



Kerns Capital Management Market Report

October 1, 2008

Anyone who is paying the slightest bit of attention to our economy can't fail to be concerned about their money - whether it be invested in banks, money market funds, bonds or the stock market.

I will deal with each in order and talk about the opportunities being created.



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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 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.

We will be adding a "Client Site" very soon where our clients will find additional portfolio views, market insight, and some cutting-edge features, such as Account Aggregation, that you won't get with many big brokerage firms. More shortly!

"Worldwide Meltdown of the Financial System Avoided" ???

When I want to talk about controversial items, I find it better to quote other people than to go on a rant, so I will start with a few quotes:

From yesterday's Financial Times (FT) about the failure of the US House to pass the Financial Rescue package on Monday: "This was politics as high drama and incredible irresponsible stewardship of government . . . We are losing a bank a day and that can only have a negative impact on the real economy."

Warren Buffett today on CNBC. The Rescue plan "is designed to help the American economy from going into the ultimate tailspin. . . We have experienced an economic Pearl Harbor. . . We have terrible, terrible, terrible problems but that has created incredible opportunities!"

In order to take advantage of these opportunities, we must emerge with as little damage as possible to our portfolios.

The markets have been driven by news and speculation about what Washington will do (or not do) with the proposed \$700 billion rescue plan. The level of meddling in the markets is unprecedented so there is no basis for even an educated guess. Most active investors have moved to the sidelines and are in no hurry to get back into what many consider a rigged game right now.

We moved to the sidelines some time ago with 82 to 100% of our managed assets now in Money Market funds.

In the last 10 days, the crisis has grown to the point where even regular Money Market funds are in question. We saw this coming and you may remember that several months ago we switched to using only Money Market funds that invest in US Government Treasury securities. These are better than FDIC insured bank accounts because they are not limited to \$100,000 of government backing. In order for them to fail, the US government would have to fail.

Last letter I described the loss of three of the five major US investment banks and indicated that "Only Goldman and Morgan Stanley remain ... and no one is sure how healthy they are." Now there are none!

In the last two weeks, in order to survive, both Goldman and Morgan had to obtain approval to become regular bank holding companies. This puts them under the supervision of US banking regulators and forever changes their ability to provide

some of the services they were providing at the level they were providing them.

Also from the last letter - "Credit will be tighter because there is less money in the system. Credit must be priced higher, credit spreads will be higher, Price/Earnings ratios of stocks must fall and the market will be punished starting today. Books will be written and we are living through it."

There aren't enough pages just to quote the negative headlines of the major financial papers. Suffice it to say, we are in defensive mode.

Outlook

The most any of the major indexes have declined is around 25%. That is not even a typical Bear market. The average Bear market since 1970 has declined 32%. I guess the good news is that we are almost there. Sizable declines of this size are always followed by strong rallies.

If the \$700 billion rescue plan gets passed in some workable form, it may stop the decline here. However, the severity of the problems that we are experiencing in this Bear suggests that the world economy will slow ... and a rally will have a hard time going very far without retreating to lower lows.

I know that readers don't want to hear this kind of news so please don't kill the messenger. The good news is that we are 82 to 100% out of the market.

More good news is that the 4th quarter is historically the strongest quarter of the year! Year-end rallies usually follow a summer bottom in late September to mid-October. While I have no way of knowing for sure, a plausible scenario is that the markets take some additional beating until the credit markets begin functioning again and then we get a very strong rally into the end of the year.

Until we see strong evidence that a rally has started we will stay on the sidelines. Whenever the market cycle does turn, my guess is that it will yield a 25 to 40% return.

So far this year, I have been wrong about bonds. I have felt that with strong inflation pressures, interest rates would rise and bonds would fall in price.

What has actually happened for most of the year is a flood of money out of equities and into Treasury bonds for safety. This flood has lowered - not raised interest rates - in spite of inflation pressures. My feeling is still that rates will rise even with a global slowdown because of the hundreds of billions of dollars being pumped into economies worldwide. This should fan the flames of inflation so we do not have a positive outlook on bonds.

Current Investments

Our investment discipline has progressively taken us out of the market. The fund is currently 82% in cash. Although it is our objective to be fully invested in equities, we wrote the fund prospectus with the ability to be up to 100% in cash to avoid losses.

Most of the money we manage in 401(k) plans has been 100% in Government Money Market for weeks so they have not suffered from the market downturn.

We continue to build a watch-list of potential purchases for when the market bottoms. We think declining stock prices are creating great buying opportunities. Most people wait until the bottom to sell and throw in the towel. When that mass capitulating happens, it is time to back up the truck and start purchasing the oversold stocks.

A Bit of Humor

If you had purchased \$1,000 of Delta Airlines stock one year ago, you would have \$49 left. With Fannie Mae, you would have \$2.50 left of the original \$1,000. With AIG, you would have less than \$15 left. But, if you had purchased \$1,000 worth of beer one year ago, drunk all of the beer, then turned in the cans for the aluminum recycling REFUND, you would have \$214 cash. Some might say, the best current investment advice is to drink heavily and recycle.

Sincerely,

Lane Kerns

All information, data, and contents are obtained from sources believed to be correct, but reliability cannot be guaranteed. Performance information is historical in nature and is not a guarantee of future performance. Actual performance will be different and may be less. Losses could occur. Time periods may reflect a trend in rising or falling stock prices which may not be sustained in the future. 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®. See separate ADV Brochure for more detail.