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THIS ISSUE

The Stock Market

Summary

"**Patience is bitter, but its fruit is sweet.**" – **Aristotle**

Dear Clients:

The U.S. equity market gained traction as the second quarter began, as hopes increased that the worst of the financial sector meltdown was finally behind us. We were encouraged that the market appeared to have escaped the vice grip of fear, allowing stocks to once again be priced on fundamentals. Indeed, KM client portfolios performed particularly well in this more rational environment and by early June had approached breakeven for the year-to-date period. Unfortunately, the market spun-out during the last weeks of the quarter in a slick of skyrocketing oil prices and concerns that a new wave of massive writedowns threatened the value or even viability of many financial sector companies. The drop has been precipitous and many investors are understandably shell-shocked and panicking. In this suddenly more hostile environment, every doomsday scenario seems plausible. This is particularly problematic for the financial sector, as perception can become reality in the blink of an eye, as no firm can withstand a "run on the bank."

Two primary factors have led to the crisis of confidence that is dominating investors' psyches and actions. First, it seems like every waking moment all of us are bombarded with apocalyptic headlines and sound bites. Opening a newspaper or turning on the television is like entering a house of horrors. The daily cast of characters and details may change, but the underlying message is clear: "Be afraid. Be very afraid." Whether it's General Motors filing for bankruptcy protection, $4/gallon gasoline surely heading to $5-$6/gallon and beyond, house prices way down and heading much lower/foreclosures way up and heading much higher or U.S. stocks "officially" in bear market territory, it's no wonder pain avoidance has become the key motivator. Second, *credibility* is a precious commodity in increasingly short supply. Regulators and company managements have repeatedly assured investors the "decks have been swabbed clean," only to have new waves of bad stuff wash over the railing days or weeks later. The damage to KM client portfolios over the past 12 months has been deeper and longer-lasting than we ever imagined. Similarly, the recovery we have presaged in recent quarterly letters is still very much "on the come." As a result, we understand with perfect clarity that we have spent some of our *own* credibility.

We've endured other excruciating periods over the past 33 years. It's scary and gut-wrenching and the current one always feels like it's the worst. We have to try to block out the hysteria and focus on managing the portfolio by looking through the windshield, not at the rear view mirror. Nobody can tell with any certainty when this all-encompassing pall will lift, but at the risk of sounding like a broken record, we believe some of the primary negatives, while important and very real, have been driven to extreme levels and should reverse at some point. The destruction to equity valuations has been widespread. Our challenge is to separate those stocks for which the downdraft represents a

terrific buying opportunity from those whose intrinsic value may be permanently impaired. We are making these evaluations continually and have been buying the former and selling the latter.

The Stock Market

Periods ending June 30, 2008
(Total Returns-Cumulative-Bloomberg)

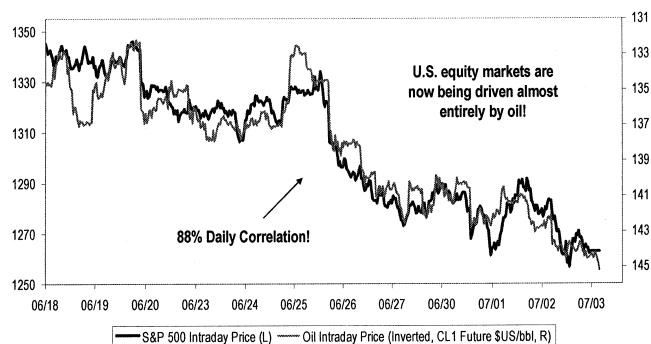
	Russell 3000 Index	S&P 500 Index
3-months	-1.69%	-2.73%
6-months	-11.05%	-11.91%
One-year	-12.69%	-13.12%
Two-years	4.84%	4.76%
Three-years	14.86%	13.79%
Five-years	49.50%	44.08%

Although the U.S. equity market continued to be weak in the second quarter, poor performance was a global phenomenon in the first half of 2008. The table below updates various overseas market returns we cited in our Q1-2008 letter, in local currency.

	Q2-2008	H1-2008
United Kingdom (FTSE 100)	-0.27%	-10.60%
France (CAC 40)	-2.95%	-18.60%
Germany (DAX)	-1.79%	-20.44%
Japan (Nikkei 225)	7.70%	-11.20%
Hong Kong (Hang Seng)	-1.97%	-19.03%
China (Shanghai Composite)	-20.41%	-47.46%

Crude oil has been at the top of investors' minds, as it closed the second quarter at $140/barrel (up about 100% since 6/30/2007 and 46% since 12/31/2007). Oil permeates our daily lives and its price is critically important to our economy and the stock market. As shown in the graph by International Strategy and Investment (ISI), the recent linkage between oil prices and the S&P 500 Index has been extremely tight.

S&P 500 Price Movement… It's All About Oil!



