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"Every strike brings me closer to the next home run." – Babe Ruth

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Securities and Exchange Commission Form ADV-Part II

Dear Clients:

In spite of a late stumble, the U.S. equity market climbed a "wall of worry" to post a solid start to 2006. The Federal Reserve raised its target for the federal funds rate from 4.25% to 4.50% on January 31, 2006 (outgoing Chairman Alan Greenspan's final meeting) and to 4.75% on March 28, 2006 (incoming Chairman Ben Bernanke's first meeting as head of the Fed's policy-making committee) and indicated "further policy firming may be needed." The Fed's actions and words shifted the entire yield curve upward, though the shape remains flattish. Crude oil futures on the New York Mercantile Exchange (NYMEX) went from $62.70 at the end of 2005 to $69.62 in late January, before closing the first quarter at $66.63. Supplies continue to be tight and Iran remains a wildcard. Finally, some of the extremes in the housing market have started to moderate, as higher interest rates have caused inventories of unsold houses to rise and price appreciation to slow. Recall lenders were eager to enable homeowners to extract "equity" from the ever-increasing market value of their homes, with a reasonable portion of the proceeds spent on consumption.

We stated our expectation in our most recent quarterly letter that 2006 would be a better year for the U.S. equity market. Nothing has happened to make us temper our outlook. We still think the Fed is near the end of the current cycle of rate increases, which should be a positive. We acknowledge the risk factors will be omni-present and cause a bumpy ride, but as we'll discuss later, this has *always* been the case.

The Stock Market

We've mentioned in past quarterly letters that it's been a challenge to find undervalued investment candidates, given valuations across market capitalizations and sectors are fairly homogeneous. However, we also noted we've had some success investing in ***spinoffs***, which occur when a corporation issues stock in a subsidiary to its current shareholders, creating a new public company. Corporations choose to spinoff subsidiaries for a number of reasons. A subsidiary may have poor margins and/or little prospects for growth and/or is causing management to lose focus on the subsidiaries with higher potential. In other words, management may view the subsidiary as no longer being a good fit. Conversely, a subsidiary may be performing so well versus the rest of the corporation that the value of the outstanding performer is not fully reflected in the price of the parent company's stock.

Regardless of the reason, spinoffs tend to do well, both in terms of operating results and stock performance. The spinoff has the undivided attention of its management team, which is now accountable for the results of a stand-alone public company. Similarly, to the extent a spinoff was previously a

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"neglected stepchild" of the parent company, management has the flexibility to access and invest capital as it sees fit. Regarding the stock, spinoffs tend to be relatively smaller operations with smaller market capitalizations. In many cases, institutional shareholders may automatically sell the shares of the spinoff, either because the new public company isn't in the manager's benchmark index or the position is deemed too small to keep and monitor. Additionally, there may be limited or even no Wall Street analyst coverage initially, due to market capitalization constraints or other reasons. This is one of the factors leading the market for spinoffs to be relatively *less* efficient, which gives *us* the opportunity to add value. Bloomberg lists 29 analysts who have formal research coverage of IBM. Our chances of developing or uncovering an original, investable insight is much greater in situations where 0-2 analysts are providing research, versus 29.

Putting it all together, the combination of automatic, reflexive selling by a number of large holders and limited or nil Wall Street "sponsorship," at least initially, has led to good opportunities for KM clients. This is a trend we expect will continue.

Periods ending March 31, 2006
(Total Returns - Cumulative-Bloomberg)

	Russell 3000 Index	S&P 500 Index	NASDAQ
3-months	5.31%	4.21%	6.38%
One-year	14.28%	11.73%	18.03%
Two-years	22.38%	19.18%	18.99%
Three-years	69.11%	61.02%	77.73%
Five-years	29.67%	21.46%	30.60%

It's hard to imagine, but March 10, 2006 marked the *6th anniversary* of the peak of the technology bubble. On that fateful day, NASDAQ closed at 5048.62 and JDS Uniphase Corporation (possibly the "poster child" of the era) at $138.00. They closed the first quarter of 2006 at 2239.79 and $4.17, still down 55.6% and 97.0% from March 10, 2001 levels, respectively. What a difference six years makes!

Interest Rates And The Bond Market

As mentioned at the beginning of this letter, U.S. Government yields were up (and prices down) along the entire maturity spectrum. The Lehman Brothers 7-10 year U.S. Government Index had a total return of -1.79% for the first quarter. Investors should not have been surprised that Mr. Greenspan ended his reign with a rate increase (solidifying his legacy as an inflation-fighter) nor that Dr. Bernanke started his reign with an increase (proving to the markets that the "New Sheriff" was just as tough on inflation as the outgoing one). Further, the Fed has been consistent in its message that future policy would be guided by economic data, which *could* warrant further rate increases. We were a little surprised at the markets' apparent disappointment that the Fed did not explicitly state the current cycle of rate increases was done or nearly-done.

