Kirr, Marbach & Company, LLC
Registered Investment Adviser

Mark D. Foster, CFA
Darrell H. "Kip" Wright, CFA
David M. Kirr, CFA
Mickey Kim, CFA
Matthew D. Kirr

Continue to Focus on the "Signal," Ignore the "Noise"

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Dear Clients:

We are pleased to report KM client equity portfolios performed well on an absolute basis and relative to benchmarks in the fourth quarter (ending December 31, 2017) and posted strong absolute returns for the year. We continued to swim upstream, with large-capitalization stocks (Russell 1000) outperforming small-capitalization stocks (Russell 2000) three out of four quarters (and by 7.04% for 2017) and Growth stocks outperforming Value all four quarters (by a whopping 14.33% to 16.55% for 2017--see tables on Page 2). Still, even with this unfavorable backdrop, the gains (in percentage and dollar terms) generated in client equity portfolios far exceeded what we could have reasonably hoped for at the beginning of the year.

We focus on the "micro" of picking undervalued stocks, so don't make "macro" predictions on what the stock market is likely to do over the next year (as this is unknowable, regardless of the confidence expressed by various market mavens and soothsayers).

Still, here's what we had to say last January:

"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. 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."

Fast forwarding twelve months, investors who were able to focus on the "signal" of improving fundamentals (i.e. synchronized growth of U.S. and global economies, strong earnings growth and still low inflation) and ignore the "noise" of the fire and fury emanating from Washington, North Korea and seemingly everywhere else were amply rewarded with a steadily rising and uncommonly tranquil stock market.

For the year ahead, we think investors would be wise to continue to focus on the ***signal*** of strengthening fundamentals (earnings improvement driven by a lower corporate tax rate and business confidence/investment/"animal spirits" spurred by lower taxes and a pro-business regulatory environment) and ignore the ***noise*** (there will be plenty). Also, while we think the fundamental backdrop is supportive of higher stock prices and realize the talking heads are breathlessly excited about the Dow Jones Industrial Average (DJIA) powering through the 25,000 milestone in early 2018, it makes sense for investors to temper expectations of the stock market duplicating its strong performance and extraordinary calm of 2017.

Periods ending December 31, 2017
(Total Returns-Annualized*)

	Russell 3000 Index	S&P 500 Index
Three-months	6.34%	6.64%
One-year*	21.13%	21.83%
Two-years*	16.86%	16.79%
Three-years*	11.12%	11.41%
Five-years*	15.58%	15.79%
Ten-Years*	8.60%	8.50%

We again "deconstructed" the returns of our benchmark Russell 3000 Index to provide an illustrative look under the surface for 2017. A stock's market capitalization is simply the price multiplied by the number of shares outstanding. Recall the Russell 3000 is a capitalization-weighted index (which means the performance of the largest capitalization stocks impacts the performance of the index itself more than the performance of the smallest capitalization stocks) comprising about 98% of the total market capitalization of the U.S. stock market. The Russell 1000 Index is comprised of the largest 1000 market capitalization stocks in the Russell 3000 (comprising 91% of the market capitalization of the Russell 3000). The Russell 2000 Index is comprised of the 2000 smallest market capitalization stocks in the Russell 3000 (comprising the remaining 9% of the market capitalization of the Russell 3000). The Russell 3000, Russell 1000 and Russell 2000 can be further broken down into "Growth" and "Value" components.

As you can see from the table below, ***large-capitalization stocks outperformed small-capitalization stocks by 7.04% in 2017.***

	Russell 3000 Index	Russell 1000 Index	Russell 2000 Index	Performance Gap (R1000-R2000)
Q1-2017	5.74%	6.02%	2.46%	**3.56%**
Q2-2017	3.02%	3.06%	2.46%	**0.60%**
Q3-2017	4.57%	4.48%	5.67%	**-1.19%**
Q4-2017	6.34%	6.59%	3.34%	**3.25%**
2017	21.13%	21.69%	14.65%	**7.04%**

The next three tables show the performance gap between Growth and Value for the Russell 3000, Russell 1000 and Russell 2000 continued for all four quarters of 2017, but we're confident nothing lasts forever!

