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"The biggest big business in America is not steel, automobiles or television. It is the manufacture, refinement and distribution of anxiety."
– Eric Sevareid, American news commentator (1964)

July 3, 2014

Dear Clients:

We are glad the major U.S. stock indices posted respectable returns for the three- and six-months ending June 30, 2014, but are less pleased to report our performance trailed our benchmarks at the mid-year mark. We take some comfort we're not alone. *The Wall Street Journal* reported data from Morningstar indicated more than 74% of actively managed funds investing in ***large***-capitalization U.S. stocks are trailing the S&P 500, the second worst performance in a decade. Our goal is always to generate outstanding ***long-term*** performance, but understand the path to achieving that will be bumpy and periods of underperformance are inevitable.

The bottom line is we think the economy and stocks are on firmer fundamental ground than many investors think. Further, though we expect returns for the full year to be decent, history suggests there is a high probability stocks will encounter turbulence in the second half. As we've said often, during times of anxiety and turmoil, it will be critically important to stay focused on our process for generating outstanding long-term returns and not become whip-sawed by weak short-term *outcomes*. That will never change.

Periods ending June 30, 2014
(Total Returns-Annualized*)

	Russell 3000 Index	S&P 500 Index
3-months	4.87%	5.23%
6-months	6.94%	7.14%
One-year*	25.22%	24.61%
Two-years*	23.33%	22.59%
Three-years*	16.46%	16.58%
Five-years*	19.33%	18.83%
Ten-years*	8.23%	7.78%

Commentary

As stated above, 2014 has been very difficult for "active managers," those who try to outperform their benchmark index by constructing portfolios differing from the index. Active managers deviate from their benchmark index by using differing stocks and/or weightings vs. the index. By contrast, "index funds" attempt to mirror the performance of a benchmark index by investing in the same stocks and with exactly the same weightings as in the index itself. Indexing is a totally mechanical process, with the goal of underperforming the benchmark by the amount of the fund's expenses.

One of the primary reasons active managers have struggled this year is the wide divergence in performance between the largest-capitalization and smaller-capitalization stocks. Our primary performance benchmark is the Russell 3000 Index, a capitalization-weighted index comprised of the 3000 largest-capitalization U.S. stocks (representing about 98% of the investible U.S. equity market). The Russell 3000 Index can be divided into the Russell 1000 Index (largest 1000) and Russell 2000 Index (smallest 2000). Because the Russell 3000 is capitalization-weighted, the performance of the stocks in the Russell 1000 have a *significantly* greater impact on the performance of the Russell 3000 than the performance of the stocks in the Russell 2000. In fact, the Russell 1000 comprises 92% of the weight of the Russell 3000, while the Russell 2000 comprises only 8%.

Looking at year-to-date performance as of June 30, 2014, the Russell 3000 was +6.9%, with components Russell 1000 +7.3%

and Russell 2000 +3.2%. Wall Street research firm Strategas Research Partners LLC ("Strategas") examined YTD returns as of 6/30/14 for the Russell 3000 by market-capitalization quintile. As you can see, performance dropped-off dramatically after the top two quintiles and virtually evaporated by the smallest quintile. Thus, active managers like KM that have significant representation in their portfolios outside of the largest 1000 stocks sailed into some stiff performance headwinds in the first half of 2014.

Russell 3000 Index Quintile Returns

Size quintile	YTD Returns (as of 6/30/14)
Largest (1)	7.45%
Larger (2)	8.16%
Middle (3)	4.66%
Smaller (4)	2.23%
Smallest (5)	1.16%

Source: Strategas Resarch Partners LLC

When investors are confident about the economy, smaller-capitalization stocks tend to thrive. However, when investors become worried, this tends to reverse. We believe investors became nervous about the strength of the U.S. economy, causing smaller-capitalization stocks to struggle. We think much of the weakness in economic activity in early 2014 was caused by the brutal winter and expect conditions to strengthen. If that happens, we believe this will lift investor confidence and smaller-cap performance.

