

April 12, 2007

Apocalypse Not

THIS ISSUE

"I buy when other people are selling." – J. Paul Getty (*American businessman*)

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DEAR CLIENTS:

Although the major U.S. stock market indices finished the first quarter of 2007 at about the same levels they started, investors had to deal with a great deal of turmoil. U.S. stocks were enjoying a solid, if unspectacular, start to 2007, building on gains from the fourth quarter of 2006. On Tuesday, February 27, 2007 the bottom dropped out, with the Dow Jones Industrial Average (DJIA) and Standard & Poor's 500 Index (S&P 500) falling 416.1 points (3.3%) and 50.3 points (3.5%), respectively. There was plenty of "dry timber" ready to ignite, as investors had become comfortable with the market's low volatility (the DJIA had not suffered a daily 2% decline since May 2003) and inexorable rise since July 2006. The spark actually started on Monday morning, Hong Kong time, when *former* Fed Chairman Greenspan told an audience via satellite that a recession in the U.S. was *possible* in 2007. China's stock market tumbled on Tuesday, with the Shanghai Stock Exchange Composite Index closing down 8.8% ahead of the opening of U.S. markets. The Commerce Department seemed to add credibility to Mr. Greenspan's musings when it announced orders for durable goods

fell sharply in January. Troubles in the "subprime" mortgage industry were accelerating and gaining headline attention and Freddie Mac's announcement that it was tightening its standards on buying mortgages added to investors' angst that the contagion would spread, threatening the economy. Panic was evident and by the end of the week, the S&P 500 had suffered its most broad-based sell-off in 18 years, with 458 of the 500 individual stocks and all ten S&P 500 Sectors declining, even those considered "defensive" (Source: ISI).

The silver lining of all this pain is investors were at least temporarily reacquainted with the Investments 101 concept of risk vs. reward. Stocks offer "excess returns" over bonds and cash *because* equity is a residual and thus subject to a relatively high degree of variability. In other words, to reap the reward of stock ownership, you must endure periods when your stomach and the headlines are telling you to sell. There's no free lunch and the wise investor has both a process to determine when the risk/reward proposition is tilted in his/her favor and the willingness to walk away when it's not. KM's process has been time- and battle-tested over almost 32 years. We evaluate companies as if we're buying the entire

business and look for candidates with good prospects, solid financials and shareholder-oriented management teams. We buy stock when the market is pricing it at a significant discount to our estimation of intrinsic value, the downside risk is reasonable and a catalyst is present to make the stock go higher. Our approach is akin to "buying straw hats in the winter" and has served KM and its clients well.

Periods ending March 31, 2007
(Total Returns-Cumulative-Bloomberg)

	Russell 3000 Index	S&P 500 Index
3-months	1.27%	0.64%
One-year	11.28%	11.83%
Two-years	27.16%	24.92%
Three-years	36.18%	33.27%
Five-years	41.78%	35.48%

THE STOCK MARKET


It's easy to be bearish now, as there is no shortage of negative threads from which you can craft an apocalyptic scenario. Although these are all very real problems that merit our close attention, we remain positive on the outlook for stocks. The overall market remains attractively valued, even after its advance from October 2002 lows. We don't see inflation as a major problem and interest rates are low (and we think eventually heading lower). Corporate earnings will continue to grow, albeit at a slower, more sustainable pace. Finally, stock buybacks and merger & acquisition activity should provide solid support to stock prices.

The buyout boom is gaining even more momentum as "private equity" and hedge funds have benefited from a veritable tsunami of capital from investors

searching for higher returns. Although credit has become marginally more costly, it remains relatively cheap and abundant, giving managers the ability to further leverage these huge pools of capital. These managers do not get paid to hold cash, so announcements of buyout deals have become frequent and size of the target does not appear to be a limiting factor. A recent article in The New York Times stated that nine of the ten largest buyouts in history have been announced in the last year and a half, including the proposed \$45 billion deal for TXU Corp., the \$33 billion acquisition of HCA and proposed \$29 billion acquisition of First Data Corp. Related to the buyout boom, corporations are also awash in cash and many are aggressively repurchasing their shares. With private equity and hedge funds ready to pounce, corporate managers need to keep their stock prices up, lest they become tomorrow's buyout headline. A corporate buyback provides two benefits to investors; an increase in earnings per share for that particular stock and a shrinking supply of shares for the overall market.

