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THIS ISSUE

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"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it." – Warren Buffet

Dear Clients:

Global capital markets experienced a great deal of tumult during the third calendar quarter. Though we've made numerous arguments over the past several quarters that risk was being priced way too cheaply in the market, we were surprised by the ferocity and depth of the negative impact on financial assets as the pendulum swung the other way. How and why this happened will no doubt be studied and debated intensely over the coming months and possibly years. During times like these it's good to step away from the cacophony and try for some clarity. The reasons are complex and inter-related, but we'll try to break them down into component pieces.

Our challenge is to invest client portfolios for the *long-term* while the headlines scream that financial Armageddon is just around the corner. The bad news is that client portfolios suffered collateral damage during this unwinding of credit and underperformed badly during the quarter.
That we've gone from being "comfortably ahead" of the major market indices at mid-July to meaningfully behind 10 weeks later makes us as unhappy as you. The good news is we don't think this is a permanent condition and remain optimistic that stock prices will be higher 12-18 months from now. We believe the economy remains fundamentally sound and the slowdown that is unfolding is of the mid-cycle variety, not a prelude to a recession. The Federal Reserve and European Central Bank have shown their resolve to aggressively provide as much liquidity as needed to make sure the short-term credit markets continue to function and not harm the broader economy. The Federal Reserve and Chairman Bernanke made strong statements to this effect by cutting the discount rate by 50 basis points on August 17, 2007 and the target for federal funds by 50 basis points on September 18, 2007. We've re-examined our holdings and underlying assumptions and still like what we own. We obviously can't guarantee time will prove us right, but we're patient, long-term investors and have endured many periods of extreme volatility and times when we've underperformed over the past 32 years. None of these were enjoyable at the time, but all proved to be good opportunities to make money. Anybody can steer the boat when the weather is calm. It's when the weather turns nasty that we truly earn our keep. The following principles serve as our "lighthouse" during times like these:

1) **We focus on *process*, not outcome.**
It is perfectly understandable investors focus almost exclusively on performance (outcome), choosing to ignore how performance was generated (process). After all, at the end of the day you can spend performance, but you can't spend process. However, we believe a sound, repeatable investment process is a vitally important foundation for generating outstanding,

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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.

2) **We look at a stock as if we're buying the whole company and believe that if the business does well, the stock will follow.** We want to see financial strength, compelling valuation, effective, ethical and shareholder-oriented management, limited institutional recognition and a catalyst.

3) **We eat our own cooking.** KM employees and our families have significant investments alongside our clients via ownership in the mutual fund we advise. We sit at the same dinner table and our interests are aligned exactly with yours.

Periods ending September 30, 2007
(Total Returns-Cumulative-Bloomberg)

	Russell 3000 Index	S&P 500 Index
3-months	1.55%	2.03%
9-months	8.77%	9.13%
One-year	16.52%	16.44%
Two-years	28.43%	28.98%
Three-years	47.14%	44.78%
Four-years	68.11%	64.83%
Five-years	111.69%	105.01%

Mortgage Securitization— Abused Financial Innovation

Prior to the 1980s, mortgage lenders typically followed the traditional approach of using deposits to fund mortgages and holding those mortgages until maturity. The primary drawbacks to this "**originate and hold**" model of mortgage lending were that the amount of lending was limited by the availability of funds available to lend (i.e. deposits) and the lender was exposed to the risk of the liability/asset mismatch between "borrowing short" (i.e. interest rates paid on deposits essentially float) and "lending long" (i.e. interest rates paid by borrowers are contractually locked for periods up to 30-years). The strength of the originate and hold model was that since the mortgage loan would remain in the lender's portfolio for up to 30-years, it was in the lender's best interest that the *underwriting* process (i.e. the evaluation of the borrower's ability to repay the loan and the underlying collateral) be complete and thorough. In addition, "buy and hold" mortgage lending is done in a highly-regulated environment.