Going back to the differences between active management and index funds, indexing is supported by the fact the majority of active managers fail to outperform their benchmark index. Further, decades of academic research also suggest it is not possible to *consistently* outperform. The upshot is Morningstar reports indexed mutual funds and ETFs account for a staggering $1.9 *trillion* of assets, 36% of the total invested in U.S. stock funds.

We're "old school" investment managers 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.

Ironically, index fund colossus Vanguard published a report, "The bumpy road to outperformance," that does an excellent job discussing both the promise and challenges of active management. Vanguard tracked the performance of all 1,540 actively managed U.S. stock funds at the start of 1998 through 2012. Only 55% survived the entire 15-year period. Only 275 funds (18%) both survived the full period and outperformed their benchmark index. These 275 funds outperformed by an average of 1.1% annualized (net of fees). Compounded over 15 years, this seemingly small performance differential translates into a *huge* dollar impact. A hypothetical $10,000 investment in the median outperforming fund and its corresponding benchmark index would have grown over 15 years to $24,900 and $19,490, respectively.

Shareholders of the vast majority of outperforming funds had their confidence tested numerous times during the 15 years. 97% of the outperforming funds experienced at least *five calendar years* of underperformance. More than 60% had seven or more bad years. Two-thirds experienced at least *three consecutive years* of underperformance, the point at which many investors will throw in the towel. Standardized fund performance reporting displays a single, average annualized return for 1-year, 3-year, 5-year, 10-year and Since Inception periods. For multiyear periods, this can mask what can be extended periods of underperformance.

Investors don't have to follow the herd and settle for the mediocrity of indexing. However, they have to both find a skillful active manager and have the fortitude stick with the manager during those inevitable periods of underperformance.

Investors have been conditioned to attach special significance to stock market milestones, like the Dow Jones Industrial Average (DJIA) reaching 17,000 (vs. 6547 at the bottom on March 9, 2009). As a result, we're frequently asked whether the DJIA at 17,000 means stocks will continue to move higher, or if they're in for a painful fall. Unfortunately, we can't (nor can anybody else) say for sure whether the DJIA's next 1000 point milestone will be 18,000 or 16,000.

However, we think there are a number of positives for stocks. The Leading Economic Indicators (LEI—See Exhibit A) point to an economy gaining momentum, recovering from a weak first quarter of 2014 caused in large part by the brutal winter. Short-term interest rates remain close to 0% and longer-term rates have defied expectations of an increase caused by the Fed's "tapering." Indeed, the yield on the 10-year U.S. Treasury Bond actually *dropped* from about 3.0% at the end of 2013 to 2.5% at the end of June. Credit spreads continue to shrink, boosting bond performance, but posing a significant challenge to find situations where we are being adequately compensated for risk.

Contrary to popular misperception, the federal deficit is shrinking rapidly (See Exhibit B). We think the overall stock market is fairly-valued, even after the surge off of the bottom. Further, investor sentiment is far from ebullient.

This is *not* to say we see smooth sailing ahead. The stock market can encounter severe turbulence at any time and for any reason.

That said, we believe in Warren Buffett's advice to "be fearful when others are greedy and greedy when others are fearful."

Investors are certainly behaving as if they're fearful. The S&P 500 returned about 16% in 2012 and 32% in 2013. Yet according to an article published on June 9 by *The New York Times*, a new study by asset manager/custodian behemoth State Street's Center for Applied Research showed U.S. retail investor cash allocations increasing from 26% to 36% between 2012 and 2014. Thus, contrary to what you might expect, investors are actually jumping *off* the bandwagon as stocks reach new highs.

