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Outlook for 2017/Investment Lessons (Re-) Learned in 2016

January 6, 2017

Dear Clients:

We are pleased to report KM client equity portfolios continued to perform well in the fourth quarter (ending December 31, 2016), posting both strong absolute and relative performance. While our performance for the full year trailed our benchmarks slightly, we made up ***significant*** ground in the second half of the year. We realize we still have a long way to go to make-up our performance shortfall that started in 2014.

Past performance is no guarantee of future results and two consecutive strong quarters do not necessarily mark the start of a new trend, but we're very encouraged as we start 2017. The U.S. economy showed signs of accelerating *ahead of* the election, so we believe the post-election rally has been well-supported by improving fundamentals (as can be seen in Crandall Pierce's Leading Indicators illustration--Exhibit A). In turn, this bodes well for a rebound in corporate earnings, which we believe are the primary driver of stock prices. Additionally, the possibility of lower corporate tax rates, repatriation of cash trapped overseas and a less burdensome regulatory environment could also enhance the profit outlook.

Since the financial crisis, investors have been focused almost exclusively on ***what could go wrong***, even as U.S. stocks more than tripled off of their March 9, 2009 lows. We're not making a prediction, but if investors would instead at least consider ***what could go right***, going forward we could have a pretty good market, even with stocks at record highs.

On the whole, while stock valuations are not as cheap as they were several thousand Dow Jones Industrial Average ("DJIA") points ago, we don't think they are overly expensive, either. Interest rates have risen and the Federal Reserve recently took another step towards normalizing rates. We are years removed from the crisis of 2008, so this move was overdue.

Economist John Maynard Keynes coined the term "animal spirits" to refer to how human psychology and the level of confidence can drive or hamper economic activity. According to Keynes, humans are *not* robots driven solely by probabilistic mathematical outcomes. Corporations have been sitting on growing piles of cash reserves and investors have removed billions from stocks, seeking the perceived "safety" of bonds. We are politically agnostic, but if the animal spirits of capitalism stir and result in even a small shift in motivation from safety to profit, the results *could be* impressive.

The Stock Market

If you like to have your wits scared out of you on stomach-churning roller coasters, you probably loved the stock market in 2016. Stocks tumbled out of the starting gate, with the S&P 500 experiencing a harrowing plunge of 11% between New Year's Day and February 11 (the DJIA closed at 15660, a two-year low), before a subsequent slingshot recovery of 13% to the end of March, finishing the first quarter essentially where it started.

Investors had plenty of reasons to have their confidence shaken in the first quarter, as headlines blared U.S. stocks had their worst start to the year in history. The possibility of an economic hard landing in China and further devaluation of the yuan, oil free-falling 50% and weak manufacturing data led to fears of a global recession.

As usual, this brought market pundits trying to become famous for calling the next crash out of the woodwork. RBS, a major global bank, advised its clients to "sell everything," predicting a "fairly cataclysmic year ahead." The first lesson is be cautious of making predictions and never put them in writing!

Global stock markets were once again rocked towards the end of the second quarter by the results of the June 23 referendum where the majority of voters favored Britain leaving the European Union ("Brexit"). Stocks, in general, performed well ahead of the referendum, as polls indicated the "Bremain" side was slightly ahead.

On Friday, June 24, stocks cratered worldwide. On cue, the talking heads and headlines poured gasoline onto the fire as they blared about "a Lehman Bros.-like contagion worse than 2008," and other dire warnings of impending apocalypse. Best of all, the various Drs. of Doom had all weekend to pile on and further heighten investor anxiety.

Fortunately, the "Brexit" shock proved to be short-lived, as it allowed investors to focus on the biggest show of all, the U.S. presidential election. Most polls gave Hillary Clinton a 70-90% chance of winning. Further, the conventional wisdom was if Donald Trump was able to overcome these unsurmountable odds, the impact on stocks would be devastating.

As we all know, the polls were wrong and while U.S. stock futures plunged precipitously after we went to sleep on election night, stocks reversed course the next day, with the DJIA gaining 257 points on November 9. Stocks rose each day during election week, which was the best for U.S. stocks since 2014. The conundrum was stocks were up on Monday and Tuesday, when Clinton was widely expected to win. However, stocks were also up on Wednesday, Thursday and Friday, after she lost.