Source: ISI Portfolio Strategy

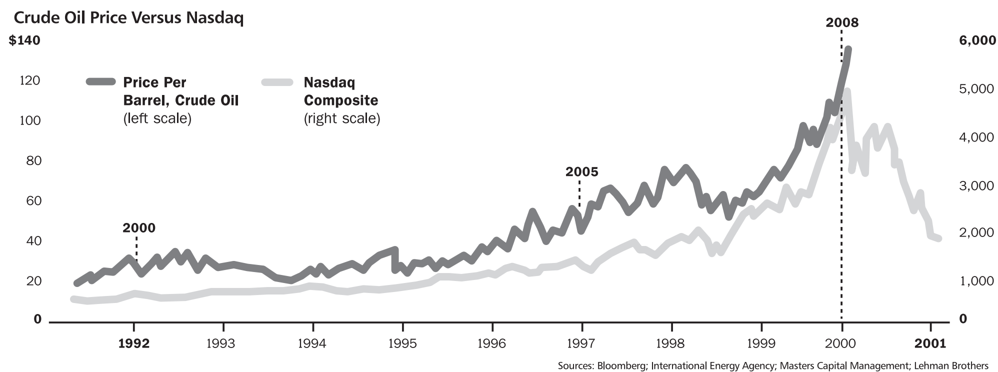
The debate as to the cause of the skyrocketing price of oil and/or whether oil is in a non-sustainable bubble has been raging. "Excessive speculation/market manipulation" has become the easiest, most visible target for politicians. The Economist pointed out that this is what happened in ancient Greece, "when the orator Lysias protested that wheat traders had reduced Athens to a 'state of siege.'" While speculators/asset allocators are likely adding to the upward price pressure at the margin, that explanation seems a little simplistic. Fundamentally, worldwide demand has been increasing at a faster rate than supply, tensions remain high in the Mideast and the U.S. dollar has been weakening. Still, it's hard to explain a 100% price increase in 12-months based solely on the fundamentals. The Economist noted that Daniel Yergin described a "shortage psychology" that causes the price of oil (more so than other commodities) to be impacted not only by current supply and demand, but by *expectations* of future supply and demand. Presumably, a producer expecting supply and demand to remain tight or tighten further will choose to leave the oil in the ground or stored in tankers rather than sell it in the spot or futures markets.

As shown in the Barron's graph on the following page, the price of oil has followed a similar parabolic track to that of the NASDAQ as it approached its peak in early 2000. We don't know if oil has peaked, but it seems that the demand side of the equation is likely to weaken, both domestically and overseas. It makes sense that anecdotal evidence indicates U.S. consumers and businesses are altering their behavior to minimize their use of

oil. Consumers are cutting back on miles driven/switching to more fuel efficient vehicles and airlines are parking planes in the Mojave. Similarly, China has been one of the largest incremental users of oil as its economy has boomed in recent years. However, China has recently begun to roll-back some of its energy subsidies and it seems likely the 50% decline in its stock market so far this year indicates investors are expecting economic growth to slow. Both of these should curb China's demand. We don't know if oil is in a bubble and/or will continue to surge higher, but extensions increasing with Iran, the fundamental case appears to be weakening. If psychology also turns negative, prices should fall. However, until this happens, the economy and stock market will continue to be held hostage by the high price of oil

A Troubling Symmetry

The run-up in oil prices in the past eight years mimics the trajectory of the Nasdaq Composite in the eight years prior to its peak in 2000. Since 2000, the Nasdaq has fallen 50%. Will oil do the same?



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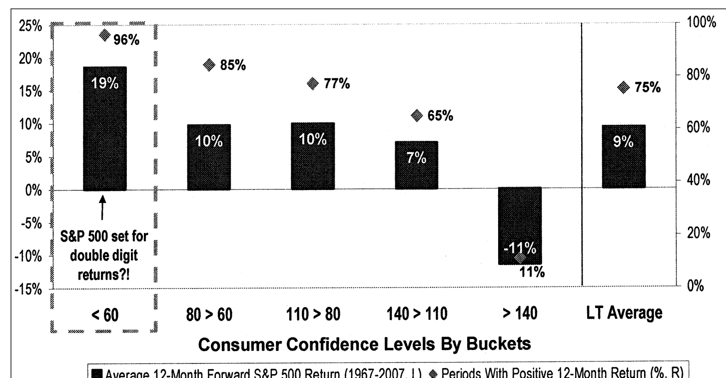
Surging gasoline and food prices, plunging home prices and flat wages have combined to crush consumer confidence. Since the consumer has been the driving force in the U.S. economy for many years, it seems logical that plummeting consumer confidence should be bad news for the stock market. As it turns out, consumer confidence is a good contrary indicator for the stock market, particularly when confidence is at extreme levels. ISI published a report stating that 96% of the time when consumer confidence falls to 60 or below (currently 50, a level reached only 4 times in the past 40 years), the S&P 500 Index has had a positive return over the following 12-months. Furthermore, the average 12-month return was 19%. Conversely, when consumer confidence is 140 or above, the S&P 500 showed subsequent 12-month gains only 11% of the time. They further noted that consumer confidence reached record highs in early 2000, just as the technology bubble was about to pop.

