



K E R N S

CAPITAL MANAGEMENT, INC.

Kerns Capital Management Market Report

November 3, 2008

During the month of October, investors have experienced the following:

1. The second worst month in market history,
2. The best week in market history,
3. Two of the best and two of the worst days in market history,
4. A day when the US dollar had its greatest fall against a trade-weighted index in more than two decades, and
5. The UK's FTSE 100 (Britain's major stock index) gained 22 percent, in dollar terms, in a little more than two days; and most alarmingly, the S&P 500 fell 5 percent in less than 10 minutes.



I will try to explain in layman's terms what has contributed to the incredibly rough waters we have just passed through and whether there is more rough sailing ahead.

We will also discuss the performance of the market, major investment advisors and our performance both short-term and long-term.

I think you will find it interesting and I will try to be brief and add some value.

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[No Place to Hide](#)

"No Place to Hide" - That was the title of an entire section in this morning's [Wall Street Journal](#). They were talking about the entire year-to-date and October in particular.

If you take the WSJ and did not read the section, I highly recommend you do

so. It compared all major asset classes and how they have performed including Bonds. The WSJ qualified some of the numbers as being preliminary but they should not be off by far.

I have included an abbreviated chart below and added our Conservative and Aggressive Models for comparison. The chart shows all major investment styles for the US markets. We have included 1 month and 5 year performance to give both short and long-term view.

Each category is the average of the Top 10 Best Performing mutual funds in the class. In other words, these are not dogs - just "Best of Class".

	October 2008	5 yr Avg.
Large-Cap Value	-17.0	0.6
Small-Cap Value	-20.6	1.9
Large-Cap Growth	-17.2	-1.6
Small-Cap Growth	-21.0	-1.8
Midcap Value	-21.2	1.3
Midcap Growth	-20.6	-0.4
Short Term U.S. Bond	-0.4	2.8
Long Term U.S. Bond	-1.9	3.0
KCM Aggressive	-2.4	6.3
KCM Conservative	-1.6	6.0

Fund Performance by Category Source:
Wall Street Journal - 11/03/08

It should be obvious to all that this has been a difficult market in which to invest consistently well. The problem is that if an investor wants to accumulate wealth over a long period of time, it must be done with equities. That is a historically proven fact! However, there are times when equities can be your worst enemy and it is better to step aside.

In past letters, I have pointed out that there are six basic parts to the typical market cycle. During phase six of those six parts, all three major asset classes - Stocks, Bonds & Commodities - decline at the

same time. That is the part we are in now. The problem is that there is no red or green light telling an investor when we have entered this or the next phase of the cycle.

So where does one put their money when equities are not behaving in a predictable manner? In our case, mostly in US Treasury Money Market funds.

Most experts now agree that three years ago the economic picture began flashing yellow - indicating a high probability that we were headed into phase six of the cycle - kind of like the caution light in NASCAR racing. We missed some returns for part of that period but as you can tell from the table above and the chart below, we missed the major losses (the crash).

On our website and in our client meetings, we try to point out that it is our objective to miss 75% of the major market down-trends and capture 75% of the major market up-trends. If we are successful in doing that, we will double the performance of the market over the long-term. If one looks at very short periods of time, you can't always see the benefit of our type of active

management. It becomes quite obvious in the longer-term chart below!

The Chart below shows our Conservative and Aggressive portfolios compared to the S&P 500 including reinvested dividends, the Nasdaq and Warren Buffet's Berkshire Hathaway A shares.

The time period is from 12/31/2000 through last week's market bottom.



What you can see is that for the period of almost eight years, a "buy-and-hold" investor of the S&P 500 or Nasdaq indexes would be **down** 26.23% and 39.05% respectively!

Warren did a much better job, **up** 48.05% over that very difficult period of time. We too were **up**, 57.73% and 54.69%, respectively! Our "active management" added value! Note that while Warren spiked above us a couple of times, he has fallen back below our returns at the end of the chart. While the markets are by their nature volatile, Berkshire Hathaway stock has been extremely so over the last year.

[Why Has the Market Sold Off So Violently? \(Update\)](#)

I am using the same topic heading as the letter of 10/15/08 in which I discussed the major flow of events in the banking crises worldwide. While massive intervention by our Treasury department and Federal Reserve banks around the world has started to stabilize the banking system, we have entered an new

phase.

While books will be written about what was done, was not done or what should have been done, there was an unintended consequence that made last month a very bad month for most investors. It involved hedge funds.

Because Hedge Funds have generated exceptional returns in recent years, billions of dollars have flowed into them from pension funds and other large Institutional investors. Their growth has made them a larger and larger factor in the world stock markets.

According to the Financial Times, so-called prime brokers, who provide a range of services to hedge funds, including loaning them money, are imposing tougher conditions on their hedge fund clients and charging them more for financing. This follows the collapse of Lehman Brothers in mid-September, raising fears that more funds will collapse.

These tighter lending standards have arrived with very little warning and mean that a hedge fund would have to put up extra collateral against financing if markets fall further. Or, they can sell down their holdings if they do not have more collateral! Many have had to sell whatever they could sell driving the markets down even more.

As the markets declined, hedge funds that operated on borrowed money were forced to sell assets to satisfy their prime broker lenders. This additional selling created a market that just fell faster and added to the problem. That is why last month turned from just bad into a financial nightmare.

This selling by hedge funds to deleverage may be mostly over. Since most of them are not regulated, no one really knows how much money is really at risk. The selling seems to have slowed and the market had a great rally last week. Let's hope we have seen the bottom.

As soon as the election is over, and we know who will be President and how Congress will be controlled, the markets could go either way. If it looks like we have passed the market bottom, we will begin to pick up some of the great bargains that exist. We just don't want to buy them today if they are going to be a better bargain tomorrow.

A Comment On Taxes

All of our letters have stayed away from political commentary. While the following comes very close to it, I just want our readers to be aware of some facts.

1. The United States has the second highest corporate tax rate in the world.
2. The only other country in the world with higher taxes has a stock market that has declined from 39,000 to less than 9,000 over the last 26 years. Yes, after 26 years of investing, they have earned nothing. Investments in stocks there have been so bad that the only way to have made money was to bet against them. It became much more profitable to invest in

the stocks of more competitive and profitable corporations in other countries. That country is Japan, the second largest economy in the world behind the US.

3. One of the Presidential candidates wants to raise corporate taxes while the other wants to lower them.
4. While there are always many factors that influence markets, do you suppose higher corporate taxes helped the investors of Japan or hurt them?

Most of our readers are investors. Please vote.

Lane Kerns

[P.S. New Website](#)

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.

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