The DJIA would go on to surge past 19,000 and get within a whisker of 20,000, with the S&P 500 rallying with a post-election total return of almost 5% through the end of the year.

Periods ending December 31, 2016
(Total Returns-Annualized*)

	Russell 3000 Index	S&P 500 Index
Three-months	4.21%	3.82%
Six-months	8.79%	7.82%
One-year*	12.74%	11.96%
Two-years*	6.43%	6.54%
Three-years*	8.43%	8.87%
Five-years*	14.67%	14.66%
Ten-Years*	7.07%	6.95%

Lessons (Re-) Learned in 2016

1) "Value" and "Growth" tend to move in cycles lasting several years and with relative performance going to extremes, but historically the pendulum eventually reverses course.

First, as stated in our letter dated April 6, 2016, returns from value investing are necessarily "lumpy." By definition, value investors are buying stocks that are out of favor. We can control the price we pay, but have absolutely no control over when other investors will recognize the company's improved prospects and start to favor the stock.

Second, value investing requires patience and a thick skin to withstand the inevitable periods of underperformance. Academic studies have shown time and again "value" investing outperforms "growth," *over long periods of time*. If this is the case, why isn't everybody a value investor? It's human nature. The majority of investors simply aren't wired to have the discipline, patience and fortitude required. In fact, we'd argue the very reason "value" outperforms over the *long-term* is ***because it has short-term periods of underperformance, sometimes severe.***

We said the reasons we expected the performance pendulum to swing back from growth to value were A) growth and value have typically run in cycles (lasting several years) and B) growth had been very much "in style" since the current bull market began (and become expensive).

We presented graphs from Strategas Research Partners showing the outperformance of growth relative to value had reached the point where, historically speaking, the pendulum had started to swing back to value. We noted the last time this occurred was at the height of the bubble in technology/growth stocks in 1999-2000. We argued fundamentals and valuation do eventually matter and when that happened, value investors would be rewarded for their patience. **In other words, we were optimistic value investors would again have their time in the sun, but had no idea when that would happen.**

Again, one quarter does not make a trend, but the Russell 1000 (largest 1000 market capitalization stocks in the Russell 3000 Index) Value Index was up 6.7% vs. 1.0% for the Russell 1000 Growth Index in the fourth quarter, while the Russell 2000 (smallest 2000 market capitalization stocks in the Russell 3000 Index) Value Index was up 14.1% vs. 3.6% for the Russell 2000 Growth Index. We asked Strategas to update the graphs (Exhibit B). As you can see, even though value outperformed growth dramatically, this one quarter is barely a blip, on a trailing 10-year basis. In other words, ***if*** this is the start of a reversal, it ***could*** have a long way to run.

2) A disciplined approach is the key to long-term investment success.

As detailed in The Stock Market section, investors endured a number of panics during 2016, any of which could have frightened you out of stocks. That wrong *short-term* move would have inflicted *long-term* damage to your financial future, as has been the case for the past 121 years (Exhibit C).

The "Brexit Panic" was surely the sequel to the "Oil/Commodity Price Collapse Panic" (earlier 2016), the "China Currency Devaluation Panic " (2015) and the "Greek Default/'Grexit' Panic" (its own series). Actually, the next Panic is always the sequel to all the Panics that preceded it. Panics are scary episodes that evoke your primal "fight or flight" survival instincts. When you're watching the Dow plunge hundreds of points in a matter of minutes, it's easy to believe you're staring into the abyss. We understand because we feel the same visceral fears and emotions.

