

MLK CAPITAL
MANAGEMENT, INC.

ADVICE ON THE MARKET



October 2, 2006

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

Re: Five Year Highs – Whoopee!?
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Five Year Highs – Whoopee!?

We have seen a lot over the last couple of weeks about the S&P 500 being at a five-year high and the Dow being close to making an all time high (where it was 6 ½ years ago).

While it is great that things have been up – let’s put that into perspective. If you bought an S&P Index fund 5 years ago, your investment has earned exactly nothing! That is because of the huge losses you would have incurred in 2001 & 2002. Since 12/31/2000, the S&P 500 is up a total of 8.65% through the end of this August. By contrast our models over the same period are up from 52% to 63%! Risk Management!

To Quote Mark Twain

(This is just a cautionary note – not where I think the market is going.) In the last 110 years there have only been three time periods where the S&P 500 has gone three years without a 10% correction. 1965-1968 and then a 24% correction, 1985-1987 “Black Monday”, 24% in one day. The next was 1997-2000: 2000 –11%, 2001 –9%, and 2002 – 22%. The next period is right now. Mark Twain once said “I don’t know if history is going to repeat itself, but it is starting to rhyme an awful lot”.

Our conservatism has served us well over the last few years – but not this year. Someone with no sense of history (translate that to mean no fear) would have done better than we have done this year. We feel that over the long run, as in the past, experience will pay off.

Battle of The Titans

Is Wall Street lining up to have a clash of the Titans? There seems to be a serious disagreement between the equity and the bond markets over US economic prospects. Much of what follows is our thinking interspersed with a line of thought that was very well summarized in the Financial Times this weekend. “With the markets setting in opposite corners of the ring, so the story goes, one will emerge with a bloody nose.”

Most people think that both Bonds and Stocks can’t go up at the same time – that one will have to suffer. Most of the time that is true but at certain points in the economic cycle they do move in tandem.

It is fairly common for bonds to rise in value (and for yields to fall) while equities are strong. After all, declining Treasury interest rates make corporate dividends and cash flows relatively more attractive. Falling Treasury yields also loosen financial conditions and stimulate economic activity.

It makes even more sense when you take into account the tough time stocks had earlier in the year while earnings continued rising strongly. Then investors were fretting about high oil prices, (which have declined 20% since then), inflation (which has weakened enough

for the Fed to stop raising interest rates), and housing (which may be finding a bottom well above the bottom many have predicted). All of this is positive for stocks.

Over the past three months, the 10-year Treasury yield has fallen from 5.25% to around 4.60% - far below short-term rates. A popular interpretation of this is that investors fear a property slump will wreak havoc on the US economy thus a slowing down the world economy. We disagree with that approach and think the lower interest rates will slow the decline in the housing markets as rates stay low.

Normally when interest rates decline, it is a sign of a weakening economy and the US dollar declines sharply because foreign investors find it less attractive to invest in our Treasury market. That is not happening. The dollar is remarkably stable. That is telling us that there is a high level of confidence that the economy will have a soft landing.

“Global equity markets extended their rallies from May lows last week, buoyed by rising hopes of a soft landing in the US, potentially delivering an equity friendly mix of lower interest rates and still decent growth, and rising confidence that the rest of the world will not be derailed by a modest US slowdown.” “The performance of world markets has been stunningly good.” “The markets have priced in a soft-landing scenario for profits, the US economy and global monetary policy.”

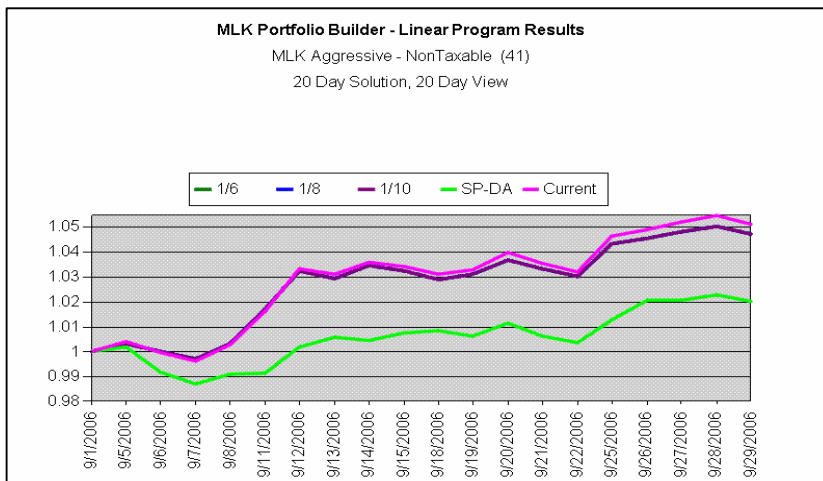
Investors are busy putting money back into the equity markets as appetite for risk has returned – thus unwinding the high cash levels seen at the time of the May sell-off. We have been more cautious – to our detriment.

We said in our September 1st letter that we thought the market was going up and the economy would have a soft landing. We gave 10 reasons why. (*You can see past newsletters on either of our websites.*)

Virtually everything we outlined is coming to pass. In fact it has come to pass much quicker than we expected. Hence our very conservative approach during September.

