

ADVICE ON THE MARKET



April 1, 2008

To: Friends and Clients of MLK Capital Management
From: Lane Kerns

Re: Why Is The Market Declining?
Economic and Market Outlook
Short Perspective on Inflation and Commodities
Current Portfolio Holdings

Why is The Market Declining?

Over the last six months the market has slowly fizzled. Since September 30th last year the S&P 500 is down 12.53% and the Nasdaq is down 15.64%. It was worse than that until the rally of the last two weeks.

If one is to gain some insight into when the markets will start climbing again, it is important to understand what has been driving them down. The following is an over-simplification – but it will illustrate what is happening.

Think of it this way. When I was in high school I wanted a car. My father told me that for every dollar I earned and saved, he would add a dollar and I could take the total and buy whatever kind of car that would buy. If I saved \$1,000 working on the farm over the summer, he would add a \$1,000, and I could go looking for a \$2,000 car. (When I was in high school, \$2,000 would buy a lot of car!)

Now let's say that my father had not been so generous. Let's say he would not give me anything and I only had the \$1000. That wouldn't impress the girls nearly as much. Or, I could have been like one of my (fictional) friends whose father's farm sat on top of a recently discovered oil field! For every dollar he saved, his father gave him \$35.00. \$1,000 saved equaled \$36,000. His \$1,000 was leveraged into a very large amount of money. He not only bought a better car but a boat to pull behind it – a very big boat. Not only did my friend spend big - but his father went out and borrowed to build a much bigger house and buy bigger farm equipment using his new found oil income as collateral.

Why do I use the simplistic analogy above? Because banks worldwide have provided leverage in the investment markets over the last few years and have been very much like the father who struck oil. Bear Stearns, the fifth largest investment bank in the US was leveraged 35 to 1 and had to be saved by our Federal Reserve, when it went broke last month. However, instead of the \$35.00 being a gift from good old rich father, it was borrowed money. For every dollar they were worth, they had borrowed an additional \$35.00 to invest. Many of the billion-dollar plus hedge funds in the world have also used leverage from 10 to 1 up to 35 to 1.

When the banks thought there was no risk in the markets, they were happy (and greedy) enough to loan money to invest in just about anything. They even made some of the investments themselves for their own accounts. This money poured into the stock markets, the commodity markets, and was used by companies to buy out other companies. Through very complex "Structured Investment Vehicles" (SIVs), a lot of that money poured into the home mortgage market and was loaned to people who had little chance of ever paying it back.

Now imagine that dad's oil wells suddenly go dry, and he has not only given you too much money, but he has over-extended himself. Now remember, you have been having a merry-old-time racing your car and have pretty well trashed your new boat when daddy says "Son, I need that \$35,000 back". You have to sell your new boat and car. We all know what things become worth when you have to sell them and everyone knows you have to sell them. Since you can't pay daddy back, he can't pay back the banks he borrowed from. Since they have to write off the

money that can't be paid back, they take dad's farm. That is what happened to Bear Stearns. And here is the point of the whole story. The banks suddenly have started saying, we are not going to make any new loans until we see how many more bad loans we are going to have to write off – and – we are going to start calling in some of the loans we have made. We will no longer loan \$35.00 for every \$1.00 our customers put up and we want some of the money back. To quote Ross Perot, this has created “a giant sucking sound” as the money rushes out of the credit and stock markets. If there is large scale selling by professional investors, there can't be enough buyers to hold up the markets. This is the “Credit Crises” the world is currently experiencing.

The investment companies and other banks that have borrowed the money are kind of like Junior and his new boat and car. Since the boat is trashed (the bad investments that have been made), but the car is still in pretty good shape (the good investments that were made) the only thing we can do is sell the car (our best investments). That is what happened to our (good) commodity investments week before last. It does not diminish our outlook for the growth potential of commodities over the next few years. But as we stated in our last letter, “There will be volatility.”

The above paragraphs describe exactly why some of the best investments, the ones with the best growth and long-term outlook, sold off strongly over the last two weeks.