THE SUBPRIME MORTGAGE DEBACLE

The subprime mortgage industry has grabbed a lot of front-page headlines since late 2006. Subprime loans are made to borrowers with limited or less than stellar credit histories. To offset the higher credit risk, these borrowers were historically charged higher interest rates than "prime" borrowers. Two important changes took place during the recent boom. First, many lenders required little or no documentation for the loan application or down payment. It may not be much of an exaggeration to say that if you could fog a mirror, the mortgage loan officer/broker could get you approved for a loan. Second, many loans featured low *initial* monthly payments (i.e. subprime ARMs) which made them seem more affordable than they might if interest rates rose. The firm originating the mortgage would receive an origination fee and then sell the loan to



a Wall Street firm (which typically also extended a large line of credit to the originating firm to facilitate its lending), which would package loans and resell them or bonds backed by them to investors, again receiving a fee for their effort. The circle of originating—selling—packaging—reselling was a money making machine and worked terrifically, as long as short-term interest rates remained low *and* real estate values continued to rise. Fast forwarding to the present, the Fed increased its fed funds target from 1% in mid-2004 to 5.25% in mid-2006, sending the yield on the short-term securities (from which the rates on ARMs are calculated) soaring. In addition, real estate values are generally *not* increasing, eliminating the sale of the mortgaged property as a bailout for the troubled borrower. The result has been predictable. Subprime borrowers are caught in the vice of increasing payments and real estate values that are flat or down and have started defaulting in high numbers, leading to foreclosure and loss of the property. Wall Street's clients no longer want the loans or bonds and firms have responded by refusing to purchase additional loans. Many have reduced or eliminated credit lines and, in some cases, forced the originator to repurchase loans previously sold. This has proven to be a death knell for a number of subprime originators.

Politicians are loath to see their constituents losing their homes, so there will be congressional hearings on how this mess occurred and who is to blame (the lenders for "predatory lending practices" and understating the risks or the borrowers for not learning about the risks—both are probably culpable), to be followed by new legislation (though the horse left the barn long ago). What is clear is the rapid, unchecked growth of the subprime mortgage industry could not have occurred without encouragement from the government, either explicit or in the form of lax oversight. Not to pick on *former* Fed Chairman Greenspan, but in a speech on **February 23, 2004** he said, "The ability of lending institutions to manage the risks associated with mortgages

that have high loan-to-value ratios seems to have improved markedly over the past decade, and thus the movement of renters into homeownership is generally to be applauded, even if it causes our measures of debt service of homeowners to rise somewhat." Further, "recent research within the Federal Reserve suggests that many homeowners might have saved tens of thousands of dollars had they held adjustable-rate mortgages rather than fixed-rate mortgages during the past decade, though this would not have been the case, of course, had interest rates trended sharply upward... American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage... the traditional fixed-rate mortgage may be an expensive method of financing a home." Thus, in February 2004 Chairman Greenspan encouraged lenders to make high loan-to-value loans and borrowers to choose adjustable-rate (with the fed funds target at 1%) versus fixed-rate financing. Talk about a conundrum! On **April 8, 2005** he said, "With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers... Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in subprime mortgage lending; indeed, today subprime mortgages account for roughly 10 percent of the number of all mortgages outstanding, up from just 1 or 2 percent in the early 1990s." He clearly didn't foresee the industry he was extolling would start to unravel the very next year.

SUMMARY

Thanks solely to our clients, KM will celebrate its 32nd anniversary in business on May 1, 2007. During this long period we've experienced exactly five years of negative performance (only two of which were double-digit) and numerous instances of market panic and euphoria. We're reminded that it is during times of extreme market stress that we truly "earn our salt." As always, our charge and challenge is to keep our eyes squarely on the goal of generating good *long-term* investment performance. This is easier said than done, particularly when the cacophony is at a crescendo, but we thank you so much for the opportunity.

KM'S FORM ADV-PART II/COMPLIANCE PROGRAM

Securities and Exchange Commission 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 February 8, 2007. 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.

As a registered investment adviser, we are subject to numerous complex rules and regulations. We devote a significant amount of firm resources to our compliance program, both out of regulatory necessity and as a good business practice. Part of our compliance program deals with disaster recovery/business continuity and we have recently contracted with Sun-Gard Availability Services to serve as our back-up site.

Regards,

Kirr, Marbach & Company, LLC