Abysmal Consumer Confidence Readings and What it Means for Equities

Source: ISI Portfolio Strategy



Summary

We are *keenly* aware of the many serious issues facing our economy and financial markets and that their resolution will be painful and come in fits and starts. There have already been false starts/hopes and nobody can say with any certainty when clarity will arrive. What we do know is the stock market is forward-looking and believe the best time to be greedy is when others are fearful and the best time to be fearful is when others are greedy. We don't know where the bottom is, but with history as our guide, attractive valuations and extremely poor sentiment should be a positive combination for stocks. As we've stated many times before, we are invested right alongside you and are disappointed and frustrated, but remain unbowed.

Finally, The Wall Street Journal published "Stop Worrying, and Learn to Love the Bear." We thought it made some interesting and valid points and that you might find it useful and informative.

Regards,

Kirr, Marbach & Company, LLC

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THE INTELLIGENT INVESTOR

by JASON ZWEIG

Stop Worrying, and Learn to Love the Bear

Take It From Graham and Buffet, These Miserable Markets Are A Gift From the Financial Gods

When you bought into the gospel of "stocks for the long run," did you have any idea how long the long run can turn out to be? Exactly 10 years ago, the Standard & Poor's 500-stock Index was at 1164; it closed Friday at 1239. That's an annualized average return of 0.63%. At that rate, it will take you 111 more years to double your money in the stock market.

Meanwhile, this newspaper, and most of Wall Street, has declared that stocks have officially entered a bear market now that the Dow Jones Industrial Average is 20% below its record high of last October. I think that's poppycock. We've been in a bear market for years; the Dow was almost 600 points higher in early 2000 than it is today. What about that 10% yearly return that U.S. stocks supposedly provide with near-certainty? To earn a 10% long-term return, according to Morningstar, you need to have bought at least 19 years ago and held on ever since.

Could things possibly get worse? I don't know, but I am an optimist — so I certainly hope things do get worse. Nothing else should satisfy an intelligent investor.

This May, at the Berkshire Hathaway annual meeting, Warren Buffett boiled down what it means to be an intelligent investor into two startling sentences: "If a stock [I own] goes down 50%, I'd look forward to it. In fact, I would offer you a significant sum of money if you could give me the opportunity for all of my stocks to go down 50% over the next month." Knowing he owns good businesses, Mr. Buffett wants prices to go down, not up, so he can buy even more shares more cheaply before the bounce back.

In the last long bear market, 1969 to 1982, stocks returned just 5.6% annually; after inflation, investors lost more than 2% a year. That mauling by the bear made stocks so inexpensive that over the ensuing 18 years they went up 18.5% a year, enough to turn $10,000 into more than $200,000.

The people who so far this year have yanked $39 billion out of U.S. stock funds, and $6 billion out of exchange-traded stock funds, do not understand this. But if you are still in your saving and investing years, a bear market is a gift from the financial gods — and the longer it lasts, the better off you will be. Instead of running from the bear, you should embrace him.

This new column takes its name from the classic book by Benjamin Graham, who wrote that "the investor's chief problem — and even his worst enemy — is likely to be himself." I hope to help you understand the chaotic markets around you, and the even more treacherous enemy within. For, as Mr. Buffett has also pointed out, investing is much like dieting: It is simple, but not easy. Everyone knows what it takes to lose weight. (Eat less, exercise more.) Nothing could be simpler, but few things are harder in a world full of chocolate cake and Cheetos.

Likewise, investing is simple: Diversify, buy and hold, keep costs low. But simple isn't easy in a market seething with "free" online trades, funds that promise to transform losses into gains, and TV pundits who shriek out trading advice as if their underpants were on fire. The real secret to being, or becoming, an intelligent investor is bolstering your self-control.

So, in these columns, I will seek to combine the wisdom we can glean from Graham with the latest insights from psychology, neuroscience and behavioral economics. The result, I hope, will be practical advice that can increase your odds of reaching your financial goals.

For now, bear this in mind: That which does not kill investors makes them stronger. Physiologists have shown that minuscule doses of poison may actually make organisms (including humans) healthier, a phenomenon called hormesis. I do not recommend seasoning your food with cyanide.

But the findings on hormesis do remind us that painstaking investors — literally, those who can take the pain of a bear market that seems to drop another 1% every day — will ultimately triumph, by patiently amassing greater and greater equity positions at better and better prices. The ancient King Mithridates of Pontus is said to have made himself immune to poison in constant gradual doses, a tale retold by the poet A.E. Housman:

They put arsenic in his meat
And stared aghast to watch him eat;
They poured strychnine in his cup
And shook to see him drink it up....
I tell the tale that I heard told.
Mithridates, he died old.

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