



K I R R, M A R B A C H & C O M P A N Y, L L C

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**"History never looks like history when you are living through it."
– John W. Gardner**

DEAR CLIENTS:

The U.S. equity market's powerful recovery from its March 9, 2009 low continued in the fourth quarter of 2009, albeit at a slightly less frantic pace. Global equity and credit markets continued to heal and evidence mounted that the deep recession is ending or has ended. As proponents of "slow and steady wins the race," the financial markets' horrifying plunge (the start of the worst part marked by the Lehman Brothers bankruptcy in September 2008) and subsequent breathtaking recovery proved to be both historic and a most challenging environment in which to invest. We hope to never endure a similar experience, particularly the first part. We are very pleased with three consecutive strong quarters, but realize we still have a deep performance hole to fill. Although we've made tremendous progress filling the hole, the obstacles ahead remain formidable. As we said in our last quarterly letter, we do not want to surrender these hard-fought gains. Further, we will remain vigilant and not let the relative recent calm lull us into complacency. Investors' psyches remain fragile and they will focus on and react quickly to each economic data point. There will undoubtedly be setbacks and disappointments along the way, but we firmly 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 December 31, 2009
(Total Returns-Cumulative-Bloomberg)**

	Russell 3000 Index	S&P 500 Index
3-months	5.90%	6.04%
One-year	28.34%	26.46%
Two-years	-19.54%	-20.31%
Three-years	-15.40%	-15.94%
Five-years	3.88%	2.10%
Ten-Years	-2.02%	-9.10%
Since 3/9/09	70.52%	67.80%

THE STOCK MARKET

As the year came to a close, much was made of the fact that 2009 marked the end of a "lost decade" for U.S. stocks. Indeed, as shown in the table above, the 10-Year cumulative returns for both the Russell 3000 Index and S&P 500 Index were negative. That much is indisputable. Fortunately, it is also indisputable that A) 10-year periods of negative returns for stocks are extremely rare and B) market recoveries following those isolated occasions have typically been strong. During the darkest days of the sell-off, it felt like a daily fight for survival as massive amounts of wealth were vaporized, for many to a life-altering extent. Much psychological damage was done and the repercussions will be felt for years to come. It is most difficult to focus on investing for the long-term when the walls seem to be collapsing around you. Now that

the markets appear to have regained their footing, we thought you might find a longer-range perspective useful and informative. As always, past performance does not guarantee future results, but we think these decades-long historical perspectives provide a good framework for how the next 10 years *might* unfold.

POOR 10-YEAR PERIODS HAVE LED TO STRONG 10-YEAR PERIODS

The Leuthold Group analyzed annual compound total returns (i.e. with dividends reinvested) for 10-year

rolling periods (forty quarters) for the S&P 500 *going back to 1926*. The reading for the 10-year period ending Q4-2009 (-0.9%) was in the third percentile (i.e. *lowest 3%*) and the *tenth lowest* of the 296 observations since 1926. The median 10-year annual compound return during 1926-2009 was 11.0%. As shown in the table below (which we also used in our Q1-2009 update), Leuthold stated that when 10-year returns fall to 1% or less, the following 10-year period had an average total return of 183%, or 10.7% compounded annually. Further, the *worst* following 10-year period had a total return of 101%, or 7.2% compounded annually.

S&P 500 Index Annual Compound Returns (ACR)—10-Year Periods Following Poor 10-Year Periods

