



K E R N S

CAPITAL MANAGEMENT, INC.

Kerns Capital Management Market Report

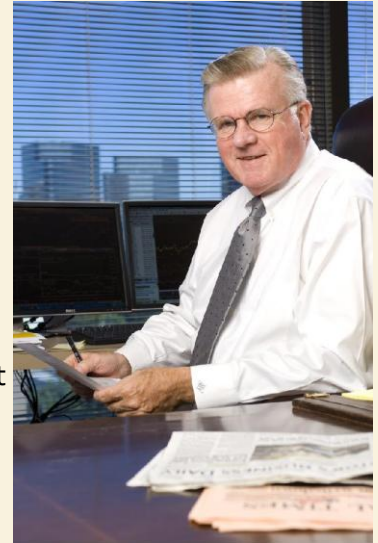
January 15, 2009

The 20% rally that began in late November appears to have died. I hope only temporarily.

The last thirty days have been very good for us - but not so good for the market in general. Our models are all up for the last month while the market indexes are down. (See Chart Below)

There are some fundamental investing rules that will work in a market like we are experiencing and some that will not. Below, I will deal with a few of them and discuss our current approach to "Growth Management" and "Risk Management".

Our mutual fund, KCMTX, is being added to Morningstar within the next couple of days and you will be able to view it there. We are very excited about getting the fund off to a good start and this letter will describe part of our investment approach. I hope you enjoy it.



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Dealing With The Big Picture

Sometimes it is good to just step back and look at a situation (in this case your investments) as if you were not personally involved. For people who have no money, that is an easy task, they just don't care. But for those who have accumulated wealth, whether small or large, it is difficult to be objective because no one wants to be a Nero while Rome burns.

In past letters I have referred to the fact that we think the economy is in a long-term (10-20 year) Secular Bear Market as well as a short-term (1-2 year) Cyclical Bear Market.

I recommend a book entitled **Active Value Investing** by Vitaliy N. Katsenelson which describes how investments perform in both types of markets.

It is our feeling that the current Secular Bear Market started in 2000. Since then the stock market has essentially gone nowhere. Some individual stocks have done well but very few were candidates to buy-and-hold. How does one invest in a Secular Bear market? First, as the name of the book implies, there needs to be an active element. We can't get married to a stock, bond or even cash. We need to pay attention and move with the bigger moves of the market. "Go with the flow", if you will.

No one wants to look back over a 10-20 year period and see that they are right back where they started. For example, if an investor just sits in a Money Market fund while inflation rages, the real value of their money is decreasing as it did in the 70's. On the other hand, to be in stock or commodity investments during a severe market decline can be very damaging to your wealth.

Every investor needs a "Risk Management" strategy and a "Growth Management" strategy. Let me describe part of ours.

"Growth Management" Strategy

During a growth or Bull market, like the 1990's, an investor wants to be in growth stocks. While corporate earnings and dividends are always important, they are not as important during Bull markets as they are during Bear markets. During the 90's, all someone had to do was jump on the fastest growing stock and there was very little risk. No one wanted to miss out on the "easy money", so dollars poured out of banks, savings accounts, bonds and money market accounts into stocks. Risk Management is of little importance.

During a Bear market (like now), investors need to completely change their thinking. Corporate earnings, dividends and Risk Management become essential.

First, let's deal with corporate earnings and dividends. If a company has growing earnings and has the ability to pay dividends, it will tend to have less downside risk than stocks of companies with no earnings, no free-cash flow and shrinking sales.

Since opening our mutual fund last year, our focus has been on companies that have a number of characteristics such as:

- High free cash flow. A company can be profitable, but if all of their profits go to service debt or are being spent to buy assets, they are at more risk in down markets. If a company is a cash machine that generates more cash than it needs to pay its bills and service its debt, it is not at the mercy of bankers. (We all know how much mercy bankers have.) Companies that have substantial earnings are going to suffer less, even if their earnings drop by 50%, versus a company with marginal earnings that goes from slightly profitable to unprofitable!
- Dividends. If a company is paying a high dividend, one that is higher than bank CD's, Money Market funds or government bonds, it is easier to ride out a decline in the stock value. We add free cash flow to dividends to get a number. If that number exceeds 7%, we feel that the potential for that company (both short-term and long-term) is better than CD's, Money Market funds or government bonds because stocks also have the potential for upside appreciation.
- Growing Sales and Earnings. If a company has growing sales and earnings, rather than contracting sales and earnings, they can maintain their free cash flow and dividend.
- Analysts Recommendations. If analysts are recommending that the stocks be sold, it is much harder for the stock to rise. In addition to our own research, we take the sum total of all analyst's recommendations into account. We are looking for stocks with no or almost no sell ratings and a large percentage of buy ratings.

