



# K E R N S

## CAPITAL MANAGEMENT, INC.

### Kerns Capital Management Market Report

August 17, 2009

Clients and Friends,

For the last several months we have witnessed an amazing rally. Many who were sitting on the sidelines have begun to reenter the market.

The rally has continued in the face of an economy that has not fully recovered and may take a lot of time to do so. There is an old saying that "Markets climb a wall of worry" and that is what has been happening.

If all we had were green lights and everyone thought the market was going up, there would not be any cash or buyers on the sidelines to continue the upward pressure in the markets. This has been the sweet-spot in the economic cycle as far as the markets are concerned.

There will be some bumps in the road - but I (we) feel that the market will finish the year higher. Read on, I think you will find it interesting.



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### What a Rally!

Throughout this quarter's corporate earnings reporting season, the market has marched steadily higher. The rally from the March 9th bottom has exceeded almost everyone's expectations. The chart below shows just how powerful this rally has been and the amount of gains missed by not being invested.

## S&P 500

% growth, 105 days after start of bull market

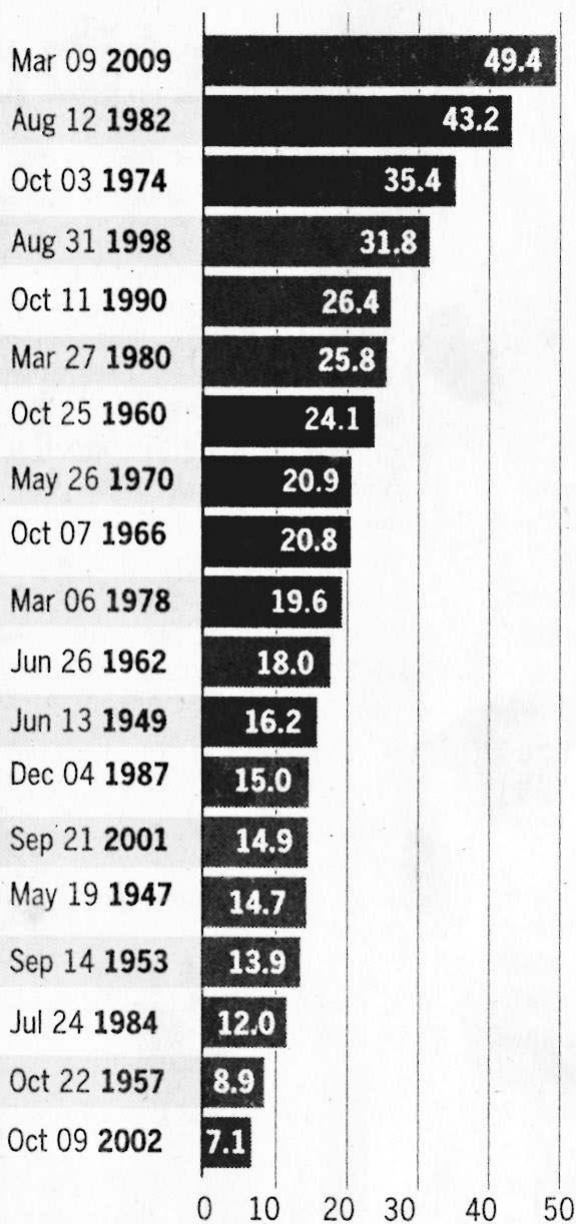


Photo: Bloomberg

Source: Mizuho Securities

The 105 days since the March 9th bottom has yielded a rally of 49.4%!

There are several points to make about this chart.

1. It is the best post-WWII market rally ever.
2. It eclipses the 43% rally reached 105 trading days after the lows of August 1982.
3. Investors in other established economies have also enjoyed big rallies from their March lows. Japan is up 50%, London's FTSE Eurofirst 300 as much as 45%, Hong Kong up 85% and Brazil has rallied 56%.
4. The S&P's rise is more than double the average 22% gain seen during the first 105 days of a post war bull run.
5. The S&P 500 Index is now up 12.97% for the year (including dividends) but still has 35% to go to get back to its record high in October 2007. KCMTX and our Aggressive model are both up 16.20% YTD.
6. The rally started from a severely oversold position based on improving economic news and investors who were not participating began chasing the rally, forcing the market higher.