Interestingly, the jump was the same for "Millennials," those under 33 and just starting their investing lives and having the longest time horizons, as for "Baby Boomers," those 49-67 and starting to liquidate investments for retirement and having far shorter time horizons. State Street said, "The crisis of 2008 is burned into their memories." Further, "when you find consensus across age cohorts, you realize it's not for liquidity needs but lack of trust across all age and wealth levels."

This phenomenon can also be seen in U.S. stock mutual fund flows. According to data from the Investment Company Institute, investors sold a net $159 billion of U.S. stock funds in 2012. Flows turned slightly positive in 2013, with net purchases of $18 billion. However, since stocks began their run of new record highs in late April, investors have been net sellers of U.S. stock funds *every* week, to the tune of $19.7 billion from the week ending April 30 to the week ending June 25.

Regarding sentiment, legendary investor Sir John Templeton said, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." We think investors are still behaving as if they remain skeptical, which should be a positive for stocks.

Seasonal tendencies of stock prices make for interesting conversation. Pundits offer the brilliant advice of "Sell in May and Go Away," which means liquidate your portfolio to avoid a summer/fall swoon. Heeding this, you must be completely reinvested in time to catch the "Santa Claus Rally," the market's post-Christmas gift to investors.

A more persistent seasonal anomaly is the "Presidential Cycle," a pattern of performance coinciding with various years of a presidency. In particular, Year 2 of a presidency is a Mid-term Election Year ("MTEY"), with Congressional elections held in November. Historically, stock prices have been weaker in MTEYs than in Years 1, 3 or 4 of a Presidential Cycle.

We are at the halfway point of 2014, a MTEY, so it's instructive to review past performance in similar years. While past performance is no guarantee of future results, studying historical patterns may give clues as to what to expect in the weeks and months ahead.

Sam Stovall, Chief Equity Strategist of S&P Capital IQ, examined monthly price changes for the S&P 500 Index since 1945. He found the S&P 500 recorded the worst 6-month stretch of the entire 16-quarter Presidential Cycle during the second and third quarter of the MTEY, with average declines of 2.5% and 0.3%, respectively. According to Stovall, the MTEY effect was even more pronounced for small-capitalization stocks. Since 1978, the Russell 2000 Index declined 3.5% and 6.6% during the second and third quarters of MTEYs, respectively. Fortunately, the two worst quarters of the Presidential Cycle were followed by the three best.

Jason DeSena Trennert, CEO of Strategas, examined the S&P 500's performance during MTEYs in a different light. As shown in Exhibit C, the S&P 500 experienced a swoon in 100% of the 13 MTEYs starting in 1962, with maximum, minimum and average peak-to-trough declines of 38%, 8% and 19%, respectively. On a brighter note, Trennert looked at the S&P 500 one-year from the trough and found it was higher 100% of the time. The lowest bounce was 12%, the highest 58% and average 32%.

The S&P 500 has avoided a 10% correction in this MTEY. History suggests investors could be in for rougher sailing in the months ahead. We won't be surprised nor discouraged.

