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David Crossman, CFA

"Probable impossibilities are to be preferred to improbable possibilities."
Aristotle (Philosopher)

"Sometimes, even the highly improbable happens."
Nick Maounis (President, Amaranth Advisors LLC)

Dear Clients:

The spectacular, cataclysmic implosion of hedge fund Amaranth Advisors LLC dominated the financial press in September and served as a near-perfect foil for some of the investment "pearls of wisdom" we've shared with you recently. We'll compare and contrast later. As we expected, the U.S. equity market responded positively to the pause in the Fed's tightening cycle after 17 consecutive 25 basis point (0.25%) increases. These increases took the target for federal funds from 1.00% on June 30, 2004 to 5.25% on June 29, 2006. The Fed left its target for federal funds unchanged at its meetings on August 8 and September 20, 2006 and we believe their next move is more likely to be down than up.

Periods ending September 30, 2006
(Total Returns-Cumulative-Bloomberg)

	Russell 3000 Index	S&P 500 Index	NASDAQ
3-months	4.64%	5.67%	4.15%
9-months	8.02%	8.53%	3.02%
One-year	10.22%	10.79%	5.84%
Two-years	26.28%	24.35%	20.85%
Three-years	44.28%	41.57%	28.95%
Five-years	47.48%	40.04%	55.05%

The Stock Market

The Fed's pause, the rapid descent of energy prices in the third quarter and corporate earnings that were on target (i.e. better than the doomsayers were warning) combined to lift the pall surrounding the market. As you know, we had been expecting a halt in the Fed's tightening cycle for some time. We thought this would be positive for the market and, accordingly, client portfolios were fully invested. As it turns out, our call was early and some days the wait became painful. We preach "patience" and "slow and steady" and though that can be tough to practice, we were eventually rewarded.

We expect the environment to remain positive for stocks. As we stated in the opening section, we believe the Fed's tightening cycle has concluded. Chairman Bernanke has stated the housing sector is undergoing a "substantial correction" that will likely cut "a percentage point off growth in the second half of the year" from what it would otherwise have been and "probably something going into next year as well." We don't see inflation as a looming problem. This economic slowdown and benign inflationary outlook should keep the Fed from raising rates and eventually lead to lower rates. We expect corporate earnings to continue growing and even after the recent rally, valuations remain attractive.

One change we have made to client portfolios of note is an increase in our commitment to larger capitalization stocks. Recall during the

late 1990's, large capitalization stocks *far* outperformed medium- and small-capitalization stocks, much to our chagrin. Following the bear market in the early part of this decade, the pendulum swung the other direction. Medium- and small-capitalization stocks soared, while large capitalization stocks lagged. This has led to a more level playing field and we're now finding more attractive investment opportunities in some large-capitalization stocks. Following the strong performance of medium- and small-capitalization stocks, valuations have become relatively more attractive in many large capitalization stocks. We expect the pendulum to reverse course again.

Amaranth Advisors LLC—A Case Study of Hedge Funds and Process vs. Outcome

Our quarterly letter to clients, dated January 9, 2006, included a section titled, **"Hedge Funds—Caveat Emptor (Let the Buyer Beware)."** An excerpt of that section appears below:

> 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.
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> 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.
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> 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.
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> 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.* 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.**

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. 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.

Amaranth Advisors LLC is the general partner for the Amaranth Multi-Strategy Funds, which are operated as private investment limited partnerships, or hedge funds. Amaranth began informing its limited partners in mid-September it had suffered devastating losses in its portfolio that month because "a series of unusual and unpredictable market events caused the Funds' natural gas positions (including spreads) to incur dramatic losses while the markets provided no economically viable means of exiting those positions." Amaranth said their portfolios experienced "roughly $560 million in trading losses on their natural gas positions" *in a single day* (September 14, 2006). Because Amaranth utilized leverage (i.e. borrowed money) in managing the portfolios, these staggering losses triggered both demands from lenders for additional collateral and threats to terminate financing agreements. Thus began Amaranth's death-spiral. Facing an ultimatum from its lenders to get rid of its energy exposure, Amaranth transferred its positions to the *only* third-party willing to take them, while limited partners tried desperately to redeem whatever capital remained. On September 29, 2006, Amaranth informed its limited partners that it 1) estimated a month-to-date loss of 65-70% and year-to-date loss of 55-60%, 2) had "temporarily" suspended redemptions, 3) had not been successful in forming a "strategic alliance" that would enable it to continue operating and, thus 4) had retained a third-party manager to liquidate its remaining positions. Amaranth has not disclosed the *dollar* amounts involved, but Bloomberg News estimated the two main portfolios had a peak value of about $9.5 billion at the end of August. This means ***over $6 billion*** was vaporized during the month of September, even using the possibly heroic assumption that the remaining portfolio positions can be sold at Amaranth's estimate of "market value."

