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"There are two types of forecasters: those who don't know and those who don't know they don't know."

– John Kenneth Galbraith *(American economist)*

THIS ISSUE

The Stock Market

Interest Rates and the Bond Market

Hedge Funds - Caveat Emptor

Summary

Dear Clients:

A year ago, we reiterated our cautious outlook that future gains for the U.S. equity market were likely to be both harder to come by and more modest than they had been in the first and second years following the October 9, 2002 low. We thought earnings *gains* going forward would need to be top line driven and the earnings *multiple* investors would be willing to pay unlikely to expand during the Fed's cycle of increasing short-term interest rates. Putting it all together, we believed a reasonable expectation for 2005 was for a modest gain, with the possibility of a loss. As stated in the quote above, forecast events typically never play-out just the way you expected over the course of a year, but the market's performance in 2005 was in line with our expectation at the start of the year.

While our performance was good in relation to the broad market indices, we understand nobody is going to be excited about a mid-single digit return (i.e. you can't spend *relative* returns). Our outlook for 2006 is for a better year. The risk factors we've discussed over the past several quarters are omnipresent and will likely cause a bumpy ride, but with the Fed likely nearing the end of its tightening cycle, we think there's an opportunity to generate good returns.

Periods ending December 31, 2005
(Total Returns-Cumulative-Bloomberg)

	S&P 500 Index	Russell 3000 Index	NASDAQ Index
3-months	+2.09%	+2.04%	+2.73%
One-year	+4.91%	+6.12%	+2.12%
Two-years	+16.31%	+18.80%	+11.47%
Three-years	+49.65%	+55.69%	+68.05%
Five-years	+2.74%	+8.16%	-8.47%

The Stock Market

On a macro level, stock prices are determined by corporate earnings and the multiple investors are willing to pay for those earnings (i.e. the price-to-earnings ratio, or P/E). ISI Group (ISI) estimates operating earnings for the S&P 500 Index will be up 13% in 2005 vs. 2004, which in turn were up 23.8% vs. 2003, a very impressive showing. ISI is forecasting an economic slowdown in 2006, which they expect will lead to a gain in operating earnings of 6.2%, an estimate they characterize as conservative. For the second year in a row, the performance of the S&P 500 Index failed to keep pace with the gain in operating earnings, which means the earnings multiple has continued to contract (see ISI graph on page 3). One of the primary causes of this contraction of earnings multiple is the Fed's cycle of in-creasing short-term interest rates, which began June 30, 2004. If the economy slows and if inflation remains contained in 2006, the

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Fed will have the opportunity to stop increasing or even reverse course on rates. Strong economies and Fed tightening combine to produce lackluster stock markets (i.e. better earnings push the market up, while higher rates push the earnings multiple down, resulting in a standoff). Similarly, slower economies and the end of Fed tightening should combine to produce a stronger market (i.e. slowing, but still solid earnings growth and expansion of earnings multiple lead to higher stock prices).

At the micro level, we expect merger and acquisition activity to continue unabated as private equity funds with access to huge pools of capital look to put that capital to work. In addition, hedge funds have become increasingly active in a low-return market as they agitate to "increase shareholder value." With valuations across market capitalizations and sectors fairly homogeneous, it is a challenge to find undervalued investment candidates with the characteristics we look for. Fortunately, we've had some success investing in "special situations," such as spin-offs and companies emerging from bankruptcy, where the market seems to be less efficient and our ability to add value is greater.