Summary

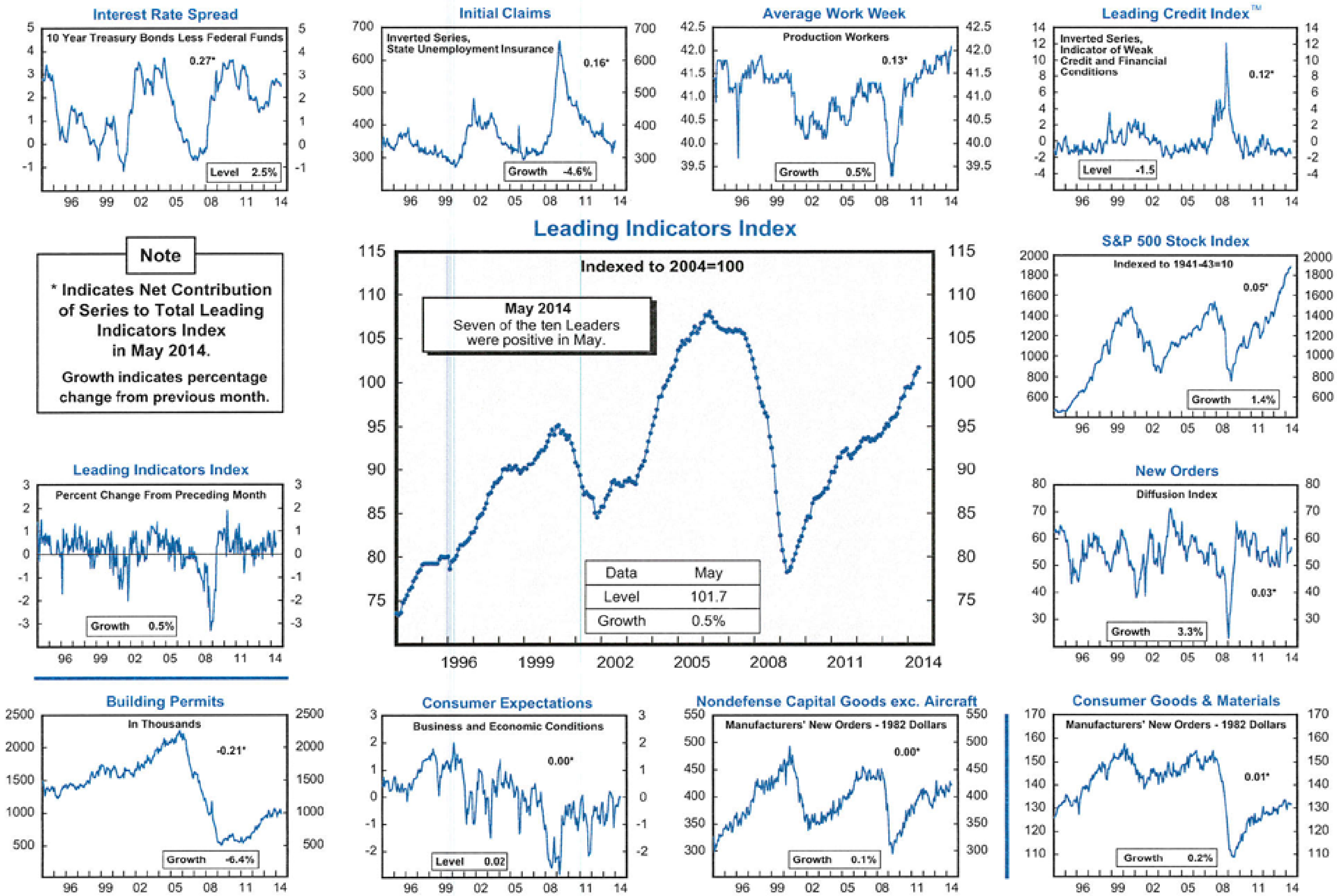
Even though periods of underperformance are inevitable for active managers, we're not happy to be trailing our benchmarks at the halfway point of 2014. Still, we've been here many times before and see reason for optimism. We'll work hard to make-up lost ground. We're invested alongside you and you can rest assured we'll continue to manage your precious assets with the same care as we invest our own.

Have a great summer and we'll be back to you in October.

