



K E R N S

CAPITAL MANAGEMENT, INC.

Kerns Capital Management Market Report

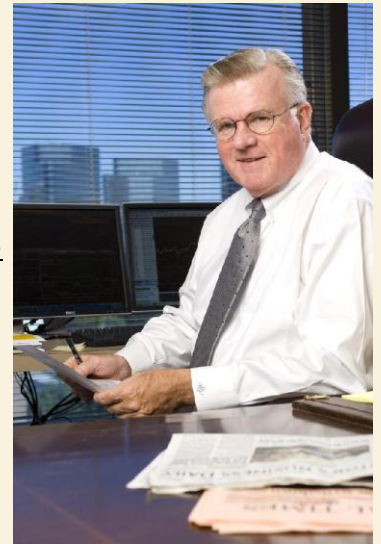
December 1, 2008

The "Silver Lining" I spoke about in our November 17th letter resulted in a powerful rally during the final five trading days of November, but the market still finished down sharply for the month.

The S&P 500 lost 7.5% for the month - not nearly as bad as the 22% it was down before the rally and much less than the 16.9% it lost in October.

Our models all outperformed the major stock indexes as well as the corporate bond indexes! (See Chart Below.)

In this letter, we will discuss the outlook for the market and the economy as well as our current investment strategy. While I do not feel that a new Bull market has begun, we are seeing opportunities to make money.



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Problems and Solutions

If you want to know what is happening so that you can better understand how to protect yourself, read this section. If you don't like strong doses of reality, skip this section. I will tell you that it is not all bad news.

November is usually one of the better months in the market. While it had a winning week last week, it turned out to be its worst November since 1991.

First, I want to highlight a few of the reasons why the market did not give us a lot to be thankful for this Thanksgiving. Then I want to point out the "Good News" of how it looks like the necessary fixes are being put in place to turn the economy and the markets around. Remember, market recoveries

always precede economic recoveries.

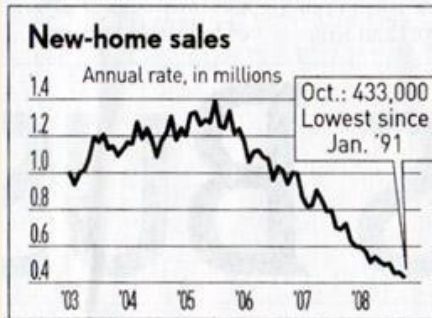
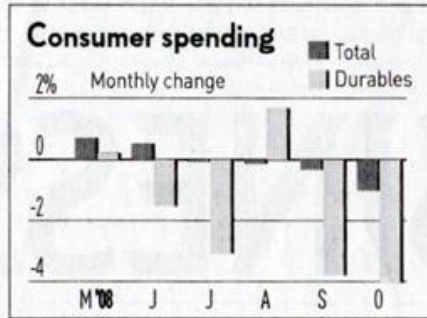
First, some of the bad ECONOMIC news from Investor's Business Daily.

VITAL SIGNS

Economic Data Terrible, But We're Already Scared

Consumer spending fell at the sharpest pace in decades ex Sept. '01, led by plunging demand for big-ticket items. New-home sales were the worst since Jan. '91, while Chicago-area factories shut down. New jobless claims fell, but the trend remains poor. Have markets already priced in the awful news?

Sources: Commerce Dept., Labor Dept., ISM-Chicago, Datastream



Clearly there is a lot of scary stuff going on which will hit virtually all of us in the "pocket book". The financial and economic systems have heart failure. Left untreated, the economic equivalent to death is depression and deflation. Since the last time either of those things occurred in the United States was in the 1930's, most everyone living today has grown up with nothing more than stories by our parents, grandparents or great grandparents as to how bad it was.

I realize that talk of this kind is very uncomfortable for everyone that does not like to deal with problems. That is exactly why things got so bad in the 1930's - the government did not deal with it and actually made it worse. That is not the case today.

Our government and governments around the world are acting in concert to avoid repeating the mistakes of the past in dealing with the equivalent to global economic cardiac arrest. If you want to read more on this subject, visit <http://fraser.stlouisfed.org/docs/meltzer/fisdeb33.pdf> and read the article titled [The Debt and Deflation Crises](#). I feel it is exactly on target.

Now let's talk about what is being done to turn things around. Last Monday, a Bloomberg article reported that the U.S. government is prepared to provide more than \$7.76 trillion to rescue the financial system. Bloomberg news tabulated the data from the Fed, the Treasury and FDIC statistics. They also interviewed regulatory officials, economists and academic researchers to gauge the full extent of the government's rescue effort. The unprecedented intervention in the financial system may succeed in unlocking the frozen credit markets.

The immediate result of last week's action was an instant lowering of home mortgage rates!

Also last week, China announced the most aggressive monetary policy easing in 11 years.

The bottom line is that the solution outlined in **The Debt and Deflation Crises** (referenced above) is being carried out. Pardon my rural upbringing when I use a phrase from my childhood years, but they are going at it like "a farmer killing snakes with a hoe". They are serious.

I feel the economy and the markets will turn around - but not without some pain. Our job is to apply portfolio risk management so that when the market does resume a steady bull market climb, our clients have minimal damage to their portfolios and can take full advantage of it.

