

January 10, 2008

THIS ISSUE

**"One cool judgment is worth a thousand hasty councils. The thing to do is supply light and not heat." – Woodrow Wilson (American president)**

The Stock Market

DEAR CLIENTS:

There is no sugar-coating that client portfolios had poor performance in 2007, in both absolute and relative terms. The U.S. market's hard tumble out of the starting gate in 2008 hasn't helped matters. We are frustrated that we were right on the money in terms of our assessment that risk was being priced way too cheaply in the market. Unfortunately, we were surprised by the rapid collapse of the global credit markets and the negative impact on many of our portfolio holdings, particularly those in the financial, housing-related and retail sectors. We have significant personal and family assets invested alongside you in the mutual fund we manage and fully understand your disappointment with these short-term results. We continually assess and re-assess each company's prospects and financial strength and have eliminated a small number of positions where our initial investment thesis proved to be overly optimistic. However, our remaining positions generally share the characteristics we demand from stocks in the portfolio; i.e. good business prospects, solid financial strength, shareholder-oriented management and a catalyst. In addition, most are sitting at historically low valuation levels, which we believe sets the stage for great upside potential.

Periods of short-term underperformance are always unpleasant, but we've endured

more than a few while we've created an **outstanding record over 32+ years** and always come back even stronger. We only have to look "way back" to the late 1990s/early 2000s to remember our gut-wrenching underperformance while technology stocks were soaring and subsequent "redemption" as that bubble burst. Studies prove value investing outperforms growth over a long period of time. However, because it involves investing in stocks that are out of favor and it's virtually impossible to tell when sentiment will turn, it is an inescapable truth that value investing is prone to short-term periods of underperformance. Not to be glib, but in order to reap the rich long-term gain from value investing, you must also have the confidence in the process and discipline needed to endure the periodic short-term pain of underperformance.

It's Not Easy  
 Being The Tortoise

Our View of  
 the Current Financial  
 Market Crisis  
 and Outlook

Summary

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

	Russell 3000 Index	S&P 500 Index
3-months	-3.34%	-3.33%
One-year	5.14%	5.49%
Three-years	29.11%	28.13%
Five-years	89.42%	82.78%

## THE STOCK MARKET

We own our performance. Period. As way of explanation, not excuse, much of our underperformance can be attributed to the fact our investment discipline leads us to predominately own value stocks that are below "large-cap" in size. During 2007, particularly the latter half, value underperformed growth and small-cap underperformed large-cap. In addition, we hurt ourselves by staying with some losing positions far too long. The Russell 3000 Index encompasses the 3000 largest market-capitalization U.S. stocks (covering about 98% of total U.S. stock market capitalization) and is one of our primary performance benchmarks. The Russell 3000 Index is comprised of the Russell 1000 Index (top 1000 by market-cap) and Russell 2000 Index (bottom 2000 by market-cap). The Russell 3000, Russell 1000 and Russell 2000 Indexes are also divided into "value" and "growth" components. The table below shows investors with high exposure to smaller-cap/value stocks faced significant headwinds in 2007 as the herd sought "safety" in larger-cap, growth stocks.

### 2007 Total Return

Russell 3000	5.1%
Russell 3000—Growth	11.5%
Russell 3000—Value	-0.9%
Russell 1000	5.7%
Russell 1000—Growth	11.7%
Russell 1000—Value	-0.2%
Russell 2000	-1.6%
Russell 2000—Growth	7.0%
Russell 2000—Value	-9.7%

## IT'S NOT EASY BEING THE TORTOISE (BUT THE POTENTIAL REWARDS ARE GREAT)

As we stated in the opening, during the process of creating an outstanding performance record over 32+ years, we (and our clients) have had to endure a number of short-term periods of underperformance. That we view these periods as an inevitable and necessary part of our value discipline doesn't make them any easier for us

or you to stomach. In addition, this doesn't mean we think our 2007 performance was satisfactory—it wasn't. While our negative return in 2007 was only our sixth in 32+ years, we're nonetheless unhappy about it. Still, we take some comfort in the fact that our experience of strong long-term results and occasional weak short-term results was and is shared by many of the most highly-regarded managers in the business.

We live in a society that values immediate gratification, which is the antithesis of the value approach. Value stocks are typically out-of-favor and "dead in the water." It takes an indeterminate period of time for fundamentals to improve to the point where other investors start to take notice. Psychologically, it's much easier to go with the crowd and just buy what's working. Being a contrarian is difficult because you are constantly going against the crowd and your stocks are bound to remain out-of-favor for periods of time. You may even look like you're foolish and/or don't "get it," as we did in the technology mania of the late 1990s. However, it's precisely because value investing goes against human nature and most investors don't have the patience to wait it out that studies have shown it outperforms growth over the long-term.

