significantly higher. More than half of households heat with natural gas and natural gas futures on the Nymex closed at $13.921/million Btu on September 30, 2005, up 126.4% year-to-date and 104.9% from a year ago. To make matters worse, ISI's economic model shows it takes a year for oil prices to work through the system, so we have yet to see the full impact.

• **Higher Interest Rates.** The Fed has increased its fed funds target from 1% in June of 2004 to 3.75% currently. At their most recent meeting, they acknowledged the possible negative effects of Hurricane Katrina, but indicated their expectation was that any such effects would prove to be transitory in nature. They also stated their plan was to continue removing accommodation (i.e. raising rates). Although long-term interest rates have actually *declined* since the Fed began its tightening cycle (i.e. the "flattening" of the yield curve referenced in our most recent letter), much of consumers' borrowing costs are tied to short-term rates, which are dramatically higher.

• **Housing Likely to Cool.** Historically low mortgage rates combined with easier borrowing standards and terms have fueled extraordinarily rapid price appreciation of real estate in a number of markets, a topic we touched on in our most recent letter. Courtesy of willing mortgage lenders, homeowners have been able to view their homes as giant ATMs (that dispense stacks of $100s instead of $20s) and extracted about $600 *billion* of equity over the past year. As evidenced by recent speeches and a study he co-authored (only the second of his entire Chairmanship), Chairman Greenspan has decided one of his last official acts will be to warn of the dangers of inflated asset (real estate) prices. The speeches and study can be found on the Fed's website at http://www.federalreserve.gov. To paraphrase the Chairman, *"This enormous increase in housing values and mortgage debt has been spurred by the decline in mortgage interest rates, which remain historically low....This decline in mortgage rates and other long-term interest rates in the context of a concurrent rise in the federal funds rate is without precedent in recent U.S. experience...The apparent froth in the housing markets may have spilled over into the mortgage markets. The dramatic increase in the prevalence of*

interest-only loans, as well as the introduction of other, more-exotic forms of adjustable-rate mortgages, are developments that bear close scrutiny…To the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is adding to the pressures in the marketplace." To the extent the Fed continues to increase short-term rates (to which adjustable-rate mortgages are pegged) and acts to compel lenders to tighten borrowing standards and terms, both the rate of increase of real estate values and the ability of homeowners to extract equity will likely be diminished.

So, we're pretty sure we're going to see an economic slowdown. The number of warnings on earnings has started to grow, so the slowdown may have already begun. If this warning trend continues, the stock market could be subject to downward pressure, as panicky sellers encounter a dwindling and increasingly cautious cadre of buyers. The market has started the fourth quarter with a decidedly weaker tone and if it continues, the stocks held in client portfolios are also likely to go down. While that won't make you or us happy, we won't be overly concerned because 1) we like what we own, 2) we know investors over-extrapolate, both on the upside and downside and lowered expectations lead to better opportunities to make money and 3) once the economy has slowed and the Fed is convinced inflation is under control, they will be in a position to stop raising or even lower short-term rates, which will be a positive for equities.

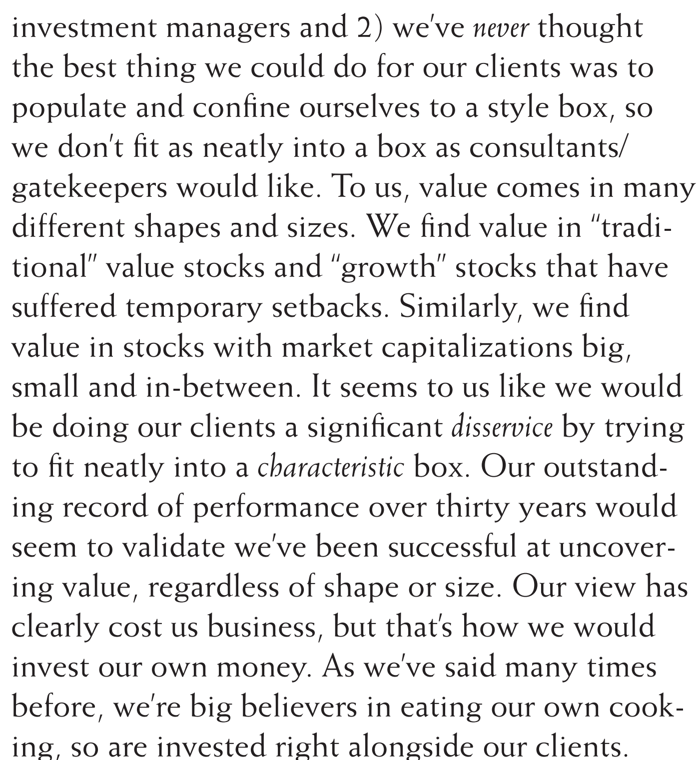
Client equity portfolios are fairly fully invested. On the fixed income side, interest rate spreads on corporate bonds are starting to get interesting, but still have a ways to go before they're compelling. Until they get there, our plan is to stick with shorter-maturity U.S. Treasury bonds, given the yield curve remains very flat (i.e. the pick-up in yield for the risk of extending maturity to 10-years and beyond is very small).