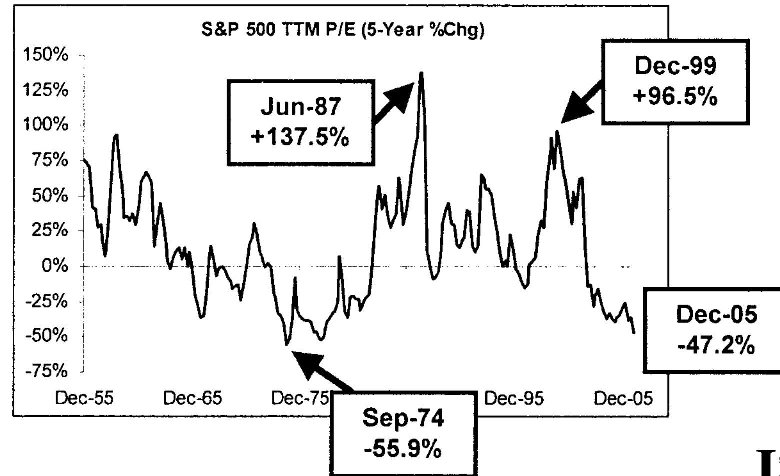
Interest Rates and the Bond Market

Investors have become increasingly obsessed with 1) trying to divine the course of the Fed's interest rate policy (i.e. when will they stop raising the federal funds rate?) and 2) the implications of a yield curve inversion. On the first topic, the last thirteen times the Fed has met, it has elected to increase the federal funds rate by 25 basis points (0.25%). The Fed increased the rate from 1% to 1.25% on June 30, 2004 and from 4% to 4.25% on December 13, 2005. Thirteen times the Fed has released a statement explaining the rationale for increasing the federal funds rate and subsequently released detailed minutes of the meeting. Each time investors have compared statements and the minutes, word-by-word and phrase-by-phrase, to determine if there has been any change in "body language" or tone from the previous meeting. The collective interpretation of an altered, new or missing word or phrase has impacted both the bond and stock markets.

"Fed watching" has reached a fever pitch, as Chairman Alan "The Maestro" Greenspan prepares to end his 18-year term and hand over the reins to Dr. Ben Bernanke. The bond market is widely anticipating a fourteenth 25 basis point increase at Greenspan's final Fed meeting on January 31, 2005. We don't know if there will end up being fourteen, fifteen or sixteen rate increases. We believe the economy will slow, as the cumulative and lagged effects of soaring energy costs, higher interest rates and a cooling housing market impact growth. In turn, this slower growth should enable the Fed to halt or even reverse course. ISI looked at the last seven Fed tightening cycles and found the average S&P 500 performance for the three- and six-month periods leading up to the last Fed tightening was +10.4% and +6.3%, respectively. In sum, we don't feel the need to predict the date the current tightening cycle will end, but believe it will be good for the stock and bond markets, whether it happens 1 month or 6 months from now.

MULTIPLE COMPRESSION AT SECULAR EXTREME

The decline in the S&P's trailing multiple over the last five years has been more severe than at any time since the great bear market of '73-'74. The current decline in multiples has been all the more remarkable given the relative stability and low absolute levels of long-term interest rates. The decline in earnings multiples during a period of relative calm in interest rates over the past few years leads us to believe that P/Es might start to expand as the Fed stops tightening.



