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

"Most people give up just when they're about to achieve success. They quit on the one yard line. They give up at the last minute of the game one foot from a winning touchdown."
--H. Ross Perot (American entrepreneur)

July 10, 2017

Dear Clients:

We are pleased to report KM client equity portfolios continued to post gains in the second quarter and nearly matched our benchmarks. While we're not satisfied our relative performance trailed (even by a small amount), value managers like KM continued to swim upstream in the quarter. As we'll explain further, while smaller-capitalization stocks narrowed the performance gap vs. larger-capitalization stocks in the second quarter, they trailed significantly for the first half of 2017. Further, "growth" continued to significantly outperform "value" in the second quarter, causing the performance gap to widen to more than 9% for the first half of 2017.

At the beginning of the year we were optimistic our very strong absolute and relative performance in the second half of 2016 marked a reversal of headwinds active managers, ***particularly value managers***, had faced for the past several years. While we continue to believe the pendulum will swing from growth back towards value, we obviously can't say when that will occur. We can say with certainty the road ahead will be bumpy and we'll encounter sharp corners along the way.

Successful investing is a marathon, not a sprint. We're invested alongside you, so understand and share your frustration over our performance over the past three plus years. We'd make two points. First, we try not to get too high or too low over the results for any short-term period (be it 3-years or 3-months). In fact, our absolute and relative performance for the 12-months ending June 30, 2017 was very good. Second, since KM was founded May 1, 1975, we've endured a number of multi-year periods of underperformance. We can assure you none was pleasant, including the present one. Still, while past performance is not guarantee of future results, we've emerged from each of these periods with strong performance.

In sum, we're taking Perot's words to heart. We have no idea what "yard line" we're on, but we pledge to you we'll trust the process that has served us so well over the past 42 years and will NEVER give up. We know it's difficult in times like these, but believe it's in your best interest to do the same.

Periods ending June 30, 2017
(Total Returns-Annualized*)

	Russell 3000 Index	**S&P 500 Index**
Three-months	3.02%	3.09%
Six-months	8.93%	9.34%
One-year*	18.51%	17.90%
Two-years*	10.02%	10.73%
Three-years*	9.10%	9.61%
Five-years*	14.58%	14.63%
Ten-Years*	7.26%	7.18%

The Stock Market

We "deconstructed" the returns of our benchmark Russell 3000 Index to provide an illustrative look under the surface for the first half of 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, while the performance gap between large-capitalization stocks (as represented by the Russell 1000) and small-capitalization stocks (as represented by the Russell 2000) narrowed significantly in the second quarter of 2017, ***large-capitalization stocks still outperformed small-capitalization stocks by a substantial 4.3% in the first half of 2017***.

Periods ending June 30, 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%**
H1-2017	8.93%	9.27%	4.98%	**4.29%**

	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%**
H1-2017	8.93%	13.69%	4.32%	**9.37%**

	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%**
H1-2017	9.27%	13.99%	4.66%	**9.33%**

	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%**
H1-2017	4.98%	9.96%	0.53%	**9.43%**

Putting the four Russell tables together, large-cap and growth stocks clearly dominated performance in the first half of 2017. We're not making excuses, but think it's important for you to understand the investment environment we are dealing with.

More important than examining the immediate past, we believe there's good reason to think value investing is ready to stage a comeback. In fact, this was the conclusion of a recent article by Barron's columnist Mark Hulbert, which cited data compiled by legendary finance scholars Eugene Fama (University of Chicago) and Kenneth French (Dartmouth College). According to Fama and French, over the past 12 years through April 2017, value lagged growth by an annualized average of 0.7%. However, over the past ***eight decades*** (going back to 1926), ***value beat growth by a whopping annualized average of 4.8%***. If value trumps growth over a long period of time, why isn't everyone a value investor? It's human nature. It takes a tremendous amount of intellectual discipline and internal fortitude to endure periods that can stretch to a decade or longer when value investors appear to "just not get it." Most investors are simply not "wired" for the challenge.

Hulbert noted, "Frustrating as the last dozen years have been, they are not unprecedented. In fact, there was one other 12-year period since 1926 in which value, on balance, lagged growth. That period was—you guessed it—the one that ended in March 2000, the month the dot-com bubble burst."

Indeed, we see parallels between now and the technology stock mania of the late 1990s. You probably have seen references to the strong performance of the "FANG" stocks (i.e. Facebook, Amazon, Netflix and Google) and their impact on index performance. The table on the last page shows the performance of the "FAAMG" stocks and their impact on the performance of the S&P 500 and NASDAQ indices. Specifically, while the FAAMG stocks comprise 13% of the market capitalization of the S&P 500, they were responsible for almost 40% of the S&P 500's year-to-date return through June 7, 2017. Amazon's market capitalization increased by $125.1 billion in less than six months, equivalent to the combined value of UPS *and* Kroger.. Clearly, if you didn't own those five stocks, it was almost impossible to keep pace.

Similar to the technology stock mania of the late 1990s, we have watched in awe as stock prices and valuations ***seem to*** grow to the sky. Amazon trades at a price-to-earnings ratio (P/E) of 187 times its earnings over the last 12 months. Facebook's P/E is 41x, Microsoft and Google 32x and Apple 17x. While we might have been able to justify owning Apple, we clearly don't find the valuations of the rest of the "FAAMG" stocks compelling.

