



K E R N S

CAPITAL MANAGEMENT, INC.

Kerns Capital Management Market Report

January 15, 2010

Clients and Friends,

The year is starting with strong performance for the markets and our portfolios.

This letter describes why we started our mutual fund and how part of our investment philosophy is not only to obtain growth with reduced risk but to do it in a tax efficient manner. It also gives our view on the direction of the market.

Within the next few days, clients will be receiving complete data to give to their tax preparer on their investments with Kerns Capital Management.

We think you will find this letter an interesting read.



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On days like today when the market decides to sell off, it brings forth an opportunity for a "reality check". Since the media likes to present sensational and negative news for us to read, watch or listen to, it can be difficult for the casual investor to get a clear perspective on what is really happening. That is why it is important to step back and look at the facts.

Here are a few facts that affect our thinking currently:

- First and foremost, the market is still in an uptrend. It has been in one since last March. It has had some pauses but it continues to inch higher. The S&P 500 has had seven new highs in the last two weeks and fourteen in the last six weeks!

- There have been no market lows that were lower than the prior market low in this uptrend. Higher market highs and higher market lows are the definition of an UPTREND.

It is true that there are persistent uncertainties about the global economic outlook, risk of countries going broke (yes, I said countries) and our own government's seeming inability to chart a clear course out of our problems.

But remember, while it is necessary to have an idea on what we think should be happening in the market, investors go broke on trading what should happen. What should happen - always comes in a distant second to what is actually happening in the market. What is actually happening is that the market is in an uptrend!

Exiting from a recession seldom occurs in a straight line. Very bad news turns to less bad news, which turns to uncertain news which turns to good news. Market uptrends start with the less bad news. If you wait until the good news arrives, you will have missed a major part of the uptrend. We are much better off to listen to the market because it always seems to lead the economy by six to twelve months.

During major uptrends, it is not unusual for the market to stop and rest. Prices can't just go straight up. When everyone that wants to buy has done so, only sellers remain. This is the point where the professional traders start selling and taking their profits. After they have sold, they then become "buyers in waiting". They are waiting for prices to pull back to a point where they look like bargains again. If companies are delivering improving earnings and sales, prices can't fall far. Since March, we have been seeing small pullbacks or sideways trading while economic and fundamental news builds to a point where stocks are once again an irresistible bargain.

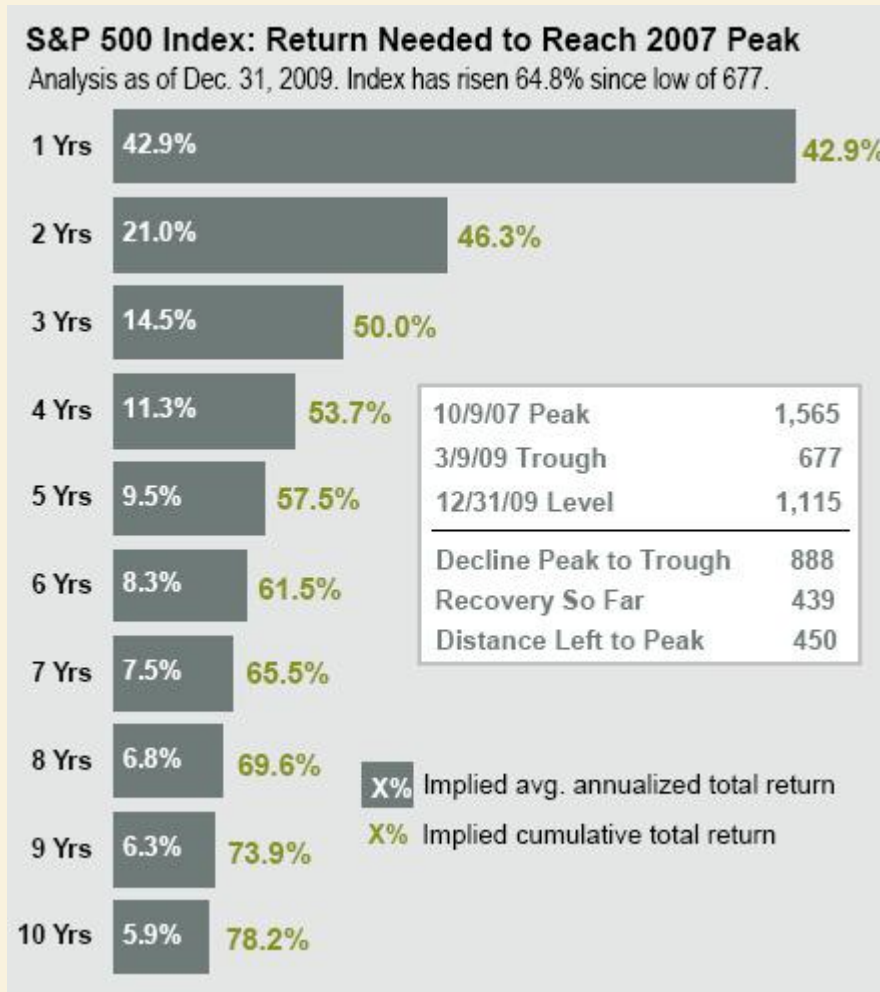
With fourteen new highs in the last six weeks, it is possible that we are approaching a pullback or sideways market for a period of time. Pullbacks present buying opportunities and we have our shopping list ready and waiting. We are operating on this thesis and feel strongly that the uptrend will continue and 2010 will be a positive year. If a major downturn interrupts the uptrend, we will take defensive action.

