



KIRR, MARBACH & COMPANY, LLC

Investment Managers
www.kirrmar.com

Mark D. Foster, CFA
Darrell H. "Kip" Wright, CFA

Mickey Kim, CFA
Richard H. Hummel, CFA

David M. Kirr, CFA

October 9, 2009

**"Keep your fears to yourself, but share your courage with others."
– Robert Louis Stevenson**

DEAR CLIENTS:

The U.S. equity market's recovery from its March 9, 2009 low continued at a torrid pace in the third quarter of 2009, as global equity and credit markets healed and evidence grew the deep recession is ending or has ended. We are very pleased with back-to-back strong quarters, but realize we still have a deep performance hole to fill. Although we've made tremendous progress filling the hole, the challenges ahead remain formidable. We have all endured tremendous pain in the year since the Lehman Brothers bankruptcy marked the start of the worst stage of the global financial panic.

We do not want to surrender these hard-fought gains. We will remain vigilant and not let the relative recent calm lull us into complacency. Investors' psyches are fragile and they will remain keenly focused on and will react quickly to each economic data point. There will be setbacks and disappointments along the way, but we believe the worst of the economic and financial crisis has passed. We like what we own, remain close to fully-invested and are still constructive on the long-term outlook for U.S. stocks.

Periods ending September 30, 2009 (Total Returns-Cumulative-Bloomberg)

	Russell 3000 Index	S&P 500 Index
3-months	16.31%	15.61%
9-months	21.19%	19.26%
One-year	-6.42%	-6.91%
Two-years	-26.56%	-27.35%
Three-years	-14.43%	-15.42%
Five-years	8.06%	5.17%
Ten-Years	7.53%	-1.53%
Since 3/9/09	61.03%	58.25%

POSITIVES AND RISKS

There has been a "Rodney Dangerfield" aspect to reactions to the market's recovery from the March 9, 2009 low and mounting evidence of economic recovery. Skepticism, doubt and "no respect" remain widespread. Naysayers say the market has come "too far, too fast." They argue its rise is not supported by economic fundamentals, which indicate while the bleeding may have slowed, the patient is far from being on the path to recovery. From a contrarian investor's point of view, this widespread doubt is good. As we stated last quarter, we acknowledge the market has had

a tremendous move off the bottom in a short period of time and *lagging* and *coincident* indicators (like employment) of the *current* economic environment are clearly not rosy. Still, the valuations of the stocks we own remain favorable, as do most of the *leading* indicators of *future* economic activity.

POSITIVES

- Positive earnings surprises have led Wall Street analysts to increase estimates. Analysts had aggressively slashed estimates in an attempt to stay ahead of the curve during the economic free-fall. Concurrently, Corporate America slashed costs "to the bone" during the downdraft. The worst-case economic scenario did not unfold and with the *tremendous operating leverage* created by lower cost structures, corporate earnings have generally been better than expected. With indicators pointing to a better economic environment ahead, we believe top-line revenue growth will lead to further positive earnings surprises and more estimate increases.
- Capital markets continue to thaw as investors' risk appetite has returned, enabling companies to issue stock or bonds to refinance debt or fund growth. Recall last fall, then AAA-rated General Electric was unable to issue commercial paper (very short-maturity debt corporations use to fund daily operations) and was forced to turn to Warren Buffet for financing (@ 10%!). Fast forwarding to the present, The Economist reported there were seven initial public offerings (IPOs) in the U.S. in the last full week of September, the busiest week since December 2007 and more than any *month*, let alone week, since May 2008. Further, American companies sold an estimated \$39 billion in new stock and convertible debt and \$156 billion in bonds in the third quarter, up 57% versus the third quarter of 2008.
- Merger and acquisition activity has resumed. This is an indication that some companies are feeling more confident, their focus having shifted from survival to growth. Further, these companies view acquiring

another company as the quickest way to generate growth in a challenging economic environment. Given the premiums above market price these acquiring companies have been willing to pay, they clearly see great value in the stocks of the target companies. Related to the prior bullet-point, we expect companies will be able to access the capital markets to finance these *strategic* acquisitions. However, we do not expect a return of *purely-financial* acquisitions by "private equity" firms, which were based on access to copious amounts of cheap and not particularly discriminating financing.