Don't Box Me In

Regarding our quarterly letters, we think (hope) clients find a historical review of the most recent quarter, the factors that shaped the quarter and our outlook useful and informative. We also realize that what's past is past and everyone has an outlook. We think clients might also appreciate our attempt to "educate" on investment topics that may be relevant to them. We can't promise our efforts as "educators" will be successful or we'll find a topic worthwhile to discuss every quarter, but we're going to give it a try.

The emergence of "style-box investing" has both intrigued and frustrated us. There are variations, but generally there are three segments on the vertical-axis related to market capitalization (i.e. small, medium and large) and three on the horizontal-axis related to "style" (i.e. value, "blend" and growth). The resulting grid contains nine "style boxes." The theory (flawed, we think) is investors are best served by allocating their equity assets among managers who populate these nine boxes, who in-turn are required to stay within the well-defined confines of their particular box (i.e. mid-cap value).

We're intrigued by this because 1) no one has ever actually demonstrated or proven this is a valid method to increase returns and/or decrease volatility and 2) "style box" itself is a misnomer, as it really refers to a box in a *characteristic* grid, *not* a style or asset class. We're frustrated by this because 1) consultants or other "gatekeepers" are increasingly key to determining selection of



investment managers and 2) we've *never* thought the best thing we could do for our clients was to populate and confine ourselves to a style box, so we don't fit as neatly into a box as consultants/gatekeepers would like. To us, value comes in many different shapes and sizes. We find value in "traditional" value stocks and "growth" stocks that have suffered temporary setbacks. Similarly, we find value in stocks with market capitalizations big, small and in-between. It seems to us like we would be doing our clients a significant *disservice* by trying to fit neatly into a *characteristic* box. Our outstanding record of performance over thirty years would seem to validate we've been successful at uncovering value, regardless of shape or size. Our view has clearly cost us business, but that's how we would invest our own money. As we've said many times before, we're big believers in eating our own cooking, so are invested right alongside our clients.

Challenges to the style-box status-quo are starting to become more prevalent. We thought you might find the enclosed reprint interesting.

KM Adds Matthew D. Kirr to Client Service Team

David Kirr and Terry Marbach founded KM on May 1, 1975, with the goals of generating outstanding long-term investment performance and providing the highest level of client service. Mark Foster and Mickey Kim are now the primary owners and managers of the business, but KM's goals remain the same. We like to think that we "walk the walk" by making investments in personnel and infrastructure necessary to continually improve the entire KM client experience, both investment performance and service.

Briefly, we decided to split KM's client service responsibilities into an "inside" role and an "outside" role. Kip Wright, partner and Senior Client Service Officer, will focus his efforts *primarily* on the "inside," administrative side of client service. Matt Kirr has recently joined our business as a Senior Client Service Officer and his efforts will focus *primarily* on the "outside" role of getting out and meeting with clients. As you can see from the enclosed press release, Matt spent the past thirteen years of his career as a Private Banker, the first ten years with Bank One (where he quickly attained the level of Vice President) and the most recent three years with McDonald Financial Group. Bank financial products are mostly similar, so as a Private Banker, all Matt had to sell to his current and prospective clients was his demonstrated willingness and ability to work harder for them to satisfy their needs than his competitors. We were impressed with Matt's experience and client service mindset and are confident our decision to split our client service effort into primarily inside (Kip) and primarily outside (Matt) roles will enhance the KM client experience.

Kip and Matt will work as a team and clients should feel free to contact either or both (812-376-9444, 800-808-9444, kip@kirrmar.com or matt@kirrmar.com). David Kirr (david@kirrmar.com) remains active in the business, on a part-time basis, and will maintain his client relationships.

Regards,

Kirr, Marbach & Company, LLC