

January 2, 2008

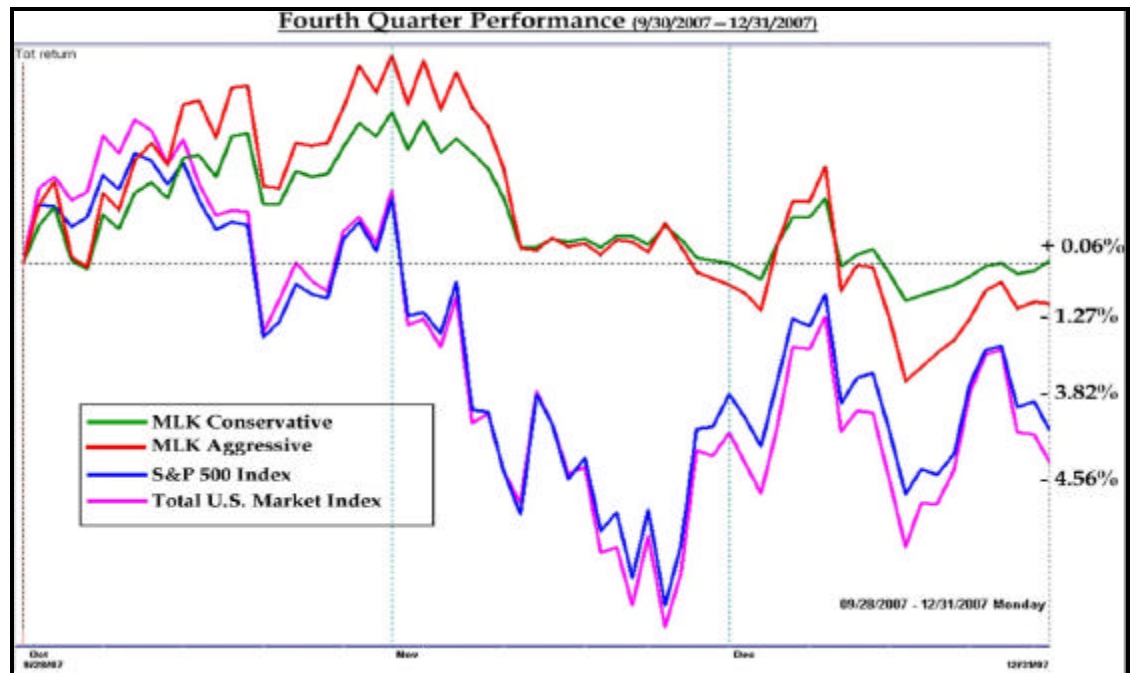
To: Friends and Clients of MLK Capital Management
From: Lane Kerns

Re: Fourth Quarter 2007 Was Very Interesting!
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Fourth Quarter 2007 Was Very Interesting!

It was interesting because stocks fell in the 4th quarter – the first time that has happened in ten years – which raises questions as to whether stocks have further to fall. We have positioned ourselves to “not get hurt” in case they do fall further while leaving room to make some profits either way. As always, our first concern is to “not lose any big money.”

Let’s look at the last three months of 2007 on the following chart. The S&P 500 (blue line) and a combination of US market indexes (magenta line) were both down in the 4th quarter. What we are calling Total US Market is a combination consisting of 1/4th each of the S&P 500, DJ30 Industrials, the Russell 2000 and the Value Line Arithmetic averages. This gives a very good look at the broad stock market because it consists of two large company indexes and two broad small company indexes.



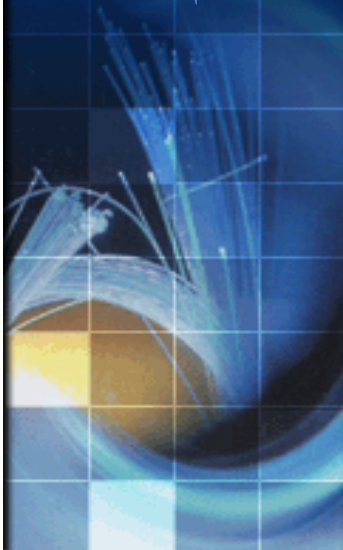
Our equity models performed substantially better. The composite return of all our Conservative accounts at Schwab was UP 0.06%. Moderate and Conservative accounts came in at down .50% and 1.00% respectively – both with no significant damage!

I think that when we get a few months down the road, we may look back and say that mid-October 2007 was the beginning of a Bear market.

Volatility

Between 2003 and the first half of 2007, investors were bolstered by predictability on several fronts. Earnings growth averaged more than 10% on a year-over-year basis for 14 consecutive

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quarters, according to Thompson Financial, ending in the first quarter of 2007. The economy grew at least 1% for 16 consecutive quarters between 2003 and 2006, the fourth longest stretch since the Bureau of Economic Statistics started recording data in 1948.

The stock market benefitted from this but it may be gone for a while.

Since July 1, 2007 the Dow Jones Industrial Average experienced 50 days with at least a 100-point move in the index, compared to just 21 days in the first half of 2007. Confirmed rallies ended abruptly as did corrections. And the market got hit by some nasty surprises. One was crude oil – which today hit \$100 per barrel. The other was the subprime mortgage crises.

Perhaps investors just have the jitters and are over-reacting but we will take a very cautious approach to the market until a firm market direction reveals itself more clearly. I think it is important to point out that in every bear market (if one has started) things become very over-sold. This inevitably creates a money-making opportunity in the form of a long rally. Over the last 50 years, the average Bear Market has lasted only 1/4th as long as the Bull markets that followed! I would remind investors that our models did quite well during the 2001 through March of 2003 bear market.