Exhibit A

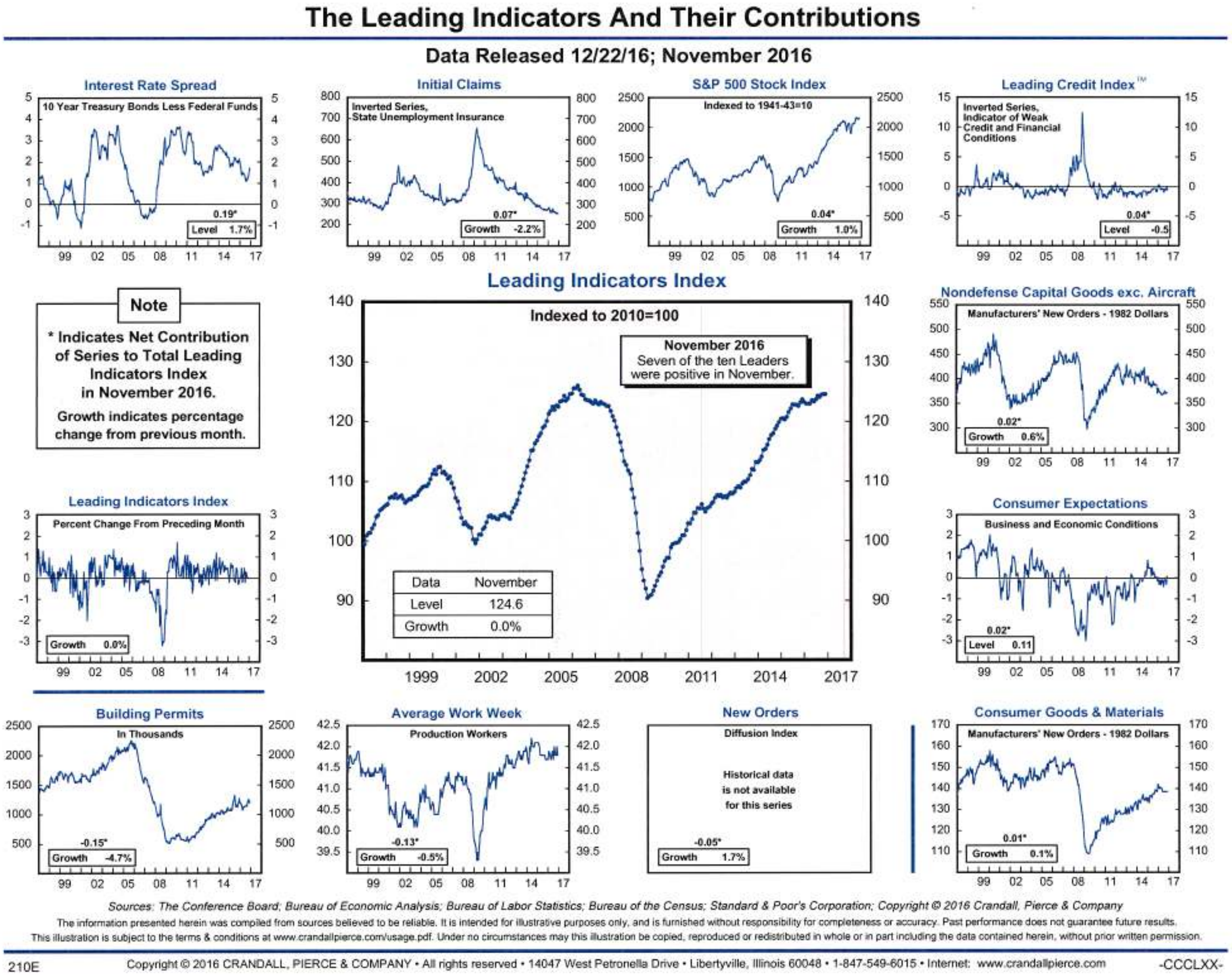

Exhibit B

VALUE INVESTING POISED FOR A REBOUND

Exhibit C

The Dow Jones Industrial Average: 1896-2016

Chronological Perspective - Market Resiliency

Shaded areas represent recessionary periods.

Data Sources: Dow Jones & Company; The Federal Reserve Board; The National Bureau of Economic Research • Copyright © 2017 Crandall, Pierce & Company • All rights reserved.

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At the same time, one of our primary roles as professional advisors is to put our emotions on the shelf and help prevent our clients from doing things harmful to their long-term financial future. In other words, we have to trust our experience and process (i.e. finding high quality companies whose stocks we believe are undervalued), no matter what.