"Securitization" refers to the process whereby large pools of assets (mortgages in this case) are aggregated and securities backed by these pools are sold to investors. The original lender sells the mortgage loan to the aggregator (typically a Wall Street firm or securities division of a large bank), earning a profit and receiving funds to make yet another mortgage loan. Call this the "**originate and distribute**" model. In the case of a collateralized debt obligation, or "CDO," the aggregator structures securities with different risk characteristics, which are backed by the mortgages in the pool and hires one of the three primary credit rating agencies to assign ratings to the various tranches of securities. By design, the lowest-rated tranche has the highest stated return, but absorbs the first loss if one or more of the mortgages in the pool goes bad. In turn, the highest-rated tranche has the lowest stated return because the lower-rated tranches act as "shock absorbers" (i.e. theoretically absorbing all losses from the pool before they impact the higher-rated tranches). The strengths of the originate and distribute model are that 1) mortgage originators have access to huge amounts of capital with which to make loans, which leads to lower interest rates to the borrower, 2) since the originator sells the mortgage, it is no longer subject to the risk of the asset/liability mismatch and 3) the buyers of the CDO's securities are able to choose where on the risk/reward spectrum they want to invest. One of the primary weaknesses of the originate and distribute model is that since the originator knows it will be selling the loan within 30-days, its underwriting process tends to be less rigorous than it would be than if it knew it was going to hold the loan for 30-years. Thus, the CDO buyer is dependent upon the credit rating agency for "protection." The problem is the rating agency is being paid by the *seller* of the CDO to rate and, in some cases, assist with the actual structuring of the securities, creating a conflict of interest and possibly leading to biased appraisals. With a bit of financial alchemy/

sleight-of-hand, CDOs backed by subprime mortgages can sell securities rated AAA, the same super-prime rating as Uncle Sam's. Additionally, whereas pools previously typically consisted of a fairly homogeneous group of mortgages, some recent CDOs are comprised of a hodge-podge of credits, which makes analysis difficult at best. Finally, CDOs operate in an essentially unregulated environment.

Fast forwarding to the present, many of the weaknesses in the originate and distribute model noted above came home to roost, with devastating results. As we know now, defaults in the underlying subprime mortgages have been far higher than expected by both the credit rating agencies and purchasers of CDO securities. The dominoes fell quickly and spread worldwide. CDO buyers disappeared, so Wall Street had no further need to purchase mortgage assets to package and re-sell, severing the lifeline that many mortgage originators counted on to thrive and even to survive (causing many to rapidly and permanently close their doors). CDO holders have found themselves with a toxic mix of illiquid securities of dubious value, angry investors and nervous lenders. The subprime debacle that first appeared at Bear Strearns soon morphed into a contagion that quickly jumped across the globe to BNP Paribas SA in France and IKB Deutsche Industriebank in Germany, to name just two.

Just because securitization is associated with the current credit crisis does not mean it's the root cause and a bad thing. Quite the opposite, securitization has been a key financial innovation that has led to the "democratization of capital" and is unquestionably a "good thing." Unfortunately, when you mix too much brainpower with an insatiable appetite for profit, good things are sometimes taken to illogical extremes. Excessive leverage combined with a witches' brew of poor-quality assets were a lethal combination.

Collision at the Intersection of a Credit Squeeze and a Liquidity Trap

We discussed above how banks "borrow short and lend long," hoping to earn a profit on the spread between the cost of borrowing (i.e. payments made to depositors) and the proceeds from lending (i.e. payments received from borrowers). Investors do essentially the same thing by borrowing liquid funds to invest in longer-term, less liquid assets. This results in a fundamental mismatch between those who have provided the capital (who would like immediate access to that capital) and those who have invested that capital in longer-term assets that may not be able to be turned quickly and/or efficiently into cash. However, as long as the capital providers continue to have faith their capital is not at risk and they have a reasonable expectation of being repaid upon demand, the fundamental mismatch has no impact.

