



K E R N S

CAPITAL MANAGEMENT, INC.

Kerns Capital Management Market Report

August 3, 2009

Clients and Friends,

An old factoid says that the most learned scientists and aerodynamic experts have concluded it is impossible for a bumblebee to fly. But, the bumblebee does not know that so it just keeps buzzing along.

Similarly, despite evidence that the rally from the March '09 market low has not conformed to the normal characteristics of a new bull market, the major price indexes have just kept advancing to new rally highs.

The difference is that scientists are dealing with absolutes while the stock market deals with probabilities. This is the first time in 76 years in which a five-month rally has occurred on diminishing volume - a very low probability event.

What are the reasons this is happening? We will discuss what we think is happening and how we are tailoring our investments to take advantage of events.



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In the July 15th newsletter, I said, "It will be a few more days before we know whether a continuation of the March uptrend will occur or whether the last three days are just a blip based on positive news releases." Now we have the answer. The rally continued and there are solid reasons why.

- European, Asian and U.S. equities have reached their highest levels of 2009 on relief that the majority of corporate earnings reports had exceeded expectations.

As of today, Bloomberg reports that 336 of the S&P 500 companies have reported earnings. Of those, 264, or 78%, have surprised to the upside! Granted, expectations were very low and because of that, stock market prices were low. Expectations more than reality move the market. The market did not expect much and was surprised so it is moving up.

- Tentative signs of stabilization in the US housing and labor markets and positive economic reports elsewhere have added to the bullish mood surrounding risk assets.
- Recent gains in global equities are only partly about improving fundamentals. Much is the result of money coming off the sidelines because safer assets have extremely low returns. A lot of money is still on the sidelines and people are chasing the rally right now, so we could see it continue.
- Existing home sales rose 3.6% in June, their 3rd straight gain, to the best levels since October. Two reports show home prices have also bottomed. Homeowner vacancies also fell in the second quarter.

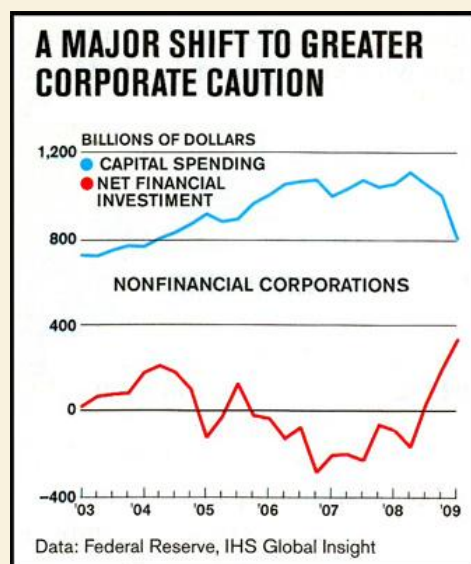
China remains a global driver and market for our products.

China's economy accounts for most of the world's current growth. According to Barclays Capital, Chinese gross domestic product grew at a an annual rate of 14.6% in the second quarter. Including China, global growth was 1.6%. Without China, global growth was flat to slightly down.

Jim Cramer says that "there is always a bull market somewhere". China's stock market has certainly been one and it has created many investment opportunities elsewhere. One of those markets is in commodities, a subject we will discuss in the next section.

Riding the Economic Cycle

We are experiencing the worst job market and unemployment in 25 years, so how can things be good? Once again, let me distinguish between the stock market and the economy. The stock market rises and falls on expectations of earnings and growth. If you wait on the reality of an economic recovery, you will have missed out on the first six to eight months of the market recovery.



All of the positive signs mentioned in the prior section are signs of an impending economic recovery.

The chart at the left shows the result of the economic recession in the US. As they should, good corporate management has cut back on spending and started strengthening their balance sheets.

According to **BusinessWeek**, "Although earnings are down, spending cuts mean non-financial businesses are able to finance all of their current capital outlays with the funds generated by their businesses without the need to tap the credit markets. Internal funds, which are similar to cash flow, are up 4.9% from a year ago, and in the first quarter they

exceeded capital expenditures by \$90 billion, a wide margin by historical standards."

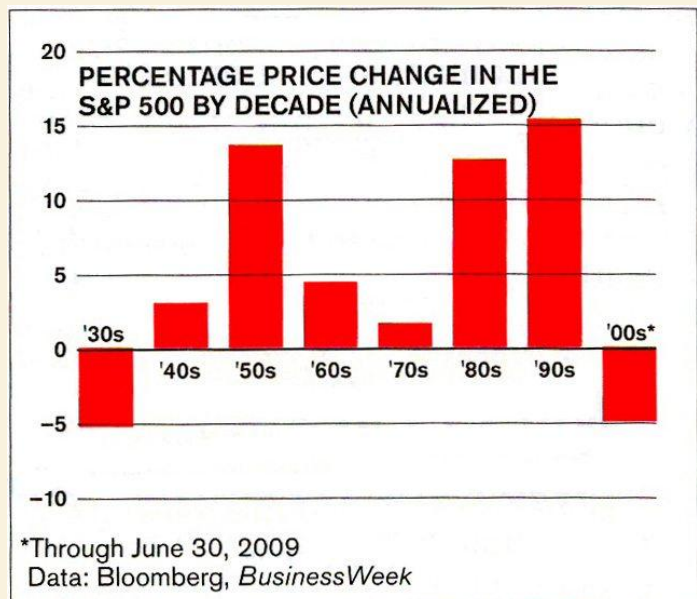
Since the inception of our mutual fund KCMTX, we have only added companies to our holdings which demonstrated that they could generate positive cash flow. These holdings have performed much better than the markets.