Economic and Market Outlook

I have been writing that “There is a ‘theme’ or ‘underlying dynamic’ at work in the market place. It goes this way – interest rates are down and the market believes more US rate cuts are coming. Lower rates almost always push up the stock market, but inflation is now more likely. Therefore, the way to make money is to invest in those things that benefit from an inflationary environment. Those things are commodities, which include oil and materials and the countries that produce them. An additional dynamic is the falling dollar in which we will discuss below.”

The first part of that theme is still intact: Additional FED rate cuts are back on the table as the economy slows and the economy weakens. Remember, the thing that makes the FED hesitate to lower rates is inflation. Inflation in the US is uncertain. What is not uncertain is the slowing economy. The FED will lower rates more – probably this month.

The prices of commodities which appeared to be moderating are heating up again! As that happens, they continue to be a good investment. We have a significant position in a commodities fund. As I write this letter, the market is down about 1.5% for the day but commodities are UP about 1.00%!

While it is likely that even with a slowing US economy there may not be weakening demand for commodities. China dropped its import tax on metals thereby making demand for commodities rise with Chinese manufacturers. As I said earlier, oil futures hit \$100 per barrel today. What is significant about \$100 oil is it is happening on a day when weak US economic data has been released. I interpret that to mean that there could easily be fundamental shortages worldwide with the slightest disruption in supply.

So, let us again revisit the fundamentals. These combined factors have proven to be a good yardstick for how investors should view market opportunity and risk.

1. Corporate earnings: Corporate earnings have softened substantially. This is putting a brake on stock prices with the exception of some of the larger technology companies which have growing exports worldwide.
 2. Personal income: Personal income growth has slowed and unemployment claims are slightly higher. *Unemployment is still very low by historical standards.*
 3. Inflation: The year-over-year core rate of inflation is 1.9%. That is well within the Fed’s comfort range of 1-2%. The problem is that the ‘core’ rate does not include oil or food. Oil and food prices are climbing again and the “prices-paid” component of today’s Institute of Supply Management report was surprisingly higher.
 4. Manufacturing Activity: Flat and weakening slightly in spite to strong export activity. The Institute for Supply Management reports that its manufacturing index fell to 47.7 percent for December from 50.8 percent in November, which raises concerns that the economy could be slowing at a quicker pace than some investors had estimated. A reading below 50 signals economic contraction, whereas readings over 50 indicate expansion.
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5. *The world economies remain very strong!* Globally, Asian economic statistics (with the exception of Japan) continue to surprise to the upside. China, India and Emerging Markets are strongly outpacing the growth of the US economy. Europe is showing strength but is slowing and Japan has weakened significantly.
6. *Dollar Weakness:* After a slight strengthening of the dollar last month the downtrend in the value of the dollar has resumed. I predicted last month that the strength might be short lived and it was. This is one reason oil and commodities prices have jumped.
7. *Oil Commodities:* We talked about these earlier. Almost everything is costing more. We are heavily weighted to take advantage of the trend.
8. *World Liquidity:* With the freezing of the credit markets in August, liquidity temporarily dried up but is slowly thawing. This could help re-stimulate the stock market and the economy but it will take a few months for it to show.
9. *Housing and Subprime Mortgages and Mortgage Defaults:* Housing is getting worse faster. New home construction has dropped to its lowest rate in years and home prices actually fell last year. There continues to be a sharp drop in home building and an increase in mortgage defaults.

In our opinion, the reasons for optimism remain balanced with a slight negative bias. While the tightening of credit occurred at an alarming rate and all of the fallout will not be evident for another few months, deposits to money market funds, government bonds and treasury bills sky-rocketed. That can be very bullish because it creates a huge pool of money available to flow back into the markets!

Current Portfolio Holdings

We hold long positions in Commodities, an Emerging market fund which invests in the most rapidly growing economies in the world (Brazil, Russia, India and China) and have moved a significant portion of our holdings to a fund that we expect to hold long-term (the CGM Focus fund). Due to the uncertain direction of the market, we hold balancing short positions with the objective of making some money whichever way the market moves.

We have started the legal process of forming our own mutual fund to both take better advantage of the new global market environment and lower our client fees at the same time. That fund should be available sometime during the second quarter of the year. We think it will be a win-win arrangement for our clients.

A Positive Dream Comes From a Very Sad Situation

One cannot open a newspaper or watch a newscast without being aware of the turmoil in the world. America was founded on a dream and that dream – however many setbacks it has had – has produced a place for its citizens to live that is desired by almost everyone in the world. Many have died to preserve that dream.

Last week, many of you saw in the news that Benazir Bhutto, one of the political candidates in Pakistan was assassinated. She had a dream for Pakistan and the world. My heart was filled with hope and my eyes with tears when I read the following words she said on the morning she was assassinated.

“The new generation will choose moderation or extremism; it will choose education or illiteracy; it will choose dictatorship or democracy; it will choose tolerance or bigotry; and it will choose peace or war.”

She returned to Pakistan to fight for all the positive choices presented. Let us hope more potential leaders with her clarity of purpose emerge throughout the world.

In America, no matter what our other problems, we benefit from moderation, free education, democracy, tolerance like no other country and a desire for world peace (though sometimes we have to fight to preserve it). I can think of no better New Year’s dream than that of seeing her dream come closer to reality.

Happy New Year
Lane Kerns

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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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