Active Management or Buy & Hold

March 2009 marked the end of the market's 57%+ free-fall that began back in October 2007. Since our clients did not suffer the same big losses, their accounts have completely recovered and they have begun making real money again!

Most buy and hold investors, as of 12/31/09, still needed another 42.9% gain on their money just to get back to breakeven as demonstrated by the following chart from J.P. Morgan. If the market climbs 42.9% in 2010, buy and hold investors will just be getting back to where they started in October 2007. To put this feat in perspective, the total return of the S&P 500 during the first decade of the 21st Century - now known in the financial world as the "lost decade" - was negative 9.28%. Ouch!

It is not likely buy and hold investors will recover for many years. The following chart shows how many years it will take Buy and Holder to break-even at varies rates of return. For example, an annual return of 5.9% will require 10 years just to get back to where they started.



Source: Standards & Poor's, JP Morgan Asset Management. Data assume 2.5% annualized dividend yield. Implied values reflect the average geometric total returns required for the S&P 500 to reach its 10/9/07 peak of 1,565 over each stated period. Chart is for illustrative purposes only. Past performance does not guarantee future results.

How Are We Doing?

We're off to a great start with Aggressive up 3.81% year-to-date through January 14th while the S&P 500 is up 2.81%!

Today finished lower, but the markets remain in an up-trend and we've learned that it is dangerous to fight the trend. If the markets reverse course and start to trend down, you can rest assured that we are paying attention and will do our best to protect your portfolio.

Note: For 401(k) plans without self-directed brokerage accounts, please see your Plan's monthly Investment Performance Summary for actual performance.

KCM Macro Trends Fund - Tax Efficiency

The **KCM Macro Trend Fund** (KCMTX) ("the Fund") is an out-growth of the model portfolios we have been successfully managing for our clients for more than 15 years. It is a proprietary fund open only to our clients and Investment Advisors (for their clients) via Fidelity, Charles Schwab (**NTF next week**), TD Ameritrade, Pershing, Southwest Securities and Trust Company of America.

The lion's share of our management activity takes place inside of the Fund. Our Aggressive model is allocated 100% to the Fund, Moderate 70%, and Conservative 60%. Since opening the Fund on August 4, 2008, we believe the Fund has met its primary goals:

1. To reduce client losses during declining market periods, thereby seeking to preserve capital for future market advances; and
2. To capture the majority of major market advances.

For the period beginning August 4, 2008 (Fund Inception) through December 31, 2009, the S&P 500 (including dividends) was negative 11.55%, while the Fund had a positive return of 14.15%. On a \$1,000,000 account that's a \$257,000 difference!

	2009 YTD	Inception (Cumulative)	Inception (Annualized)
KCM Macro Trends Fund	26.16%	14.15%	9.86%
S&P 500 TR	26.46%	-11.55%	-5.34%

Source: Morningstar. As required by FINRA: Past performance does not guarantee future results. Performance current to the most recent month-end may be lower or higher and can be obtained by calling 1-800-945-2125. The investment return and principal value of an investment will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost. The KCM Macro Trends Fund's total annual operating expense ratio is 1.82%. The Fund's Investment Advisor has contractually agreed to reduce its fees and/or absorb expenses of the Fund, at least until August 30, 2010, to ensure the net annual fund operating expenses will not exceed 1.70%, subject to possible recoupment from the

Fund in future years. Please review the Fund's prospectus for more detail on the expense waiver. The S&P 500 TR is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market. You cannot invest directly in an index. Our Aggressive Model has been invested 100% in KCMTX since August 2008.