The Dreary Decade

The following section is from the July 13 & 20 issue of **BusinessWeek**. I think it demonstrates the folly of being a Buy-and-Hold investor and validates the need for more active management of your portfolio.

"There are still six months left in this decade, but it may not be too soon to start drafting its obituary.

And a look at the numbers shows that investors calling the 10 years "lost" may have understated the case. As of June 30, the Standard and Poors 500-stock index was down 37% or 5% a year from its Dec. 31, 1999 close of 1,469.25. So it would take quite a rally just to breakeven for the decade: the index would have to climb 60% by Dec. 31, 2009. The last such negative decade? The dreadful 1930s, which suffered a 42% cumulative stock market loss. Factor in dividends, says Howard Greenblat, a senior index analyst at S&P, and the "aughts" - the 2000 through 2009 - look even worse. In the '30s, dividends turned the decade's 5% average annual drop into a positive return of 1% a year. That return for the '00s: So far it's -3%. **David Henry and Tara Kalwarski**



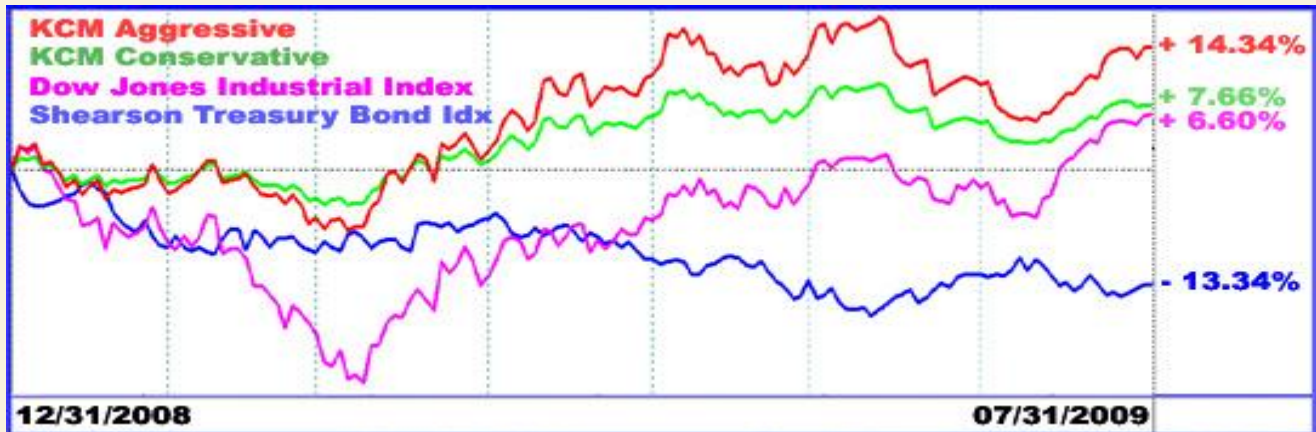
KCM Aggressive Model during the same period was up 36.64% (including dividends) rather than down 25.94% (including dividends) for an annual return difference of 6.47% per year after fees and expenses.

How Are We Doing?

Below is a chart showing our Aggressive and Conservative Models compared to the Dow Jones Industrial Index (including dividends) and the Shearson Treasury Bond Index year-to-date. We are outperforming both for the year, and even though we had a great July, the markets did catch up with us a bit during the last three months.

While I would have liked to have participated more fully, the same risk management perspective that allowed us to miss most of the bear market decline that began in October 2007 caused us to move to a more conservative posture shortly before the market headed higher. We are now back in sync with the market.

KCM VS. THE MARKET (YTD)



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

[KCM Macro Trends Fund](#)

Our mutual fund - KCM Macro Trends Fund (KCMTX) - continues to grow both from investment gains and deposits from clients and new investors. The fund's assets have grown more than \$20 million since the first of the year.

We have added a [new chart of interest to our website - Contrarian Value Strategies](#). It shows the historical performance of buying stocks with low price to earnings ratios over other types of stocks. [This is the approach we are currently following in KCMTX](#). [It is very enlightening and I encourage you to take a couple of minutes to study it!](#)

The fund is open exclusively to our Clients, Advisors and Institutional Investors. It is now available through Fidelity as well as Charles Schwab, TD Ameritrade, Pershing, Southwest Securities and Trust Company of America. Our Aggressive Model is invested 100% in KCMTX.

For more information go to www.KernsCapital.com

[In Closing](#)

Bumblebees do fly and the market is still rising. The positive signs that have unfolded since our last letter tell the story. I still expect that there will be some pullback into the fall with a major rally from there into the end of the year. Whatever happens, we will react accordingly to protect and grow your money.

We have an exciting announcement to make. [David Land, an investment analyst with several years of experience, joined our firm starting today](#). David brings skill sets that will greatly enhance our ability to care for client's money. Welcome David. We will have his biography on the website soon.

School starts soon. Where has the year gone?

Enjoy the balance of your summer.

Lane Kerns

[Website](#)

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.

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. 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.