KIM: 2017 Outlook and Lessons (Re-) Learned in 2016

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The following is an excerpt from Kirr, Marbach & Co.'s fourth quarter client letter, available at www.kirrmar.com.

We're encouraged as we start 2017. The U.S. economy showed signs of accelerating *ahead of* the election, so the post-election rally has been well-supported by improving fundamentals. In turn, this bodes well for a rebound in corporate earnings, which 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.

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. Humans are *not* robots driven solely by probabilistic mathematical outcomes. Corporations and investors have been sitting on growing piles of cash reserves.

We are politically agnostic, but if the animal spirits of capitalism stir and result in a shift in motivation from safety to profit, the results *could be* impressive.

"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.

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 stock's discount to the intrinsic value of the business.

Second, value investing requires patience and a thick skin to withstand the inevitable periods of underperformance. Numerous studies have shown "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.*

One quarter does not make a trend, but the Russell 1000 Value Index was up 6.7% vs. 1.0% for the Russell 1000 Growth Index in the fourth quarter, while the Russell 2000 Value Index was up 14.1% vs. 3.6% for the Russell 2000 Growth Index. ***If*** this is the start of a reversal, it ***could*** have a long way to run.

Don't base investment decisions on macro forecasts, which are a waste of time and energy.

The "smart money" was on "Bremain" (British voters choosing to remain in the European Union) 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.

Earnings drive stock prices. 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.