Interest rate increases impact the economy with a lagged effect, which we're beginning to see in housing. The Fed has now increased their targeted federal funds rate by 25 basis points at 15 consecutive meetings. We're not particularly concerned if the 15th, 16th or 17th rate increase ends up being the last, but believe we're close to the end, which will be good for the markets.

We were clearly early in initiating our commitment to 10-year maturity U.S. Treasuries, but the strategy of locking-in what we believe will prove to be an attractive yield is still sound. Spreads on corporate bonds remain very tight and generally provide insufficient compensation for the incremental risk, particularly in

How Value Investors Are Different

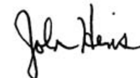
As we listened to the lineup of brilliant speakers at this month's inaugural Value Investing Congress in New York, we were struck by their diversity in style, but similarity in substance. Let us explain…

Some of the speakers invest primarily in small-cap stocks while others stick to large-caps; some invest mostly overseas while others stick to U.S. markets; some run concentrated portfolios, others more diversified; some are activists while others never are; some invest only on the long side, others are long-short, and one (Jim Chanos) only shorts stocks.

But while specific styles may vary, the fundamental characteristics that unite value investors are many. We've come up with an even dozen:

1) We tend to buy what's out of favor rather than what's popular.
2) We focus on intrinsic company value and only buy when we're convinced we have a substantial margin of safety, rather than just trying to guess where the herd will go next.
3) We understand and profit from reversion to the mean rather than projecting the immediate past indefinitely into the future.
4) We understand that beating the market requires having a portfolio that looks quite different from the market and we recognize that truly great investment ideas are rare. So we invest heavily in our handful of best ideas rather than hide behind the "safety" of closet indexing.
5) We are focused on avoiding permanent losses and on absolute returns, rather than on relative returns and outperforming a benchmark.
6) We typically invest with a multiyear time horizon rather than focusing on the month or quarter ahead.
7) We pride ourselves on in-depth and proprietary analysis in search of what Michael Steinhardt calls "variant perceptions," rather than acting on tips or relying on the work of Wall Street analysts.
8) We spend much of our time reading – business publications, annual reports, etc. – rather than watching the ticker or television shows about the market.
9) We focus on analyzing and understanding micro factors such as a company's margins and future growth prospects rather than trying to predict the direction of interest rates, oil prices, the overall economy, etc.
10) We cast a wide net, seeking mispriced securities across industries and types and sizes of companies, rather than accepting artificial "style-box" limitations on market capitalization or other criteria.
11) We make our own decisions and are willing to be held accountable for them rather than seek safety in whatever everyone else is buying or decision-making-by-committee.
12) We admit our mistakes and seek to learn from them, rather than taking credit for successes and attributing failures to bad luck.

None of this is easy, of course. But if it were easy, everyone would be doing it … which would make investing a lot less interesting. VII



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light of the increased level of "shareholder enhancement" activity, which in most cases represents a transfer of wealth from the bondholders to the shareholders. If spreads widen to the point where we think we're receiving adequate compensation, we will consider redeploying some of the assets currently committed to U.S. Government bonds.

Summary

We mentioned in the opening section that there has never been a period when investors didn't have a plethora of risks to worry about. Due solely to our clients, KM celebrated its 30th anniversary last year. When we turned the time machine back to 1975, we found: 1) on February 22, the Watergate principals were sentenced to prison; 2) on April 30, Americans were evacuated as Saigon fell to the communists and 3) in September, President Ford survived not just one, but *two* assassination attempts. Further, the U.S. economy was still reeling from the effects of an oil crisis caused by the Arab oil embargo of 1973-1974 and the Consumer Price Index for December, 1974 showed a 12.3% year-over-year increase. At the end of this trip down memory lane, David Kirr and Terry Marbach turned to each other and said something like, "we must have been crazy starting an investment management business with all this bad stuff going on." The Dow Jones Industrial Average and S&P 500 Index stood at 616.24 and 68.56, respectively, at the start of 1975. They closed March 31, 2006 at 11,109.32 and 1294.83, respectively. Dave and Terry ended up being crazy like foxes and we're all glad they had the faith and courage of their convictions.

In closing, we spend *a lot* of time reading. We find *interesting* pieces in mainstream publications like *Business Week, Fortune* and *Forbes*, but we find value in some of the more esoteric publications. One of the best is *Value Investor Insight* and we thought you'd find "How Value Investors Are Different" (November 30, 2005—reprinted by permission) to be a good primer on how value investors tend to view the world and practice their craft. As always, we thank you so very much for your business.

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 on March 14, 2006. 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