Coming during a period of short-term underperformance, it may seem self-serving or like we're making excuses, but we'll highlight two articles published in *Hermes*, the magazine of the Columbia University Business School. The first appeared in the Fall 1984 issue and is an edited transcript of a talk given by Warren Buffet at Columbia in 1984 commemorating the fiftieth anniversary of *Security Analysis*, the seminal book on value investing written by Benjamin Graham and David L. Dodd. We've referenced "The Superinvestors of Graham-and-Doddsville" in prior quarterly letters. Buffet pre-selected a group of managers that had either been taught or inspired by Graham and Dodd and presented their annual and long-term performance records. Each implemented the value investing discipline in a different manner, but their "common intellectual theme" was their search for discrepancies between the value of a business and the price of small pieces of that business in the market. They focused solely on value and price and

their long-term results were spectacular. The second article was a follow-up published in the Spring 1986 issue, "Are Short-Term Performance and Value Investing Mutually Exclusive? The Hare and Tortoise Revisited," by V. Eugene Shahan. Shahan made the following observations about the annual performance records of the seven "Superinvestors" identified by Buffet:

1. None of the seven outperformed their benchmark each year
2. Six of the seven underperformed their benchmark between 28.3% and 42.1% of the years covered (i.e. more than one in four to almost one of two years)
3. Pacific Partners trailed only Buffet in Total Annual Return, yet in its 19-year period had a single stretch of 6 consecutive years of benchmark underperformance, the worst 3-year stretch trailing its benchmark by a whopping cumulative -49.1%.

The relevance of these 20+ year-old articles (which we'll be pleased to provide to you) to the current discussion is the analysis is perfectly consistent with KM's performance record over 32+ years. We'd like to outperform every year and never post a negative return, but that's not the nature of investing, particularly value.


## OUR VIEW OF THE CURRENT FINANCIAL MARKET CRISIS AND OUTLOOK

As you can see in the graph on the insert, the U.S. equity market has had to deal with many crises over the past decades. Some of these were the result of external forces and some were created by investor greed. As each crisis unfolded, it probably seemed like the world was coming to an end and the wisest course of action was to sell everything for whatever price you could get and stuff the proceeds in your mattress. Yet 10 times out of 10, that would have been precisely the *wrong* thing to do as the market eventually recovered and moved higher. Each crisis created an opportunity, but only those with the fortitude to deal with the associated discomfort reaped the benefits. It may be instructive that on April 30, 1975, the front page headline of The New York Times read,

"Minh Surrenders, Viet Cong in Saigon; 1,000 Americans and 5,500 Vietnamese Evacuated By Copter to U.S. Carriers." Below the headline was the famous photo of a long line of evacuees climbing stairs in an attempt to board a helicopter that had landed on the roof of a building. KM opened its doors for business the very next day. David Kirr and Terry Marbach must have been crazy to launch our business at that time, but we're sure glad they did.

A recent piece from Davis Selected Advisers, L.P. put the current crisis in perspective. They said the housing/credit crisis we are experiencing may be different in its particulars but follows the same pattern as many past crises created by investor greed. Further, the pattern can be described in four stages, but can be reduced to an old Spanish proverb, "What wise men do in the beginning, fools do in the end." In the first stage, a previously undiscovered or new asset class generates great returns for early investors. The second stage occurs when mainstream investors recognize the great past performance and start jumping on board. Capital begins to flow into the asset class, usually facilitated by intermediaries charging high fees or commissions. The third stage marks the point where the influx of capital that occurred in the second stage has compressed returns to the point investors (still confident the asset class will grow to the moon) are compelled to increase leverage and/or lower quality standards. In the final stage, the house of cards collapses under the weight of higher leverage and toxic quality as latter-stage investors are forced to unwind positions, en masse, into a falling and increasingly illiquid market.

The fear and loathing related to the current housing/credit crisis will likely persist until there's some clarity as to who owns what toxic asset and what those assets are worth. Multi-billion dollar write-offs have become common and there are surely more to follow. It's understandable that nobody wants to be a hero and step in front of what seems like a runaway train. This crisis wasn't created in a day and neither will it be resolved quickly. It may seem reasonable that the best course of action is to get out of the market until the wished-for clarity arrives, asset prices appear to have bottomed and the environment seems less risky. In our opinion, what may



seem reasonable would be exactly the wrong thing to do because it confuses risk with the *perception* of risk. For investors, the time to be nervous is when there's nothing but blue skies on the horizon. The time to be opportunistic is when there's blood running down the Street and the high-paid talking heads are screaming that the sky is falling. It's tough being a contrarian because these periods of great opportunity are "obvious" only in hindsight, but the market is a prospective, forward-looking mechanism and will start to turn up *long* before the storm clouds disappear.

We think we're being realistic in maintaining our belief that the U.S. economy is experiencing a mid-cycle slowdown. We don't dismiss the possibility of a more severe outcome, but note that if a recession does unfold, it will be perhaps the most widely anticipated one in history. Regardless, the bond and stock markets are telling the Fed in no uncertain terms that it is significantly behind the curve and we think Chairman Bernanke will be compelled to ease aggressively, hopefully sooner rather than later. Finally, we believe the markets are suffering from a lack of confidence, not liquidity. Financial institutions have turned 180 degrees and almost completely lost their appetite for risk, as soured loans have led to pink slips. We expect their appetite to return once this thick fog begins to lift. In addition, there are trillions of dollars sitting in money markets and offshore. We don't think

those holders will be content to earn short-term interest rates indefinitely and expect a portion of these funds to find its way to the stock market. Indeed we've started to see some of this activity with the foreign capital infusions of Merrill Lynch, Citigroup and UBS AG, to name just three.

## SUMMARY

Investing is a long-term, probabilistic endeavor and the best practitioners emphasize process over outcome. While anything can happen in the short-term, we think our solid investment process combined with our positive outlook for the overall market will lead to continued good long-term performance. We are invested right alongside you and share your disappointment with our subpar short-term performance. As always, our challenge is to tune out the noise and focus on the prize of superior long-term performance. We thank you for the trust and confidence you've placed in us and wish you and your families a healthy and prosperous 2008.

Regards,

Kirr, Marbach & Company, LLC

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