ISI Group

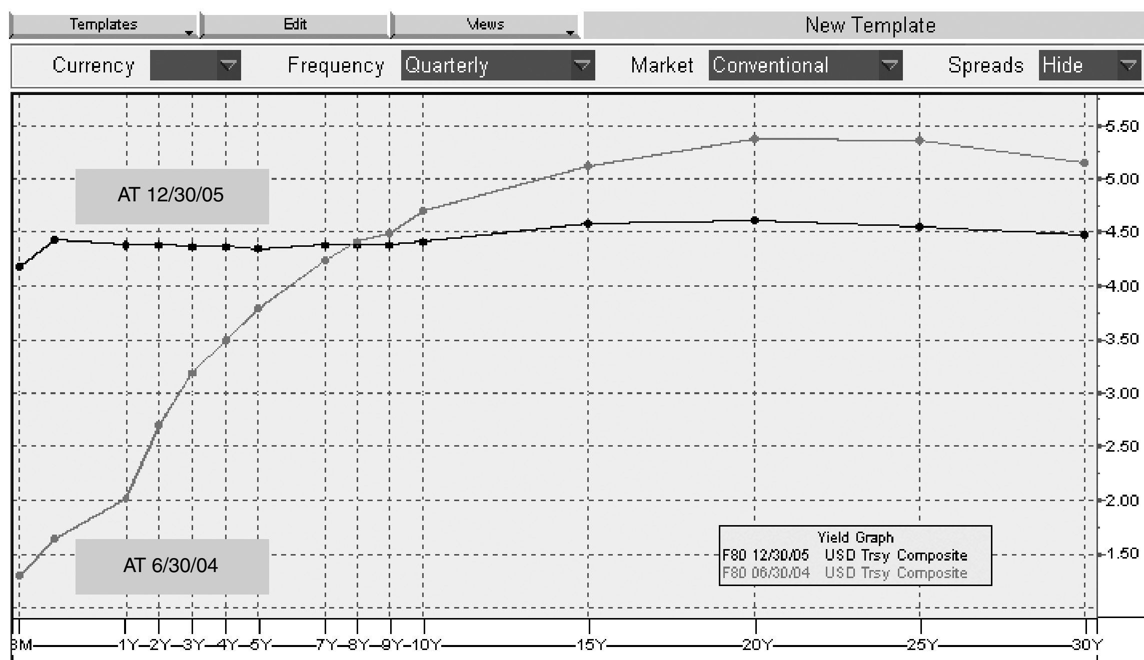
The table on page 4 lists the yields of various maturities of US Treasury securities. If you plot the yield on the vertical axis and the maturity on the horizontal, the result is a graph of the term structure of interest rates, or the "yield curve" at that point in time. Typically, the yield curve slopes up, as investors demand a higher yield for taking on the risk of a longer maturity. The bottom two rows of the table list the difference between the yield of the 10-year Bond and 2-Year Note/3-Month Bill and give you the idea of the slope of the yield curve. For instance, the yield curve at June 30, 2004 (the start of the Fed's current tightening cycle) had a positive slope, with yields increasing from 1.27% for a 3-month maturity to 4.56% going out to 10-years, a differential of 3.29%. As you can see, this differential has shrunk throughout the current tightening cycle to the point where the yield curve is essentially flat (i.e. very little difference between short- and long-term interest rates).

We first discussed this flattening of the yield curve in our July 2005 letter, but the prospect of an ***inverted* yield curve** (i.e. long-term rates are *lower* than short-term rates) has spooked investors. Inverted yield curves are seen as "black cats," reliable indicators of an imminent economic slowdown or recession. The basic line of reasoning is short-rates rise to a level where demand for loans slackens, choking off growth and causing the economy to weaken and rollover, which pushes longer-rates lower. Although "it's different this time" is possibly the most dangerous phrase for investors, there are a number of reasons why we're not losing sleep over the recent inversion. First, as you can see from the chart, the absolute amount of inversion between the 2-Year and 10-Year at the end of 2005 was essentially nil (but enough to cause the markets to stumble). Second, past Fed tightening cycles were aggressive responses to surging inflation. The current cycle has seen a *gradual* lifting of short-rates from an artificially low level (i.e. 1% federal funds) and inflation expectations remain low (which explains low long-rates). Third, there simply aren't many alternatives to U.S. Treasury bonds for foreign investors who need to invest their trade surplus (our deficit).