Our View

I have included a chart below that shows what our current holdings in Aggressive have done over the last 20 days compared to the S&P 500. (*We have not held these the full 20 days.*)



The Current (Pink) Line is our Aggressive model and the Green line is the S&P 500. The significant thing about this allocation is that it has had only a 0.87% drawdown over the last 20 days while growing by 4.84%. That compares to the S&P which has had 1.45% drawdown while growing only 2.03%.

What these holdings have done the last 20 days is no guarantee of what they will do in the future, but things that are in motion tend to stay in motion and the relationships to each other do not change rapidly. If the dynamics of the market change quickly, these may change – but so

will anything else you may hold.

The advantage to this approach is that we can dial in a fairly predictable risk limitation (drawdown) and capture returns of the best sectors of the market while maintaining that risk control. When we have a high degree of confidence that the general direction of the market is up, we will loosen up the risk management and let the best performing sectors run.

Managed Account Performance versus Market Indices

PERIOD ENDING 9/30/2006	PERFORMANCE					RISK	
	One Month	Last 12 Months	Since 12/31/03 Annualized	3 Years Annualized	5 Years Annualized	3 Yr. Standard	5 Yr. Deviation
Equity							
Dow Jones Industrials	2.80%	13.30%	7.19%	10.49%	8.10%	8.45%	13.07%
NASDAQ	3.42%	5.78%	5.24%	8.40%	8.72%	13.55%	20.44%
S & P 500	2.60%	11.08%	9.87%	12.38%	7.02%	7.68%	12.72%
MLK Conservative Growth	-0.03%	-0.14%	11.75%	13.47%	11.42%	9.58%	8.36%
MLK Cons. Growth Margin	-0.07%	-4.04%	11.63%	N/A	N/A	N/A	N/A
MLK Moderate Growth	0.56%	-0.10%	11.74%	11.74%	10.64%	11.69%	10.48%
MLK Moderate Growth Margin	0.33%	-2.75%	12.20%	N/A	N/A	N/A	N/A
MLK Aggressive Growth	-0.06%	-0.87%	13.83%	15.18%	10.92%	11.99%	10.97%
MLK Aggressive Growth Margin	-0.25%	-6.44%	12.78%	N/A	N/A	N/A	N/A
INCOME							
LB 1-3 Yr. Govt. Bond	0.16%	2.47%	1.93%	1.66%	2.71%	1.20%	1.53%
3 Month T-bill	0.48%	4.78%	3.41%	2.92%	2.35%	0.44%	0.40%
MLK Stable Value	0.49%	3.76%	6.74%	6.44%	5.11%	3.13%	2.83%

The above fund 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 in all funds. Time periods may reflect a trend in rising or falling stock prices which may not be sustained in the future. MLK Capital Management, Inc. ("MLK") performance figures are after the deduction of MLK's actual management fee and include reinvestment of dividends and earnings on accounts held at Charles Schwab & Co., Inc. MLK performance figures represent a composite of all individual portfolios managed in accordance with each investment category. ¹ Standard Deviation is a measurement of risk and smaller numbers indicate less volatility or risk.

Current Portfolio Holdings

Last Thursday we realigned all our models to pick up the current strong market segments and hedged them to a risk level we are comfortable with. We have dialed in a drawdown factor of 1/10th of 1% per day as the risk level we are willing to accept in the Conservative models. Based upon this you should not be surprised to see your portfolio go down on any day by 1/10th of 1%.

It is impossible to beat the market by being invested in a portfolio that duplicates the market. Therefore, minor drawdowns could occur both on down market days or up market days. We do not attempt to be correlated with the market – we attempt to control risk while leaving ourselves the opportunity to outperform the market. Moderate is currently set to allow a 2/10th of 1% daily drawdown and Aggressive 3/10^{ths} of 1%. More risk tends to allow greater upside performance.

Another New Associate – Last month I introduced James Salter who joined MLK Capital Management three months ago. This month I would like to introduce Sayure Bailey who recently graduated from the University of Houston with a BS degree in Information Technology. She will be a full-time programmer assisting Mark Ellender and Dr. Cackowski in the development of our investment analysis and trading systems. She is a native of Brazil and is fluent in English, Portuguese, and is currently improving her Spanish. It's nice to be surrounded by smart people.

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401(k) Investment Advice

If you are managing your own money, www.401k-Investment-Advice.com would have told you that it was time to become more aggressive or when to go to more conservative holdings - also what funds to buy. It gives you a view of Current Market conditions by going to "Current Market Conditions". It gives users the tools that we use in managing client portfolios. Check it out. Once you log in, go to Investment Advice – Actively Manage. Or, if you prefer not to do it yourself, we can manage your account for you. If your company does not sponsor it, or you are not a member, contact us at MLKCM@MLKerns.com. If we do not already do so, we can manage your 401(k) account – as well as your personal and IRA investments.

MLK Capital Management, Inc. is a fee based investment advisor. Our income can not grow unless our assets under management grow. We do not make money by trading client's accounts. When we make a trade, it is to keep the account from losing money or to put it in a position to grow more. The success of our firm is tied to the success of our client's investment accounts.

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 40 plus years of experience including a fair amount of both "Good Judgment" and "Bad Judgment". Or, as a friend of mine says, we may not be right - but this is our opinion. 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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