Past Ten Years	10 Year ACR	Next Ten Years	Annual Compound Return	Total Return
Q2 1929 to Q2 1939	-3.65	Q2 1939 to Q2 1949	8.62	128.54
Q1 1929 to Q1 1939	-2.79	Q1 1939 to Q1 1949	9.12	139.36
Q3 1929 to Q3 1939	-2.74	Q3 1939 to Q3 1949	7.74	110.79
Q1 1928 to Q1 1938	-2.54	Q1 1938 to Q1 1948	11.76	203.87
Q1 1930 to Q1 1940	-1.42	Q1 1940 to Q1 1950	9.65	151.31
Q2 1930 to Q2 1940	-1.42	Q2 1940 to Q2 1950	12.19	215.88
Q4 1928 to Q4 1938	-0.65	Q4 1938 to Q4 1948	7.21	100.63 ← WORST
Q3 1928 to Q3 1938	-0.10	Q3 1938 to Q3 1948	8.12	118.31
Q3 1930 to Q3 1940	0.18	Q3 1940 to Q3 1950	12.57	226.85
Q4 1927 to Q4 1937	0.20	Q4 1937 to Q4 1947	9.61	150.39
Q4 1929 to Q4 1939	0.23	Q4 1939 to Q4 1949	9.09	138.67
Q2 1928 to Q2 1938	0.44	Q2 1938 to Q2 1948	9.52	148.39
Q3 1964 to Q3 1974	0.49	Q3 1974 to Q3 1984	15.58	325.30 ← BEST
Q1 1931 to Q1 1941	0.71	Q1 1941 to Q1 1951	14.47	286.14
Q4 1964 to Q4 1974	1.24	Q4 1974 to Q4 1984	14.76	296.23
		Average	10.67	182.71

Source: The Leuthold Group 2009

Performance data quoted represents past performance; past performance is no guarantee of future results.

ASSET ALLOCATION – RISK & REWARD

Crandall, Pierce & Company analyzed the impact of altering investment time-frames (1-year (Exhibit A), 3-years (Exhibit B), 5-years (Exhibit C) and 10-years (Exhibit D)) and allocations between Stocks (S&P 500) and Intermediate Treasury Bonds, using monthly returns *going back to 1950*. The tables demonstrate what may seem intuitive: A) the higher your allocation of Stocks, the higher your average return *and* variability of return and B) the longer your investment time frame, the less variability of return *and* possibility of a negative return.

Related to both the Leuthold and Crandall, Pierce studies referenced above, the graph of rolling 10-year annualized returns for the S&P 500 (Exhibit E) clearly illustrates just how extremely poor and how very unusual recent rolling 10-year periods have been. Reversion to the mean is one of the most powerful “universal truths” and we are certainly hoping for some of that in the 2010s!

STRONG RALLY FROM MARCH 9, 2009 LOW – BUT STILL LAGS IN TERMS OF RECAPTURE OF LOSS

Leuthold examined past recoveries from the sixteen bear markets during the 84-year history of S&P 500 returns, in terms of the “recapture rate” of losses. The S&P 500 Index declined 56.4% from its October 9, 2007 peak to its low on March 9, 2009. As of December 31, 2009, the S&P 500 Index had recovered about 49% of the decline. There can be no denying that the subsequent rally has been powerful. However, Leuthold stated that in terms of “recapture rate,” the current rally would actually be the *second weakest* recovery in the history of the S&P 500. We are *not* forecasting that the S&P 500 will achieve anything close to the median recovery of 186% of loss, but *would* argue with those who say the recovery has come “too far, too fast.”

U.S. EQUITIES HAVE SURVIVED MANY CALAMITIES – TIMING THE RECOVERY CAN BE COSTLY TO RETURNS

Crandall, Pierce graphed the Dow Jones Industrial Average from 1896-2009, indicating various historical

milestones (Exhibit F). As you can see, there have been many challenges along the way, some of which undoubtedly seemed insurmountable at the time. Not to minimize the financial and psychological damage inflicted by past bear markets, but the market recovered from every calamity and eventually moved higher.

Related to the above, in a “perfect” investing world, you would be 100% invested at the bottom and 0% invested at the top. It’s human nature for investors to attempt to “time the market” and many try. Few, if any, succeed. We don’t believe it’s possible to time the market on a consistently profitable basis. Further, if your timing is off, by even a little bit, the cost to your returns can be very high. Crandall, Pierce analyzed returns for various multi-year periods, both for the entire period and removing just the *single best* trading day from each calendar year in the period (Exhibit G). As you can see, missing just one day a year had a tremendously negative impact on returns. Indeed, there have been studies that indicate *actual* returns experienced by investors trail various performance benchmarks, often by a substantial amount, because in their quest to avoid the pain of losses by being out of the market during difficult periods, they invariably miss-out on rallies (which can be powerful, as the current one has shown).

