



# K E R N S

## CAPITAL MANAGEMENT, INC.

### Kerns Capital Management Market Report

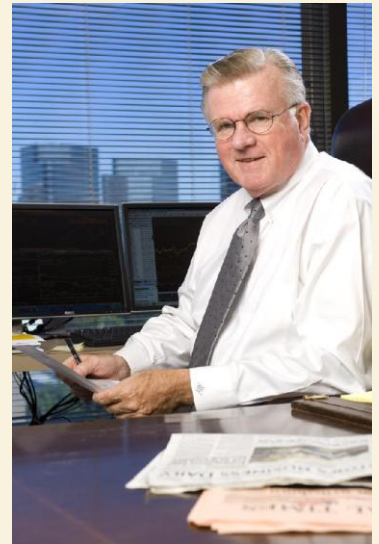
February 2, 2009

The Stock Market has started to show some signs of life after a brutal downtrend which produced the worst January in history. Fortunately, we fared much better than the market.

If one reads the daily news about the economy, it is bad. Even I could get wrapped up in it if I had not learned a long time ago to separate the economy from the stock market. Eventually one affects the other but almost never at the same time. That is why it is important to look at what is actually happening. I will do that in this letter.

The Fed has already lowered the Fed Funds Target Rate and the Discount Rate effectively to zero. Speculation is that they will now begin buying back government bonds. Additionally, the President promised and congress is trying to deliver a stimulus package.

The longer-term outcome of this massive infusion of capital is uncertain. In the shorter-term it will surely deliver a bull market rally sometime this year, perhaps earlier than many investors expect.



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### **Corporate Earnings Verses Perception**

There is no doubt that America and the world are slowing down. This has to mean that corporate earnings are slowing - doesn't it? That is certainly the market's perception - and the stock market is very effective at discounting in advance what investors expect earnings to be. This is why the market has suffered such a massive selloff.

Since people have anticipated the worst, it is being reflected in the market. But, let us look at how corporations are faring so far in this earnings reporting season. The following chart is from Bloomberg for the current quarter and is current through this morning. Many of the news programs are reporting terrible numbers. What I have done is removed the financial companies from the chart below to get a more accurate picture of how the rest of the country is doing.

I have highlighted line 1) below representing all non-financial securities in the S&P 500 which report this quarter. Note that there are 321 total and 137 of those have reported thus far. This line shows the amazing reality of what is really happening. The average growth reported is POSITIVE - NOT NEGATIVE. Admittedly, the growth is small at .21% but it certainly does not coincide with the almost 50% drop in the stock market from its high. Even more important, and this is the real point I want to make, take a look at the Surprise column. Almost every market sector has surprised to the upside! There have been 100 positive surprises and only 35 negative surprises.

Season		Current	01/12/09	-	04/06/09	Periodicity		Annual
GICS		EPS	Net Income	Sales	Source	Equity Index	Name	*SPX EX FIN
Sector	Reported/Total	Growth	Pos Grw	Neg Grw	Surprise	Pos Surp	Neg Surp	
1) All Securities	137 / 321	.21%	84	51	1.12%	100	35	
2) > Energy	15 / 38	12.59%	13	2	1.08%	11	4	
3) > Materials	17 / 27	-11.18%	6	11	6.19%	13	4	
4) > Industrials	30 / 48	-3.16%	21	9	.88%	23	6	
5) > Consumer Discretionary	16 / 58	-67.09%	2	14	7.06%	13	3	
6) > Consumer Staples	5 / 23	-42.06%	2	3	.01%	3	2	
7) > Health Care	22 / 45	5.11%	17	4	.82%	15	7	
8) > Financials	0 / 0		0	0		0	0	
9) > Information Technology	22 / 39	4.12%	15	6	.93%	16	6	
10) > Telecommunication Ser	2 / 9	-4.45%	2	0	-4.46%	0	2	
11) > Utilities	8 / 34	-3.97%	6	2	.82%	6	1	

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000  
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2009 Bloomberg Finance L.P.  
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Since the stock market has anticipated very big drops in earnings and has priced itself to reflect those overly pessimistic expectations, the positive earnings surprises shown above are the seeds for a rally off the market bottom.