These are just a few of the essentials we look for. The essential thing to be gained from stocks that have these characteristics is that they will generally do better in both Secular and Cyclical Bear Markets! In addition to the 70 stocks we hold, I have at least 30 more I would like to buy. Many opportunities are presenting themselves with the market down as much as it is.

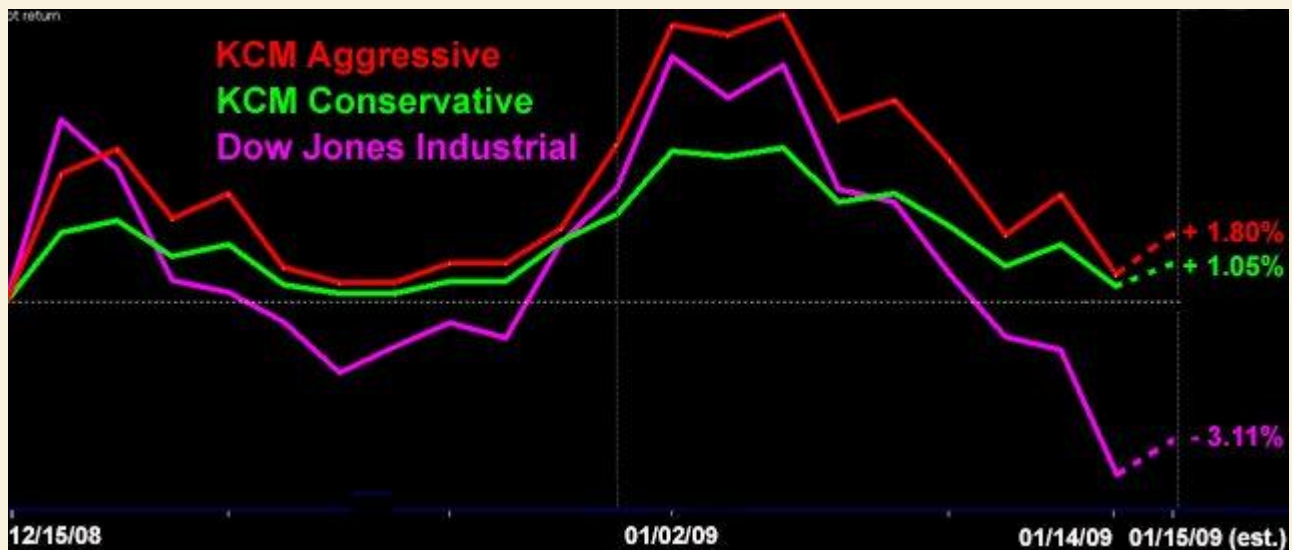
Investment risk comes from many directions, but the two main influences are company specific

risk (discussed above) and market risk. We substantially reduce company specific risk with the characteristics outlined above.

"Risk Management" Strategy

If we are successful in picking stocks with lower company risk than the market as a whole, we are still at the mercy of the market's direction. While we want to hold good companies for the long-term, in order to realize their long-term growth potential and obtain long-term capital gains taxation, even good stocks go down when the market declines. We deal with market decline risk by actively trading our market hedge.

We hedge the market risk with futures and options contracts and ETFs that will go in the opposite direction of the market. If our stocks generally outperform the market and we are successful in hedging out a substantial part of market risk, we will substantially improve profits. The last 30 days is a good example:



Please note that today (the last day on the chart) is an estimated number because it is the exact position of our fund holdings and the Dow at 1:45 PM as I write this letter. The Aggressive model is 100% invested in KCMTX (our fund). Conservative is 60% invested in the fund.

The point to be gained is that we are up over the last month while the market is down! We are up 1.80% while the market is down by 3.11% for a difference of 4.91% on the month. If we are fortunate enough to do that well for the rest of the year, I think clients will be quite excited.

If you know people who did not fare as well as this, please tell them about us and us about them. All of the above returns were after all management fees and any expenses.

As always with my remarks, they may not be right - but they are my opinion!

I hope everyone's New Year is getting off to a good start.

Lane Kerns

P.S. New Website

We take pride in providing a high level of personal service. We continually work to earn your trust by investing in tools and resources that strengthen our relationship with you. I'm pleased to announce our latest service - our firm's new Web site. We hope you like it. Please give us your feedback.

Now you can visit www.KernsCapital.com to view your Schwab Account, as well as your 401(k) Account if our sister company M.L. Kerns & Associates administers your company's 401(k) plan.

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