THE ECONOMY INTEREST RATES AND THE BOND MARKET

Policymakers worldwide took unprecedented fiscal and monetary actions to resuscitate global financial markets and economies. Investors are rightfully concerned about what will happen as this massive government support is eventually removed. Some worry about the possibility of a “double-dip” recession. Deutsche Bank stated in a recent report that the National Bureau of Economic Research (NBER), the official arbiter of recessions, identified 32 recessions (not including the current downturn) dating back to 1854. Following the end of these 32 recessions, economic activity dropped again within 12-months on only three occasions (1913, 1920 and 1981). The 1981 double-dip was caused by the Fed aggressively increasing rates in order to tame inflation. We acknowledge policymakers walk a thin line, wanting to continue nurturing a fragile recovery, but avoiding

stoking the next inflation or asset bubble. However, we think they will err on the side of keeping their feet on the gas pedal too long. Finally, as the Crandall, Pierce graph of Leading Economic Indicators (Exhibit H) shows, the trend is clearly higher. While investors are currently obsessed with still puny employment figures, employment is a *lagging* indicator that will turn higher *after* the economy does. In sum, we think concerns over a “double-dip” recession are overblown.

Even though U.S. Government bond yields increased from their panic-induced levels at the start of 2009, on a historical basis they remain *extremely* low. The Crandall, Pierce graph (Exhibit I) shows how the yield curve (i.e. yields for various maturities from 3-months to 20-years) at 12/31/09 compares with historical yields looking back 1-, 5-, 10- and 20-years. Short- to intermediate-term yields (i.e. 3-months to 10-years) are very low in the context of the past 5-20 years. It seems likely to us with the economy recovering, the Fed phasing-out its buy program, the probable return of *mild* inflation at some point and huge government funding needs, yields are more likely to move higher than materially lower from their current historically low levels.

Given the stock market’s poor performance over the past decade, money market rates that are essentially 0% and strong corporate/high yield bond fund performance during 2009, it’s not surprising that investors poured money into those funds. It’s also human nature to chase performance. Bond fund managers scrambled to invest this flood of cash, sending prices higher and yields lower. As you can see from the graphs published by Bespoke Investment Group (based on data from Merrill Lynch indices—Exhibit J), corporate bond spreads ended at their lowest levels since November 2007 and high yield spreads ended at their lowest point since June 2008 (and well below the level immediately preceding the Lehman Brothers bankruptcy). Given that spreads have compressed so rapidly and returned to pre-crisis levels, we don’t think it’s likely they can move much lower.

It appears that some combination of poor performance for stocks, the steady drumbeat of Ponzi-schemes/insider trading scandals and anger at hundreds of billions of

dollars of bailouts for “fat cat” Wall Street titans drove many investors to the conclusion that the stock market is a “rigged game” they cannot win. This caused them to flee to the *perceived* safety of bonds. With U.S. Government yields more likely to move higher than materially lower and corporate/high yield spreads having already experienced massive compression, attractive returns (vs. stocks) will be much tougher to come by going forward. Indeed, Dealogic reported that U.S. corporations scrambled to take advantage of low rates and investors’ huge appetite for bonds to issue more than \$1 trillion in investment grade bonds (*double* the 2008 amount) and \$140 billion of high yield bonds (almost *triple* the 2008 amount).

SUMMARY


We feel fortunate to have exited the first decade of the millennium bruised and battered, but still standing. We thank you for sticking with us during this most difficult period. We are energized to face the challenges and opportunities of the new decade and will try each day to repay you for your loyalty and trust.

REGULATORY UPDATE

Kirr, Marbach & Company, LLC (KM) is registered with the U.S. Securities and Exchange Commission (SEC). As a SEC-registered investment adviser, KM is subject to periodic examination by the SEC, which can occur at any time. In the aftermath of the Bernie Madoff scandal, the SEC has determined that it’s a good idea for their examiners to independently verify records provided by registrants (like us). This being the case, it is *possible* during our next examination that the examiners will contact clients to confirm account balances, holdings or other information. We do not know if this will become a standard part of routine examinations, but just wanted to alert clients ahead of time.

Regards,

Kirr, Marbach & Company, LLC



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