Although the implosion of a multi-billion dollar hedge fund certainly caused jaws to drop and tongues to wag, there are valuable lessons to be learned, many of which we identified in our January 2006 letter. Investors didn't understand what they owned or the risks involved. They were blinded by the light of eye-popping returns and clamored for a piece of the action. Amaranth billed its management style as "multi-strategy," which implies the general partner would employ a wide range of strategies, thereby limiting downside risk should any single strategy fail. It now appears "multi-strategy" can also mean placing massive, leveraged bets in whichever market happens to be hot at the time. Even worse, Amaranth itself clearly didn't understand the risks involved. During a conference call with limited partners on September 22, 2006, Amaranth president Nick Maounis said, "We had not expected that we would be faced with a market that would move so aggressively against our positions without the market offering any ability to liquidate positions economically…We viewed the probability of market movements such as those that took place in September as highly remote…But sometimes, even the highly improbable happens." The Wall Street Journal reported Maounis contended as recently as August 29, 2006 the natural gas bets were designed to have minimal risk and maximum reward. Perhaps hubris got the better of him.

We've argued a sound investment *process* is a vitally important foundation for generating outstanding, *long-term* investment outcomes. Over the short-term, a good outcome does not imply a good process and a bad outcome

does not imply a bad process. Investing is a long-term, probabilistic endeavor. The best long-term performers all emphasize process over outcome. We'd characterize Amaranth's approach as similar to a gambler sitting at a roulette table and betting on "23" with each spin of the wheel. The number 23 hit a couple times in a row and some investors came to believe the gambler/trader must be some sort of roulette savant. They were happy to pay the gambler/trader 2% to place the bet for them and 20% of the payoff if 23 continued to hit. As we know with hindsight, Amaranth enjoyed good outcomes, but had a lousy process. The wizard behind the curtain had no mystical powers, the emperor had no clothes and when "00" finally came up, the result was unmitigated disaster. Although the general partner's partnership interest also suffered, the blow was undoubtedly softened by the management fees and profit splits accumulated in the good times. By contrast, KM's process is to find good businesses selling at attractive prices. We try to construct a diversified portfolio of securities with the following characteristics: financial strength, strong management, good profitability and compelling valuation. Using a baseball analogy, we try to hit singles and doubles and let the "miracle of compound interest" put runs up on the scoreboard. It's not as "exciting" as managing a multi-billion dollar, multi-strategy hedge fund, but that's fine with us. The Amaranth experience should remind investors that if you're in the business of hitting home runs, by definition you're also in the business of striking out. Losing 70% in one month is a real detriment to compounding.

Interest Rates and the Bond Market

We noted in our most recent quarterly letter that we had begun moving out of our shorter-maturity U.S. Treasury securities and locking-in better rates in longer-maturity, higher-quality corporate and U.S. agency securities. Our move proved timely, as the U.S. Treasury market experienced a nice rally in the third quarter. Investors anticipated the Fed's pause, sending the yield on the 10-year U.S. Treasury bond from 5.14% at June 30 to 4.63% at September 30, 2006. We will continue to be opportunistic in deploying our fixed income component.

Summary

We know riding out the market storm was more difficult for you than for us, particularly as it became fairly uncomfortable sailing into the middle of July. We thank you for your patience and continued trust. The pervasive pall seems to have lifted and sunnier skies are currently prevailing. Still, as North Korea's recent announcement of its first nuclear test and the uncertainty surrounding the upcoming mid-term elections attest, rough seas can reappear out of nowhere. Rest assured we have our collective eye on the ball and remain heavily invested alongside you.

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 2006 annual update to each client account with this letter. In addition, given the 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@kirrmar.com).

KM Welcomes David Crossman, CFA

We are pleased to announce Dave Crossman has recently joined our business as a Senior Research Analyst (Equities). Dave formerly held the same position with Reams Asset Management Company and previously worked at J.C. Bradford & Co. and Fidelity Investments. Dave received an MBA degree in Finance from Vanderbilt University and a Bachelor of Arts degree in Economics from Duke University. Welcome aboard!

Regards,

Kirr, Marbach & Company, LLC