If you can use a period of relative calm to evaluate and get comfortable with your investment plan, it will help you maintain discipline and resolve to hold the course when the next panic hits and the "Chicken Littles" are screaming at you to "do something."

3) Don't base investment decisions on macro forecasts.

The "smart money" was on "Bremain" and Clinton. Further, the conventional wisdom was "Brexit" and Trump would be bad for stocks.

First, it's obvious no one can really predict how events will transpire. Second, even if they could, no one knows what the market's reaction to those events will be. In other words, macro forecasts are a waste of time and energy.

4) Earnings drive stock prices.

According to *The Wall Street Journal*, the S&P 500 gained a paltry 1.9% from the end of 2014 through the first half of 2016. It's no coincidence these weak returns coincided with a five-quarter slump in corporate earnings from the end of the first quarter of 2015 through the end of the second quarter of 2016.

Earnings grew 3.1% in the third quarter of 2016, which was the first positive comparison since the 0.5% growth in the first quarter of 2015. This also coincided with the S&P 500's total return of 7.8% in the second half of 2016.

Again, one or two quarters don't necessarily mark the start of a trend, but we believe the rebound in corporate earnings will continue, which should be positive for stocks.

5) Headlines can be great contrary indicators.

Index funds mindlessly and mechanically seek to mimic the performance of a given index (like the S&P 500), minus fees (which are low, relative to active managers). They have been in vogue and grown assets under "management" tremendously over the past three years (net inflows of $914 billion, according to Morningstar), as the majority of active managers (including KM) have failed to outperform their benchmark index (net outflows of $478 billion over the same period). Further, decades of academic research also suggest it is not possible to consistently outperform.

With active managers struggling and index funds offering low fees, we certainly understand the marketing challenge. Still, we're "old school" stock pickers and think having the objective of underperforming the market by a little bit is the very definition of mediocrity. We reject the notion it's foolish to even try to outperform. We acknowledge the small universe of outperforming active managers who have a proven philosophy, follow a well-defined process and maintain discipline through the ups and downs constitutes a rare breed.

On October 17, 2016 *The Wall Street Journal* published **"The Dying Business of Picking Stocks,"** which argued attempts by active managers to outperform the benchmarks by picking individual were futile and declared passive index investing the winner. This headline could be the distant cousin to the infamous *BusinessWeek* cover of August 13, 1979 **(DJIA 875.26)**, which declared **"The Death of Equities."** As contrarians, we love to see headlines like these, as they typically appear at or near inflection points.

In 2017, we think active management will reassert itself, as it has since the October WSJ article.

6) Don't mix your portfolio with politics.

As the Hartford Funds report by the same name suggested, "As the 2016 presidential election continues to unfold like a circus sideshow, now might be the perfect opportunity for us to stop for a second for a quick sanity check. Making an anxiety-based change today because of your political beliefs is more likely to be harmful than letting this partisan storm pass us by."

Hartford pointed out, "the last time the nation welcomed a new president, many investors decided to pull out of equities in favor of cash. After President Barack Obama was inaugurated in 2009 **(DJIA 7949)**, the market saw 12-year lows and Republicans believed the fallout from the 2008 downturn would continue with his proposed policies. Those who sold their stocks avoided the great economic implosion that followed, right? Wrong. Instead they missed out on a portion of one of the longest-running bull markets we've ever seen. Fleeing from stocks cost these investors as the market has nearly tripled in value from it March 2009 low **(DJIA 6547)** over the next seven years."

Warren Buffett favored Clinton, but said the U.S. is headed in the right direction, and "no presidential candidate or president is going to end it." In other words, investors selling stocks just because they don't like Donald Trump and/or his proposed policies are likely making the same mistake as those who sold because they didn't Obama and/or his proposed policies.

As an aside, we mentioned the S&P 500 has been a good predictor of presidential election outcomes. According to S&P Global Market Intelligence, since 1944 when the S&P 500 rose in price from July 31 through October 31, the incumbent person or party was reelected 82% of the time. Whenever the S&P 500 fell in price during those three months, it signaled the replacement of the incumbent 86% of the time. The S&P 500 ended July at 2173.60 and October at 2126.15, so this indicator called the election correctly.