While at the same time, people who had stayed out of the market and had a lot of cash on the sidelines, started looking for bargains among the investments that had been the worst performers over the last few months and whose prices have declined the most. This bottom fishing for oversold investments is a very risky proposition. Investors have jumped into the “oversold” banking stocks on their way down, only to find out that these stocks have had much further to decline. Each rally over the last few months has been met with more selling.



First, how have we weathered the market decline so far?

This chart shows our Conservative and Aggressive models over the last six months. Our goal is to reduce losses during down markets so that when the bottom arrives we still have your assets to reinvest in the rally that will follow.

Economic and Market Outlook

I am going to greatly shorten the nine points in our normal Economic and Market Outlook and reduce it to five.

We feel that the US economy

has not suffered severe damage yet - but it is slowing and could roll into a deeper recession that we have experienced to this date.

1. The Economic slide can't be reversed until the “Credit Crises” finds a bottom.
2. The “Credit Crises” won't find a bottom until the US housing market stabilizes.
3. The US housing market can't stabilize until the inventory of unsold homes (currently running at about a 10 month supply) stops growing and is reduced to a more normal three to four months. That can't happen if we go into recession.
4. In order for the economies of the world to avoid severe damage, the “Credit Crises” which has eroded the balance sheets of major banks around the world has to be stabilized. This morning, UBS announced that it will take a **fresh**

\$19 billion write-down due to additional declines in the value of its mortgage assets and other credit instruments, following an \$18 billion write-down last year.

- The Fed and congress as well as other central banks around the world will have to reduce rates further and continue to be creative in breaking the log jam in the credit markets so people can begin buying homes again. This will take at least one to two years.

The larger the decline in the market and the more pessimistic the attitude of investors, the larger will be the rally that follows. There are now Trillions of dollars of cash setting on the sidelines earning very meager interest rate returns. At some point we will have an explosive rally that will stick. Perhaps it started today. If it persists a few more days and we see some reduction in risk aversion in the credit markets we will join in. Until then, we will remain conservative and will let part of the next few days pass us by. If, as we suspect, it does not stick, we are properly positioned to avoid big losses.

A Short Perspective on Inflation and Commodities

It is very easy to get wrapped up in the day-to-day gyrations of the markets and forget the bigger themes in world economics. The following table points out three things I feel are of importance.

- Inflation is increasing. See the years 2001 through 2004 where the average annual inflation was 1.95%. This is well within the FED's target for the US inflation rate. This was accompanied by a modest price growth in the cost of commodities. It was also a period when the stock market fell an average of 4.01% per year while our Aggressive Model grew by 6.01% per year.
- The years 2004 through 2008 had increased inflation and the average annual growth in the price of commodities grew at 16.90% annually. The S&P 500 grew but our models grew faster.

	CNPI- Annual Inflation Rate	Average Annual Inflation Rate CNPI	Average Annual Growth in the Price of Commodities CRBI	Average Annual Growth in SP-500	Average Annual Growth in MLKA
2000	+3.39				
2001	+1.55	+1.95% Avg.	+3.89% Avg.	-4.09%	+6.01% Avg.
2002	+2.38				
2003	+1.88				
2004	+3.26				
2005	+3.42	+3.32% Avg.	+16.90% Avg.	+6.11%	8.96% Avg.
2006	+2.54				
2007	+4.08				
2008	+3.39				

Current Portfolio Holdings

I have said in the past that it is much easier to make money in an up-market or a down-market than it is in a market that just bounces sideways. We are now in a down-market. Remember, as bad as the markets are, we have continued to make money! We continue to hold long positions in Commodities. We have temporarily discontinued our holdings in Emerging markets, a BRIC fund (Brazil, Russia, India and China). Because we are in a strong down-market we have hedged these long holdings with counter balancing short positions (things that go up when the market goes down). That combination reduces volatility, holds your money together and has been profitable while the markets are going down.

The legal process of forming our own mutual fund is still progressing nicely. Our fund should be available sometime during the second quarter of the year. We think it will be a win-win arrangement for our clients.

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This letter is published periodically with my views on the market, investing and things that seem important to me at the time. Remember, all of this is filtered through 45 plus years of experience including a fair amount of both “Good Judgment” and “Bad Judgment”. Please feel free to share this with anyone you think might be interested. If someone would like to be put on the list just send me an email with his or her email address. You can reach me at:

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