Regards,
Kirr, Marbach & Company, LLC

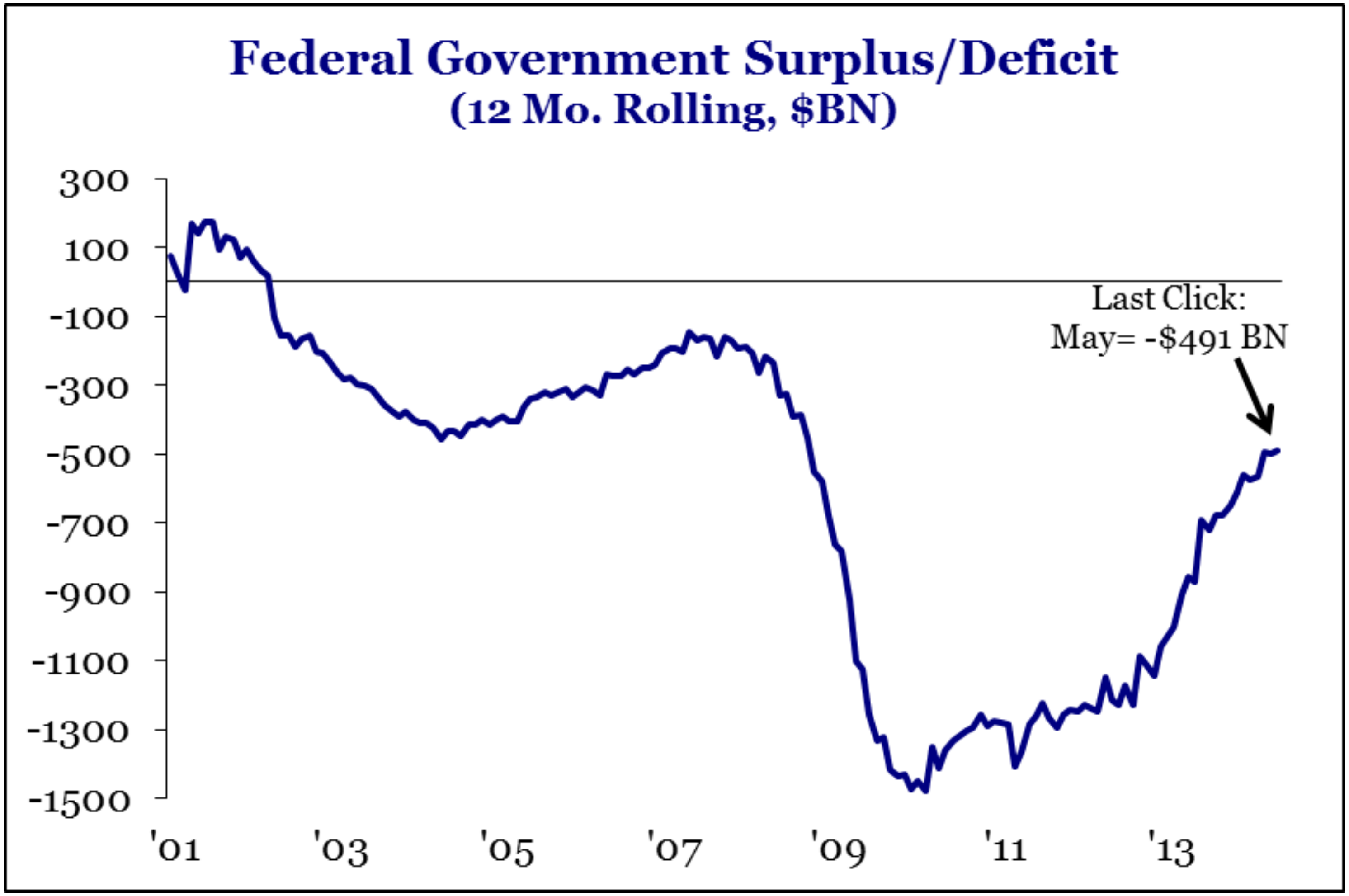
Exhibit A

Data Released 6/19/14; May 2014



Sources: The Conference Board; Bureau of Economic Analysis; Bureau of Labor Statistics; Bureau of the Census; Standard & Poor's Corporation; Copyright © 2014 Crandall, Pierce & Company