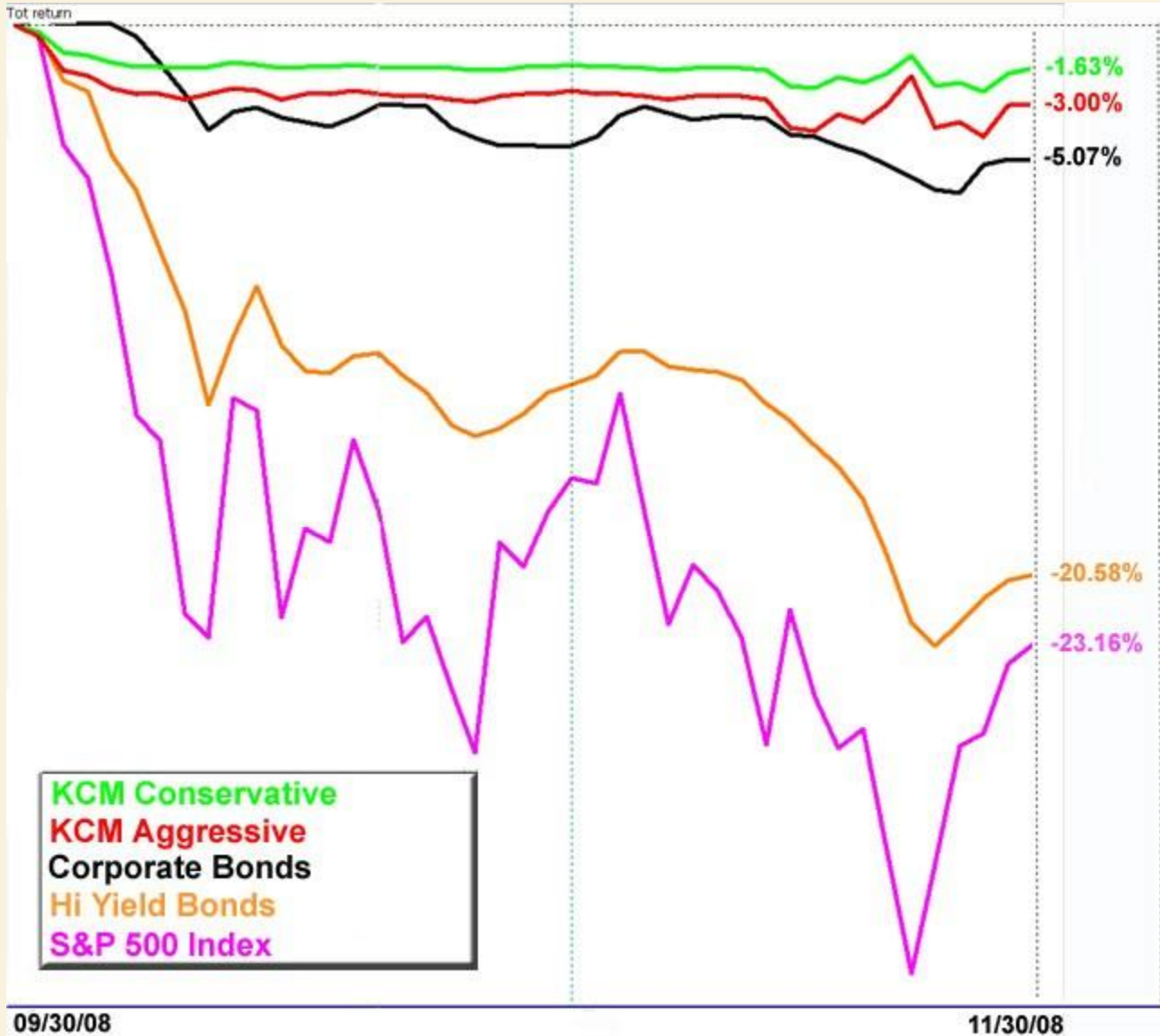
Investment Strategy and Performance

As I stated in a prior letter, I do not recommend, nor have we, returned to being 100% exposed to the market. We have however, moved from a position of being primarily invested in Government money market funds to a Long-Short strategy.

Unfortunately, for most investors and their investment managers, it has been difficult to hide from the market damage. As bad as the pain has been in the stock market, some parts of the bond market have been just as bad. In a WSJ article in the November 22-23, 2008 issue entitled ***In Bad Year For All, Bonds Suffer Most***, the journal points out that many mortgage bonds and corporate loans have lost 30% to 80% of their value.

In the chart below, the Black line represents top grade Corporate Bond values being down 5.07% over the last two months. High Yield bonds are down over 20% in the last two months. One of the largest bond mutual funds - American Fund's Bond Fund of America with over \$30 billion in assets - is down over 15% year to date.

LAST TWO MONTHS PERFORMANCE



As the chart above shows, we have held up very well. In addition, our 401(k) models have had no losses during this same period.

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.

One last thing, even though the market declined over 55% from its high in October of 2007, corporate earnings, excluding financials, are still actually growing.

We can get through this with minimal damage and be ready to participate in the good times.

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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