	Russell 3000 Index	Russell 3000 Growth Index	Russell 3000 Value Index	Performance Gap (R3000 Growth-R3000 Value)
Q1-2017	5.74%	8.62%	2.99%	**5.63%**
Q2-2017	3.02%	4.65%	1.29%	**3.36%**
Q3-2017	4.57%	5.93%	3.26%	**2.67%**
Q4-2017	6.34%	7.61%	5.08%	**2.53%**
2017	21.13%	29.59%	13.19%	**16.40%**

	Russell 1000 Index	Russell 1000 Growth Index	Russell 1000 Value Index	Performance Gap (R1000 Growth-R1000 Value)
Q1-2017	6.02%	8.90%	3.26%	**5.64%**
Q2-2017	3.06%	4.67%	1.34%	**3.33%**
Q3-2017	4.48%	5.90%	3.11%	**2.79%**
Q4-2017	6.59%	7.86%	5.33%	**2.53%**
2017	21.69%	30.21%	13.66%	**16.55%**

	Russell 2000 Index	Russell 2000 Growth Index	Russell 2000 Value Index	Performance Gap (R2000 Growth-R2000 Value)
Q1-2017	2.46%	5.34%	-0.13%	**5.47%**
Q2-2017	2.46%	4.39%	0.67%	**3.72%**
Q3-2017	5.67%	6.22%	5.11%	**1.11%**
Q4-2017	3.34%	4.59%	2.05%	**2.54%**
2017	14.65%	22.17%	7.84%	**14.33%**

KM's Investment "Themes" for 2018

1) **The corporate tax cut (reduction of statutory rate of 35% to 21% and 100% first-year expensing of capital expenditures) and pro-business agenda from Washington will lead to stronger economic growth, corporate earnings and business investment.**

While there is clearly room for debate on the long-term impact of tax cuts on interest rates, the deficit and the dollar, the short-term effect of the reduction of the statutory rate on the economy and corporate profits should be positive and direct. The U.S. had one of the highest statutory corporate tax rates, so the reduction to 21% will allow U.S. corporations to compete on a more level playing field. The ability to expense 100% of the cost of capital expenditures should also spur investment, which will benefit both the purchasers and sellers of capital goods. Finally, there is anecdotal evidence businesses have started to loosen their purse strings and spend/invest cash they had been hoarding or using for stock buybacks because of increased confidence in the economy and a likely rollback of regulations.

2) **Smaller companies should benefit most from the corporate tax cut and lower regulatory costs.**

Smaller/domestically-oriented companies bear higher effective tax rates than large, global companies because they have fewer tax reduction/avoidance tools available to them. It follows they will benefit most from the reduction in statutory rate from 35% to 21%. In addition, larger companies have the ability to spread regulatory costs over a larger revenue base, so smaller companies should benefit more if these costs decline.

3) **The Value vs. Growth pendulum will should back towards Value, eventually.**

We realize we sound like a broken record, but with Growth outperforming Value between 14.33% (Russell 2000) to 16.55% (Russell 1000) in 2017, the performance disparity continued to grow. Part of this may be attributable to the massive flows into passive indexing. As growth stocks perform relatively better, their index weights increase, which leads to more mindless buying. This "virtuous circle" will continue, until it collapses of its own weight and the circle turns vicious. In addition, in a low-growth world, investors were attracted to and bid-up the stocks of companies that were able to generate significant growth in revenue and earnings (think the "FAAMG" stocks—Facebook, Amazon, Apple, Microsoft and Google). Presumably in a higher growth world, the spoils will become more evenly distributed and Value stocks won't be at such a disadvantage.

We've pointed out the performance gap between Growth and Value had reached an extreme level that historically has indicated a reversal point. We believe this reversal of fortunes will occur, but unfortunately can't say when.

4) The U.S. stock market's steady, uninterrupted run of record highs in 2017 is unlikely to be repeated in 2018.

According to Bespoke Investment Group, 2017 was the first calendar year in history where the S&P 500 saw positive total returns for each month. Not only was the trend straight up in 2017, there were no setbacks along the way. It wasn't too long ago 2% up or down days weren't uncommon, but there wasn't a single one in 2017. Further, not only did the stock market not suffer a 10% pullback at any point, it didn't experience a 5% or even 3% pullback, either. In fact, the S&P 500 hasn't had a 3% pullback from a high in more than 409 calendar days going back to November 4, 2016, the longest streak on record (going back to 1928). It's obviously been even longer since the S&P 500 had a 5% pullback, more than 539 days (the second longest stretch after the 593-day stretch that ended in August 1959).

All of this is to say from a historical standpoint, the calm conditions investors enjoyed in 2017 were a statistical anomaly. Indeed, you only need to go back to 2016 to recall a dramatically more turbulent environment.

Stocks tumbled out of the starting gate in 2016, 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***). Investors had plenty of reasons to have their confidence shaken 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"). 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.

According to Crandall, Pierce & Company, since 1900, 5% corrections have occurred about 3 times a year and 10% corrections about once a year, so we're ***long overdue***. Just remember ***corrections are a normal part of the stock landscape and nothing to fear***. Headlines and talking heads are noise to be ignored. As Bespoke says, "investing based on the headlines is only profitable for the people buying from you or selling to you."

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.