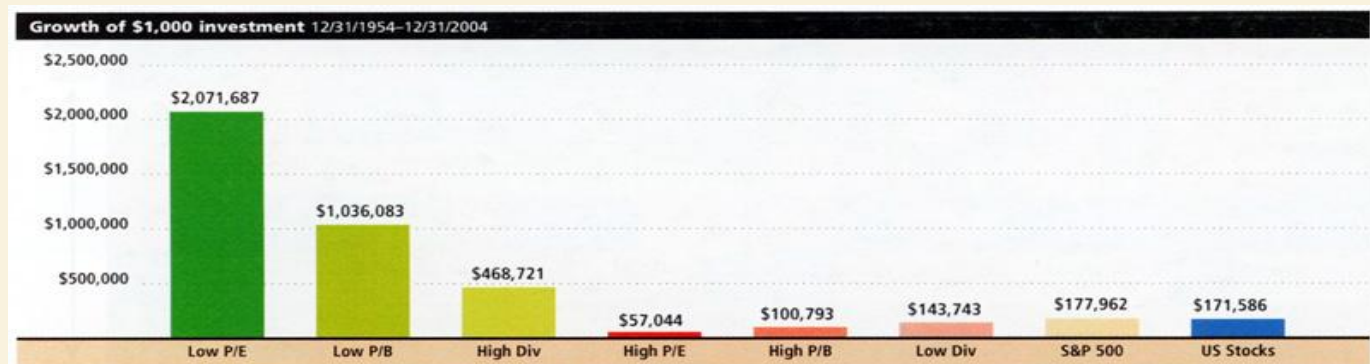
Also - remember that market bottoms ALWAYS coincide with the most pessimistic news and usually with people throwing in the towel just at the wrong time. If you have been a buy-and-hold investor through this bear market, I can see why you would want to do just that.

We use achieve risk management and have had very modest portfolio declines compared to the market and I have a feeling we may be recovering those draw-downs sooner than expected.

## More on Our Investment Process

In our last letter I talked about part of our investment process. I stressed that we are looking for companies with growing earnings, free cash flow and that we feel are undervalued.

Over the weekend as I was looking through numerous research papers that I have accumulated over the years, I found the following chart. It covers a 50 year period from 1954 through 2004. While it is true that it does not include the last four years, it does cover many market cycles (both short Cyclical and long Secular ones like we are in now) to make a valid point. Over that 50 year period, it shows what \$1,000 would have grown to based upon investing in each of the eight different approaches. Notice that investing in Low P/E (Price-to-earnings) and Low P/B (Price-to-Book-Value) stocks far exceeded any of the other strategies! That is a major part of our investment process.



Sources: Deutsche Asset Management, with use of data compiled by Professor Kenneth French, Dartmouth College—Tuck School of Business (<http://mba.tuck.dartmouth.edu>). This chart is for illustration purposes only. It should not be construed as a recommendation and does not represent any Scudder portfolio or fund.

Past performance does not guarantee future results.

You may also remember from the last letter that another major part of our strategy is "Risk Management". While investing in Low P/E stocks has yielded good results over the years, it is good to remember that virtually all stocks decline in Bear markets. That is why we reduce market risk by hedging against it on a daily basis. In a trading-range market that just moves sideways between an upper and lower limit, is important to be very active with "Risk Management".

If you know people who have not fared well during the last year, please tell them about us and us about them. If they are with Investment advisers who have not successfully protected their assets from the majority of the 2008 decline, please tell them about us. At the very least, use the button at the bottom of this letter to forward this letter to a friend.

Now that we have a mutual fund regulated by FINRA and the SEC, I am prevented from putting anything current in the newsletter by their rule that they must pre-approve any promotion of the fund. That pre-approval process usually takes a minimum of several days. I can say however that while the S&P 500 was down today, the fund was up. You can get more performance information by contacting us directly or looking us up as KCMTX on Morningstar.com.

As we work our way toward Spring, don't forget to work in some family vacation time. Let us do the worrying about your portfolio.

Sincerely,

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](http://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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