U.S. Yields (Last trading day of quarter – Bloomberg)

	Q2/2004	Q3/2004	Q4/2004	Q1/2005	Q2/2005	Q3/2005	Q4/2005	Change (Q2/2004-Q4/2005)
30-Year Bond	5.29%	4.89%	4.83%	4.76%	4.19%	4.57%	4.54%	-0.75%
10-Year Bond	4.56%	4.12%	4.22%	4.49%	3.92%	4.33%	4.40%	-0.16%
5-Year Note	3.77%	3.38%	3.61%	4.17%	3.70%	4.19%	4.35%	+0.58%
2-Year Note	2.69%	2.61%	3.07%	3.78%	3.64%	4.17%	4.41%	+1.72%
3-Month Bill	1.27%	1.71%	2.22%	2.78%	3.13%	3.55%	4.08%	+2.81%
Fed Funds Target	1.25%	1.75%	2.25%	2.75%	3.25%	3.75%	4.25%	+3.00%
10YR-2YR	1.87%	1.51%	1.15%	0.71%	0.28%	0.16%	-0.01%	-1.88%
10YR-3MO	3.29%	2.41%	2.00%	1.71%	0.79%	0.78%	0.32%	-2.97%

Yield Graph



Source: Bloomberg

Would you rather lend money to Uncle Sam for 10-years @ 4.4%, Japan @ 1.5%, Germany @ 3.3% or Greece and Italy @ 3.5%?

We increased our commitment to 10-year Treasury bonds during the quarter, as the yield increased to 4.6%, a level we viewed as attractive. Along with term risk (risk of increasing inflation over time) and credit risk (risk the issuer defaults on its contractual payments), there is also reinvestment risk. This is the risk that when the bond you own matures, the rate you are able to reinvest the principal has fallen. Thus, while "rolling" shorter-maturity bonds given a flat yield curve makes sense, we thought this was a good opportunity to lock-in an attractive yield for a longer period of time. On the corporate side, yield spreads versus credit risk-free U.S. Treasury securities remain generally unattractive, particularly as shareholder activists force managements to take actions to increase shareholder value, which almost always *decrease* bondholder value.

Hedge Funds—Caveat Emptor (Let The Buyer Beware)

Hedge funds have become all the rage over the past five to ten years, as their siren song of offering *outsize absolute returns regardless of the overall market's direction* has become captivating music to the ears of many investors, given the devastating bear market at the start of the millennium and recent modest returns in the equity and fixed income markets. It almost sounds too good to be true—oftentimes, it is. In the interest of full disclosure, KM was the general partner of three investment limited partnerships (hedge funds) in the late 1990s, which were subsequently closed after we determined they were not a good fit with our traditional money management business.

Part of the attraction of hedge funds is few people actually know what they are. They generally operate in secrecy and many utilize investment strategies you need to be a Nobel prizewinner to understand. Like moths to a flame, history has shown many investors prefer to invest in things they don't understand. Finally, the best of the hedge fund managers earn annual compensation greater than the gross domestic product of many small countries. Hedge funds have been around since 1949, when Alfred Winslow Jones, a sociologist working on an article for Fortune magazine about trading strategies, started A.W. Jones & Co. with $100,000 in capital. His concept was to buy an asset (long) and hedge the position by selling another (short), trying to lock-in some profit from the expected relative return of the assets, regardless of the overall market's direction. Presumably, his "longs" would make money in an up market and his "shorts" would do likewise in a down market. His short positions acted as protection (or hedge) against a down market and, thus, the first "hedge fund" was born. Jones' true genius was how he decided to implement his concept. He wanted complete freedom to invest as he pleased and freedom from regulatory restrictions/oversight, so structured his fund as a limited partnership. To avoid regulation, the number of limited partners was capped and each was required to attest to qualifying as a "sophisticated investor" (i.e. capable of evaluating risk and fending for ones self without the protections afforded other, less sophisticated investors by the Securities and Exchange Commission (SEC)). In addition, A.W. Jones & Co. was able to employ leverage (i.e. borrow money) to attempt to magnify gains and paid the general partner, Mr. Jones, 20% of any gains.