Exhibit B

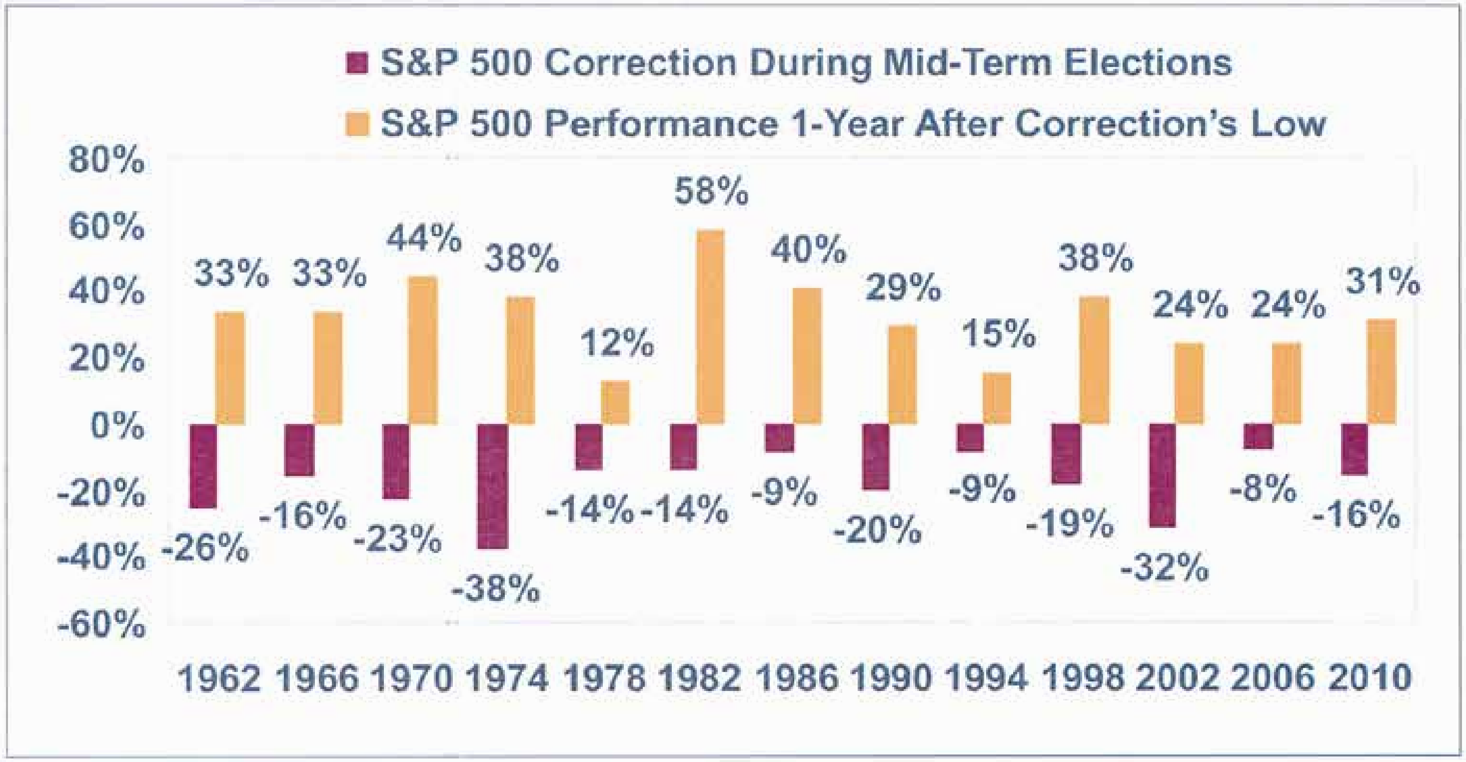


Source: U.S. Treasury and Strategas Research Partners, LLC

Exhibit C

Long history of mid-term election year swoons

Subsequent rallies have quickly erased losses



- -19% = average S&P 500 correction during mid-term elections
- +32% = average S&P 500 performance 1-year after correction's low

Source: Strategas Research Partners LLC and Charles Schwab & Co.