Our Reasons for Starting the Fund

As you may recall, we established the Fund for several reasons, and believe things are working out as intended:

- **Improve Performance.** In 2006, in response to the mutual fund insider trading scandal involving several major institutions, the SEC and most mutual fund companies imposed various trading restrictions on the active trading of their actively managed funds through the imposition of long-term holding requirements and short-term redemption penalties. This unfortunately cut off our ability to hire quality fund managers on a short term basis or go to cash to protect your accounts without incurring substantial dollar penalties. We were therefore forced to make index funds our primary management tools. The problem with index funds is you get the index ... which means you get the good, the bad and the ugly stocks/bonds in the index with no ability to screen out weak companies.

Consequently, we decided to bring the asset management (security selection) in-house through the establishment of our own mutual fund. As shown above, the results have been outstanding relative to the markets!

- **Reduce Trading Fees.** We incur one trading fee on behalf of the Fund (and its shareholders) when we trade (buy or sell) a security in the Fund. Without the Fund, we would incur a trading fee for each trade in each client account. Our objective is to diversify the Fund across 100 securities (currently 90), so as to minimize stock specific risk, which without the Fund would be cost prohibitive.
- **Reduce Client Management Fees.** Before, as in most Advisory relationships, our clients paid management fees on two levels: our management fee and the management fee contained within the underlying mutual funds investments held in their accounts. We have eliminated the underlying management fee for money invested in the Fund by crediting it against our normal Investment Advisory fee. Reducing your fees increases your ability to grow your assets.
- **Improve Tax Efficiency.** Long-term capital gains and qualified dividends are currently taxed at 15%. Short-term capital gains are taxed at your much higher marginal rate. The investment process we follow in the fund is designed to minimize taxes. We do this in three ways:
 1. We attempt to select stocks that have good long-term growth potential which will allow us to hold them at least one year which qualifies them for the lowest Capital Gains tax rate. We hold the winners.
 2. We have a sell discipline of cutting losses quickly on stocks that do not work out. Stocks sold quickly at smaller losses help protect capital. Those losses are also short-term losses so they can be used to offset any short-term gains in the Fund.
 3. While we pick stocks to hold for the long-term, we actively hedge for the short-term to reduce portfolio losses during weak markets. Gains from hedging are usually short-term gains and can be offset with short-term losses from stocks held less than one year.
 4. We favor stocks which have the ability to pay qualified dividends which are currently taxed at the lowest rate.

This process produced an extremely tax-efficient result for 2009. Even though the Fund grew by 26.16% during 2009, the total taxable distribution to shareholders was less than three cents per share. To put this into perspective, a \$1,000,000 portfolio held for the entire year would have grown to \$1,261,600 but would have had a taxable distribution of only \$3,010.03 - all taxable at only 15%. This resulted in taxes of \$451.00. Tax efficiency at work!

For more information about the Fund, including its objectives, strategies and performance, please give us a call at (800) 945-2125, or click on the following direct links: [KCM Macro Trends Fund](#) or [2009 3Q Fund Fact Sheet](#) (FINRA reviewed) - 2009 4Q Fact Sheet will be posted shortly.

In Closing

We truly believe that our approach to investing will add value to every client's long-term financial well being and sincerely appreciate the trust our clients have placed in us.

If you know of anyone that might benefit from our investment management, please pass our name along to them or let us know. There is no greater vote of confidence than your referrals.

Best wishes for a great 2010. We will do our part to help make it that way.

Lane Kerns

Important Notice & Disclosures

Performance data is historical. Past performance does not guarantee future results. Current performance may be lower or higher than the performance data quoted.

Kerns Capital Management, Inc. ("KCM") performance figures represent a composite of all individual portfolios managed in accordance with the investment category, are after the deduction of KCM's actual management fee, and include reinvestment of dividends and earnings. The composites contain accounts structured with mutual funds that are managed with a view toward capital appreciation. Standard Deviation and Alpha are calculated monthly and then annualized to be consistent with Morningstar®.

Mutual Fund investing involves risk including possible loss of principal. Investors should carefully consider the investment objectives, risks, charges and expenses of the **KCM Macro Trends Fund**. The Fund may invest in small, less well-known companies, which may be subject to more erratic market movements than large-cap stocks; foreign securities, which are subject to currency fluctuations and political uncertainty; and derivative securities, which may carry market, credit, and liquidity risks. The Fund may also engage in short selling activities, which are more risky than "long" positions because the potential loss on a short sell is unlimited. These risks may result in greater share price volatility. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling 1-877-275-5599. The [Prospectus](#) should be read carefully before investing. The KCM Macro Trends Fund is distributed by Northern Lights Distributors, LLC member FINRA/SIPC.

The S&P 500 Index is an unmanaged composite of 500 common stocks. This index is widely used by professional investors as a performance benchmark. You cannot invest directly in an index. **The Dow Jones Industrial Average** is a price-weighted average of 30 of the largest and most widely held stocks traded on the New York Stock Exchange and the Nasdaq.