



# K E R N S

## CAPITAL MANAGEMENT, INC.

### Kerns Capital Management Market Report

November 17, 2008

Last week the market finished a highly volatile week with sharp losses after a bleak round of economic data. Hidden within the volatility of the week was a potential "Silver Lining".

That "Silver Lining" has caused us to slightly change our investment strategy.

In this letter, we will discuss what market bottoms look like and how and why we have changed our strategy.

We will also discuss what factors move the markets and how those factors are playing out now.

We think it is time to finally start making some money rather than just playing 100% defense.

This should be an interesting conversation.



#### IN THIS ISSUE

**[The Sun is Trying to Shine](#)**

**[Change in Investment Strategy](#)**

**[New Website](#)**

### [The Sun is Trying to Shine](#)

The economic news has become unrelentingly bad as the recession that started months ago has become obvious to even the most inexperienced investor. But this is not the end of the world. Recessions and market bottoms always look the worst at market bottoms.

I have pointed out many times that while the economy and the markets are related, they seldom move in the same direction at the same time. They are usually disjointed with the market sensing where the economy is going many months before we see it turn. Because of this, there are tradable rallies even in the worst bear markets.

All "Bear Markets" and Recessions of the past have ended followed by profit making opportunities.

There is no question that a dark economic cloud currently hangs over the globe. However, from an investment standpoint, some rays of sunlight are beginning to shine through that merit a slight change in our investment approach.

**The chart below shows the last six months history for the S&P 500.**



The S&P 500 has had a relentless fall of over 36% during the six months the chart shows. When markets finally reach a bottom, it is seldom a V-shaped reversal. Usually the market rallies, then reverses down to "retest" that bottom. Additionally, there is usually a "trading range" established. In the chart above we can see both of these things occurring.

When a bottom occurs, and the market reverses upward, that bottom usually becomes support for the market (marked as S1 on the chart). In other words, it is usually hard for the market to break back down through that prior low. In a similar manner, when the market reaches a top and reverses, that top becomes resistance (marked as R1 on the chart) and is hard for the market to break up through that resistance. When it does, that becomes a new uptrend with risk diminished profit to be made. Until the market breaks above resistance or falls below support, the area between R1 and S1 above have become a trading range.

When the market bounces off of a prior bottom or top, that support or resistance becomes even more firm. Therefore, for technicians of the market, a "Double

Bottom" is a very big deal. A "Double Bottom" is what we see in the chart above. Because this Double Bottom level of support has held, there is potentially less risk of a fall below that level. No guarantee - but the probabilities have improved.

But, on the top-side, the double top will be hard to break up through so this is not the time to throw caution to the wind.

Another positive thing that has not been so obvious is that performance among fundamental stock characteristics has become more predictable. What that means is that certain types of stocks (not necessarily market sectors) that exhibit those characteristics are starting to be more predictable.

What has become somewhat obvious is that up until recently, companies exhibiting high "free cash flow" and/or high dividends have had their stock fall in price along with companies that are under severe financial stress. Therefore, bargains abound.

When these high cash-flow/high dividend stocks were crashing with everything else, we felt the smart thing to do was stand aside and wait until they became even bigger bargains. While we were down slightly during October (1.5% to 2.4%) the S&P 500 was down 16.94%. Those stocks are now being recognized for their value and are being bought on dips by large institutional investors. Therefore, they have begun to outperforming the market.

The fact that the markets have retested their October lows and put in a double bottom - combined with the fact that some of the chaos in the stocks of better earning companies is disappearing, we feel it is time to move from a "Bunker Mentality, Cash-only" position and take advantage of this opportunity. It is time to MAKE SOME MONEY! However, this is not a time to throw risk management to the winds.

While last week was a negative week in the market, during the day on Thursday the market rallied 911 points, or 11%, from being down over 300 points to being up well over 500 points. It did so on very high volume. High volume rallies are a good thing.

Usually a strong rally is followed by a pullback of about 50% of the amount of the rally. Such pullbacks are normal and to be expected. That is exactly what happened on Friday. However, the pullback was on much lighter volume - another very good thing.

All of these occurrences (and others) have prompted a change in our investment strategy.

### [Change in Investment Strategy](#)

I do not recommend returning to being 100% exposed to the market. Last week however, we moved from a position of being primarily invested in Government money market funds to a Long-Short strategy.

In our case, a Long-Short strategy means we are investing (Long) in the stocks of companies that have high "free cash flow" and/or high dividends that have out-performed the market. At the same time, we are betting (Short) against the market in an equal amount. This means that when the market moves in either direction, half our portfolio should go up and the other half down. So you ask, why bother?

The advantage to Long-short market neutral investing is that we can begin to accumulate stocks in good companies that have good earnings while reducing the volatility of the portfolio. We will neither go up or down as much as the market - nor are we trying too. If we do a good job of picking stocks, this type of portfolio will produce a much straighter line and generally make money. It won't do it every day, but we should begin to take advantage of some of the predictability that is creeping back into the market!

Remember, if we are exactly market neutral, we don't care which way the market goes. We are just trying to capture the earnings of the good companies without the volatility of the market. We can also tweak our bet against the market by betting more or less against it as conditions change.

As of close of market today Aggressive is up 0.67% and the S&P 500 is down 2.58% for the day. For the month, we are ahead of the S&P 500 by more than 12%.

Let's look forward to more days like this.

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](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.

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