Terminator 3: Rise of the Machines was released 14 years ago this month. Machines, in the form of passive index investing, are clearly on the rise and we think are responsible for much of the overvaluation for these large-cap technology stocks. It is a well-known fact active managers have generally underperformed their benchmark indices since the financial crisis. Passive index funds offer to match index performance, minus fees (which are much lower than for active management). We certainly understand the elegant simplicity of the index fund sales pitch, which investors have responded to in droves. According to a research report from Bank of America Merrill Lynch, "The ETF-ization of the S&P 500, Part 1," the percentage of U.S. equity fund assets that are passively managed has ***nearly doubled*** since the crisis, from 19% in 2009 to 37% today. In fact, Vanguard (the largest passive index fund manager) owns more than 5% of 491 of the S&P 500 stocks, up from "just" 116 in 2010 (and more than 10% of 80 S&P 500 stocks, up from six).

Passive index investing "machines" mechanically and mindlessly "invest" this torrent of cash pouring in by buying stocks in the same proportion as in the indices they happen to track, with no regard for company fundamentals or stock valuation. Thus, every index fund tracking the S&P 500 will buy enough Amazon every day to make it a 1.9% position (AMZN's current weighting in the S&P 500), regardless of its P/E of 187x earnings for the last twelve months or prospects going forward. If this constant buying pressure causes AMZN's weighting to rise to 2% of the S&P 500, the index funds just keep buying more.

Our fear is this "virtuous circle" of constant buying leading to higher stock prices leading to more buying will continue—until the music stops at some point for whatever reason. The resulting fund outflows could cause the virtuous circle to turn vicious as indiscriminate buying turns to indiscriminate selling. Index funds haven't been tested under extreme market stress since they've reached gargantuan size. Trading liquidity is like air—you take it for granted, until it's not there. With index funds simultaneously selling the same positions, the question becomes—sell to whom?

Passive index investing is a pure form of follow-the-crowd behavior. We can't say for sure if passive index investing is a fad, but the herd mentality of investors has certainly caused it to become a crowded trade, perhaps overly so. If it turns out to be a fad, we've seen plenty over the past four decades plus. ***Nothing*** grows to the sky and all have ended badly.

We remain constructive on the stock market and positive on the outlook stocks held in client portfolios:

- The U.S. economy continues to show more signs of strength (employment and manufacturing activity) than weakness (auto sales), which should bode well for corporate earnings and stock prices.
- We think we're in a "Goldilocks" economic environment of 2-3% GDP growth and 2-2.5% inflation, which should be good enough to boost profits, but not too strong as to raise concerns of the economy overheating.
- The Federal Reserve will be deliberate in its pace of weaning the stock market from its dependence on the stimulus of ultra-low interest rates and quantitative easing.
- Investors remain cautious, despite stocks at record levels. The American Association of Individual Investors bullish sentiment reading is below 33% and has been below 50% for 129 consecutive weeks.
- The P/E of "the market" is at the high end of historical ranges (stretched somewhat by the aforementioned high P/Es of some of the large-cap technology companies), but not in danger territory. More importantly, we believe the stocks held in client portfolios are still reasonably valued.

That said, the U.S. stock market is long overdue for a correction, which could occur at any time and for any or no reason. According to Bespoke Investment Group, it's been more than 250 trading days since the S&P 500 saw a correction of at least 5% (the longest streak since 1996). Further, since 1928 there have only been seven other streaks where the S&P 500 went longer without a 5% correction.

Interest Rates and the Bond Market

The U.S. Treasury market was fairly volatile during the second quarter of 2017. The yield on the 10-year U.S. Treasury Bond started the quarter at 2.39%, plunged to 2.13% on June 14 and backed-up to 2.31% at the end of the quarter. As expected, the Federal Open Market Committee (FOMC) raised its target for Fed Funds by 0.25% in mid-June, the second increase of 2017. We think a third increase is likely before year-end, but as long as the "Goldilocks" scenario of growth (2-3% GDP) and inflation (2-2.5%) remains in place, we think increasing short-term interest rates will have limited impact on intermediate- and longer-term rates, resulting in the "yield curve" (continuum of rates from shortest- to longest-maturity) flattening as the year progresses.

Summary

KM celebrated its 42nd Anniversary on May 1, 2017. This is a milestone very few investment management firms reach. We owe it all to you, our clients. We thank you for the trust and confidence you've placed in us and work hard every day to earn it.

Save the Date

We are planning a client event on Wednesday, September 20, 2017 after work at Harrison Lake Country Club in Columbus, IN. Mr. Peter Dunn (aka Pete the Planner) will give an informative and entertaining presentation on personal finance and investing. Pete's column appears every Sunday in The Indianapolis Star and regularly in USA Today. Check out his website at http://petetheplanner.com. Invitations will follow.

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.

Exhibit 1: SPX and NDX returns are increasingly dependent on five Tech stocks

FAAMG YTD performance and index contribution, as of June 7, 2017

Ticker	YTD Price Perf (%)	% of SPX	% of SPX Move	% of NDX	% of NDX Move	Market Cap Created ($,bn)	Equivalent to the Mkt Cap of:
AAPL	34%	4%	13%	12%	18%	200.1	CMCSA
GOOGL	26%	3%	7%	9%	11%	145.4	IBM
AMZN	35%	2%	6%	7%	11%	125.1	UPS + KR
FB	33%	2%	5%	5%	8%	111.0	BA
MSFT	16%	3%	5%	8%	7%	78.7	MS
Top 5		13%	37%	42%	55%	660.4	
S&P 500/Total	9%					1,808.1	

FAAMG is 13% of the SPX but responsible for ~40% of the YTD perf.

FAAMG is 42% of the NDX but responsible for ~55% of the YTD perf.

Note: For purpose of this exercise we combine GOOGL and GOOG.

Source: FactSet, Bloomberg, Goldman Sachs Global Investment Research.

Goldman Sachs