- Selling pressure from forced liquidations of equities due to redemptions lifted, but investors remain skeptical and the proceeds have yet to return to the stock market. Equity portfolio managers basically spent the last 3 months of 2008 and first 3 months of 2009 selling stocks to meet massive redemptions driven by investors and/or creditors. Managers were forced to sell whatever they could at whatever price increasingly scarce buyers were willing to pay. A good portion of the redemption proceeds were parked in money market funds, where they earn essentially 0%. Given bonds' outperformance versus stocks for the 10-years ending 2008 and investors' propensity to chase past performance and yield, it was not surprising to see a subsequent stampede from money market funds into bond funds. The combination of this flood of new investor money that needed to be invested along with the fact the worst-case economic/financial scenario did not come to pass led to a massive compression of spreads and great performance for bonds. With U.S. Government yields exceptionally low and spreads having declined so much, we think further gains in the corporate bond market will be much harder to come by. If investor behavior runs true to form, this huge pool of investable capital (about \$3.4 *trillion*) remaining in money market funds and earning 0% along with the significant amount recently invested in bond funds may be attracted to the stock market if it is able to continue climbing the "wall of worry."
-

RISKS

- The unprecedented amount of monetary and fiscal stimulus will lead to huge deficits and possibly higher inflation/interest rates and a weaker dollar. While we don't view these as immediate problems, we understand things can change quickly and will be monitoring them very closely.
 - We think preventing *deflation*, not inflation, should be policymakers' focus. There is a large surplus of industrial and labor capacity worldwide. In addition, inflation-protected bonds are trading at levels that indicate investors do not anticipate dramatically higher inflation. That said, we expect commodity prices to remain volatile and subject to traders' reactions to the latest economic statistic. We note that a number of our portfolio holdings are beneficiaries of higher commodity prices.
 - Given low interest rates, our expectation of a firming economy and higher levels of government and corporate bond supply that will need to be absorbed, we will not be surprised to see interest rates *gradually* move higher. For now, though, the Fed has stated its intention to keep the fed funds rate at essentially 0%. Additionally, the yield on the 10-year U.S. Treasury bond has actually drifted lower—from almost 4% in early June to about 3.3% at the end of the third quarter.
 - The dollar has declined over the past seven months (since the world financial markets bottomed). There are two schools of thought on the reasons for and implications of this decline, one benign and the other negative. The benign explanation, to which we subscribe for now, is investors viewed the dollar as a safe haven during the crisis and bought dollars aggressively. As the panic eased, this trade reversed as investors' focus shifted from capital preservation to capital appreciation. Seeking greater returns in higher-yielding currencies and potentially faster growing economies, they have sold dollars, causing it to fall versus other currencies. The more trouble-

some explanation is investors are concerned enough about huge budget deficits, anemic economic growth and higher inflation they are no longer comfortable holding dollars. With interest rates still low and the stock market marching higher, it appears to us the decline in the dollar is due to a healthy return of risk appetite, not a vote of "no confidence" causing foreign capital to flee. In either case, we've calculated that on a dollar-weighted basis, companies in our portfolio do about 1/3 of their revenue overseas, so a slightly weaker dollar will actually be helpful.

- Although relatively large, well-capitalized companies now have access to generous amounts of credit at attractive rates, the debt securitization market remains moribund and bank lending continues to contract. Many small businesses and consumers are encountering great difficulty getting credit, at any price. Until these important parts of the credit market thaw, improvements in consumption and growth will be difficult to realize.
- We mentioned the threat of protectionist *rhetoric* to globalization, which, on balance, has been good for the worldwide economy. Protectionist sentiment almost always rears its head during economic crises, yet policymakers "know" protectionist measures end up being harmful to the global economy. This is why it is troubling the Obama administration caved to this sentiment and slapped a 35% tariff on Chinese tires. It is difficult to make economic sense of this move on a couple of levels. First, in most cases, we view protectionist measures as bad policy, period. Second, it generally is not a good idea to antagonize a large country on which you have grown dependent for trade and financing of your deficits. We hope this is a "one off" case of poor judgment, but if it is an indication of trade policy going forward, it will be alarming, at best.



SUMMARY

We remain persistent and single-minded in our effort to continue to regain the ground we lost during the crisis. We will likely have to endure bumps and bruises along the way, but we're up to the task. We truly appreciate the trust and confidence you've shown by remaining with us during this extraordinarily difficult period. We are working hard for you each and every day and hope you will be rewarded.

Regards,

Kirr, Marbach & Company, LLC