On the other hand, providers of capital can become very nervous when they believe the return of their capital may be problematic. In the current situation, the lack of transparency (i.e. the ability to determine what assets are owned and evaluate their quality) and lack of faith in credit ratings have caused capital providers to view all of their counterparties with suspicion. Because of this, they are both hesitant to make new commitments and more likely to want to unwind current commitments. To use banks as an example, no bank can survive if enough of its depositors want to be repaid at the same time. What was true for the Bailey Bros. Building & Loan in *It's a Wonderful Life* is true for Northern Rock, Britain's fifth-largest mortgage lender, which was bailed-out by the Bank of England as depositors lined up on the sidewalk to remove their deposits. A number of highly-leveraged hedge funds imploded as they were forced by lenders to liquidate positions into a rapidly falling and increasingly illiquid market, regardless of price. Many of the very largest hedge funds are known as "quantitative/ market-neutral." The "quantitative" part refers to the fact a computerized, multi-variable model generates portfolio trades. "Market-neutral" refers to the use of short-positions to hedge against declines in long-positions, meaning the portfolio should do well regardless of whether the overall market is up or down. As it turns out, many of these quantitative/market-neutral hedge funds utilized models that created portfolios that were striking in their similarity. When these funds started reducing their posi-

tions almost simultaneously, selling their longs and covering their shorts, their frantic, massive trading nearly overwhelmed an already skittish market. The impact was stunning, with Goldman Sachs' flagship Global Equities Opportunities Fund losing 30% in one week. As Lehman Brothers analyst Matthew Rothman was quoted by The Wall Street Journal, "Events that models only predicted would happen once in 10,000 years happened every day for three days."

The Fed's Moral Hazard Dilemma

"Moral hazard" refers to the risk that an action that serves to rescue or save someone from their own reckless behavior tends to encourage more of that behavior. In this case, many lenders, borrowers and speculators acted recklessly. Some suffered the consequences of their reckless behavior and went belly-up. We believe this is how it should be and think the Fed feels the same way. However, when the velocity and violence of this process threatened the ability of non-reckless, solvent entities to access capital, the Fed faced a dilemma. On the one hand, providing liquidity and lowering short-term interest rates gives investors the confidence that the Fed won't allow the financial markets and economy to fall into the abyss. On the other, this very act also serves to relieve pressure on the reckless speculators and give them the confidence that the Fed will continue to rescue them from their folly.

As stated in the opening, the Fed did cut the discount rate and then their target for federal funds, both by 50 basis points. We think the Fed will continue to lower their target for federal funds, though it will not be a steady, meeting-by-meeting progression. We suspect they will keep their cards close to the vest as they continue to deal with the moral hazard dilemma, a slowing economy and weaker dollar.

Putting It Together

The process of repricing/reassessing risk is unpleasant, but necessary for the financial markets to continue their function of efficiently allocating and providing capital. We think ***more transparency*** and ***better disclosure*** are vital to enable investors to analyze complex structures. We believe investors have learned that leverage is a double-edged sword and will utilize less of it going forward. Another lesson is models are imperfect and there are certain risks that cannot be hedged, including "black swans" and liquidity. But life will go on in the financial world. Mortgage loans will be made again. Mergers and acquisitions that make sense for *strategic* reasons (vs. those that made sense due only to the availability of copious amounts of cheap financing) will continue. In addition, with the weaker dollar, we expect foreign buyers to become more active. Finally, in the wake of this downdraft, there is now almost $3 *trillion* sitting in money market funds. If the stock market continues to recover, this could set the stage for an *up*draft.

We thank you for the trust and confidence you've placed in us. We're frustrated that some of our stocks have been marked-down based on fear, not fundamentals, but thankful we have the staying power to ride out the storm. As always, we will do our best to block-out the noise and focus on finding good companies trading at a discount to their intrinsic value.

Regards,

Kirr, Marbach & Company, LLC