Fast forwarding to today, the hedge fund universe has exploded. The New York Times recently reported that Hedge Fund Research had tallied at the end of the third quarter of 2005 approximately 6600 hedge funds with capital of $1.1 *trillion*, roughly doubling the number of funds and amount of capital from just five years ago. The vast majority of these funds have adopted the *structure* of Mr. Jones' hedge fund and operate as largely unregulated, leveraged pools of investment capital. Other typical features are limited redemption privileges and a fee structure that calls for the general partner to receive a percentage of the gains *and* a management fee based on assets. Whereas a 1% management fee and 20% of the gain ("1 and 20") was the previous standard, some of the newer mega-funds have had investors beating down the doors to pay 2 and 20 or more. It seems like the shorter track record a manager has and the higher fee he charges, the more investors are attracted. Go figure.

Some hedge funds follow Mr. Jones' long-short *strategy* and truly attempt to hedge, but for many others "hedge fund" is a misnomer. The term now really applies to the structure of the vehicle, not the strategy employed, and there is no better vehicle for creating vast wealth *for the manager/general partner*. Consider a hedge fund with $4 billion in capital at the start of the year, a 2 and 20 fee structure and a 10% gain at the end of the year. The manager/general partner is entitled to an $80 million management fee (2% of $4B in starting capital) and an

$80 million incentive fee (20% of $400 million gain), or a total of $160 million. The limited partners are left with a net gain of 6%, which may or may not be good relative to the overall market, but in most cases won't hold a candle to the compensation received by the manager/general partner.

As has been shown time and time again, wherever there's a huge migration of money, particularly to a largely unregulated sector, the opportunity for a spectacular blow-up leading to total loss of ones investment is always a risk. The roster of alleged hedge fund frauds in 2005 included Bayou Group ($400 million in reported capital), Wood River Partners LP ($265 million), KL Group ($200 million), Groundswell Partners LLC ($43 million) and HMC International ($12.9 million). In addition, many investors seem to have forgotten the travails of Long-Term Capital Management (LTCM) in 1998, whose complete collapse was averted only by the Fed intervening to prevent a feared meltdown of the financial markets. LTCM's Nobel prizewinners created models for a "hedged" strategy which their collective hubris caused them to implement with massive leverage.

In short, the hedge fund universe is like Forrest Gump's proverbial box of chocolates. There are certainly organizations managing hedge funds that have stood the test of time and delivered the Holy Grail of consistent high returns with low risk, but they are the few and not the many. The catch is hedge funds have a limited number of slots for accredited investors and the funds with good long-term records generally reserve those precious available slots (if any) for large, institutional investors willing to lock-up their capital for a long period of time. In other words, unless your name is Bill Gates, an individual is unlikely to get in. Although the SEC is requiring some hedge funds to register and become subject to some level of regulatory oversight, there is an exemption for funds that lock-up their investors for 2-years, which we expect many funds to take advantage of. David Swensen is Yale's Chief Investment Officer and responsible for investing its $14 billion endowment. His success investing in hedge funds and other "alternative investments" over the last two decades made him an investment guru and the envy of institutional investors, particularly as they struggle to meet high investment return hurdles in a period of lower returns. In a recent editorial in The New York Times, Swensen described the current hedge fund frenzy as a "mania" and "typical financial excess" that "began as a reasonable opportunity for sophisticated investors" but had become a "killing ground for naïve trend-followers," with "scandals and frauds prompting predictable calls for increased regulation of hedge funds." Finally, "over-the-top hedge fund fees virtually guarantee subpar results for investors."

KM's strategy of "buying straw hats in the winter" may not make for as interesting cocktail party talk as the multi-variable, market-neutral model utilized by Acme Hedge Fund LP, but we think our long-term record proves that slow and steady wins the race.

Summary

As KM embarks on its second thirty years in business, we're reminded that very few investment management firms see their first thirty year anniversary and feel truly blessed. We thank you so much for the opportunity to manage your precious assets. We're obviously pleased the new year has started with a positive tone and hope for more to come. We wish you and your families a healthy and prosperous 2006!

Regards,

Kirr, Marbach & Company, LLC