I think it is appropriate here to point out something that almost always happens in a recession-driven bear market. Investors who either did not pay attention to their portfolios or who thought they were buy-and hold investors rode the market down (in this case, the S&P declined 55.31% from its October 2007 highs) only to bail out near the bottom. After a decline of that size, an investor who bailed out at exactly the bottom would have to earn 123.7% on their remaining money just to get back to break even!

These points are supported by the chief investment strategist at Mizuho Securities who was quoted in the Financial Times as saying that equity inflows since the March bottom total \$47.3 billion, less than the \$60 billion liquidated in the 3 weeks prior to the bottom. Estimates are that there is approximately \$3.5 Trillion (yes, trillion with a T) of uninvested capital worldwide setting on the sidelines. What kind of a market rise will that create when it starts coming back into the market??!

More people got out of the market just prior to the market bottom than have returned to the market since the rally started! This is the worst of both worlds. Not only did they take the big loss - they have missed the big gain. This is why we preach risk management. As you will see in the section below, we did not take the big loss and did benefit from the majority of the gain since the bottom.

## Danger Ahead?

There are too many good pieces of economic news surfacing to think that the market will not be higher between now and the end of the year. While our crystal ball is never crystal clear, there are a number of reasons to use caution for the next few weeks.

- A summer pullback usually follows a summer rally.
- September is historically the weakest month of the year.
- Most of the few really bad things that have happened in the market have happened in October.
- After a run like we have had, the market is no longer grossly under-priced like it was earlier this year. It may need time to digest its gains.

I am not predicting bad things to happen, but I would not be surprised to see a modest 5-10% pullback prior to a strong rally into the end of the year. If we do not handle your investments, I would suggest setting stop-losses so that a big drop in the market does not surprise you.

One advantage to our form of risk management is that while we need to expose ourselves to some risk to get the advantages of big market gains, we have missed the majority of major market downturns - as you will see in the next section.

## How Are We Doing?

I changed our normal performance chart to emphasize several points.

- On the five year chart below, I added a line for corporate bonds. The line is a composite of all 176 corporate bond funds from the Investor's FastTrack database.

The point is that all of our equity models have outperformed both corporate bonds and the S&P 500 over the five year period ending August 14, 2009! It is not a matter of either bonds or stocks being good or bad - we have outperformed both. Why? Because we use a combination of risk-management and equity selection that has consistently outperformed buy-and-hold investing over full market cycles.

- Notice the shaded area on the chart. This is the period from the October 9, 2007 top in the S&P 500 and the March 9th, 2009 bottom. During that time, our models declined, but bonds did not offer the safety that most people have been led to expect. During that period, declines were as follows:
  - S&P 500 - Down 55.31% (including adding back dividends.)
  - Aggressive - Down 23.46%
  - Corporate Bond Average - Down 22.63%
  - Conservative - Down 14.63%

As you can see on the chart, our Aggressive model outperformed the S&P 500 (with dividends) 48.7% to 3.06% - more than 45%. On a million dollar portfolio, that would equal \$450,000!

Our Aggressive and Conservative models also outperformed the corporate bond average significantly. Since most buy-and-hold investors using Strategic Asset Allocation use a combination of stock, bonds and cash, and we have outperformed all three; our active tactical trading strategy with risk-management must be adding value.

## KCM VS. THE MARKET (Five Years)



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 \$28 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. The chart 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](http://www.KernsCapital.com)

## In Closing

The market is due for a consolidation. That is another way of saying that it needs to either go sideways or pull back slightly to digest the significant gains it has had since March. Positive signs continue to unfold - but the damage to the US and world economies was great and recovery will take time.

This is a time of opportunity to add companies to our portfolios that have pulled back to undervalued prices. We look at modest pullbacks as buying opportunities and bigger pullbacks as hedging opportunities. While we do not like the bigger pullbacks our investment strategy allows us to take defensive action. This gives us the opportunity to avoid big losses.

Our investment team continues to mature. It now consists of David Land, Marty Kerns, Stan Ehrlich and I. Our support staff is magnificent. Visit our website for biographies.

Enjoy the balance of your summer.

Lane Kerns

## Website

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.

### **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.