Interest Rates and the Bond Market

Stronger economic growth and the surprise presidential election result caused the yield on the 10-year US Treasury Bond to surge from around 1.60% to over 2.40% by year-end. Most of the increase was due to the economic rebound that began in the early fall, but more pro-growth policies have given the Federal Reserve comfort in forecasting three additional hikes to short rates in 2017.

Regulatory Update

Kirr, Marbach & Company, LLC (KM) is registered with the U.S. Securities and Exchange Commission ("SEC"), which requires advisers to file Forms ADV-Part 1 and 2A ("Brochure")/2B ("Brochure Supplements") electronically on the Investment Adviser Registration Depository (www.iard.com). Registration of an investment adviser does not imply any level of skill or training. Form ADV-Part 2A is a narrative disclosure of an adviser's business, written in "plain English." The SEC mandated the headings, specific topics to be covered and the order of presentation.

KM files its annual updating amendments to its Form ADVs with the SEC during the first calendar quarter. Our standard practice has been to distribute the annual updating amendment to Form ADV-Part 2A to each client account with the first quarter mailing in April. We filed an amendment to Form ADV-Part 2A on December 19, 2016 with two Material Changes, so are distributing this version now, instead of waiting until April.

First, we are "incubating" a Micro-Cap Value equity strategy. KM currently offers All-Cap and Small-Cap Value equity strategies. The Micro-Cap Value equity strategy will be managed by Colin King, CFA, assisted by Roger Lee, CFA and Collin Foster. The reason we are incubating this new strategy is to give the next generation of KM's portfolio managers experience managing a live, real money portfolio. Additionally, we hope the performance will be good enough to enable us to offer this third equity strategy to clients in the future (i.e. the Micro-Cap Value equity strategy will initially be funded by KM and employees only).

Second, KM has implemented a sliding scale for brokerage commissions, based on the price of the security being purchased or sold, intended to recognize and adjust for the impact a fixed brokerage commission rate can have on the transaction cost of a trade. While the intent of utilizing a sliding scale of brokerage commissions is to even-out transaction costs, on a percentage basis, this also creates an additional conflict of interest between KM and its clients.

Matthew Kirr, KM's Director of Client Service, Named 2016 Five Star Wealth Manager

We are proud to announce Matt was recently informed by Five Star Professional (www.fivestarprofessional.com) he was named a Five Star Wealth Manager for 2016, based on 10 objective eligibility and evaluation criteria related to providing wealth management services to clients. Congratulations, Matt!

Regards,

Kirr, Marbach & Company, LLC

Past performance is not a guarantee of future results.

The Russell 3000 Index is an unmanaged, capitalization-weighted index generally representative of the U.S. stock market. This index cannot be invested in directly.

The Russell 1000 Index is an unmanaged, capitalization-weighted index generally representative of the U.S. market for large-capitalization stocks. It is a subset of the Russell 3000 Index. This index cannot be invested in directly.

The Russell 1000 Growth Index is an unmanaged, capitalization-weighted index that measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. This index cannot be invested in directly.

The Russell 1000 Value Index is an unmanaged, capitalization-weighted index that measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values. This index cannot be invested in directly.

The Russell 2000 Index is an unmanaged, capitalization-weighted index general representative of the U.S. market for small-capitalization stocks. It is a subset of the Russell 3000 Index. This index cannot be invested in directly.

The Russell 2000 Growth Index is an unmanaged, capitalization-weighted index that measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values. This index cannot be invested in directly.

The Russell 2000 Value Index is an unmanaged, capitalization-weighted index that measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. This index cannot be invested in directly.

The S&P 500 Index is an unmanaged, capitalization-weighted index generally representative of the U.S. market for large capitalization stocks. This index cannot be invested in directly.

The Dow Jones Industrial Average ("DJIA") is an unmanaged index comprised of common stocks of thirty major industrial companies. This index cannot be invested in directly.