



# K E R N S

## CAPITAL MANAGEMENT, INC.

### Kerns Capital Management Market Report

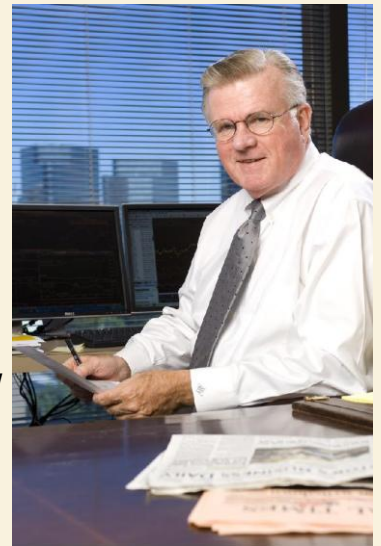
December 15, 2008

Many technical and fundamental indicators show a strong possibility of the current rally continuing for the next two months. While there is never a guarantee, the seasonal Santa Clause rally may show itself and continue into the early part of the year.

Market volatility remains very high by historical standards. However, as the dust begins to settle from the credit crises, the main factors influencing the market movement are becoming clearer.

We will discuss factors the market is currently rewarding and those it is not.

One thing is certain, the US and Global economies are slowing. As I will show below, a slowing economy does not preclude opportunities to build wealth with good stock picking.



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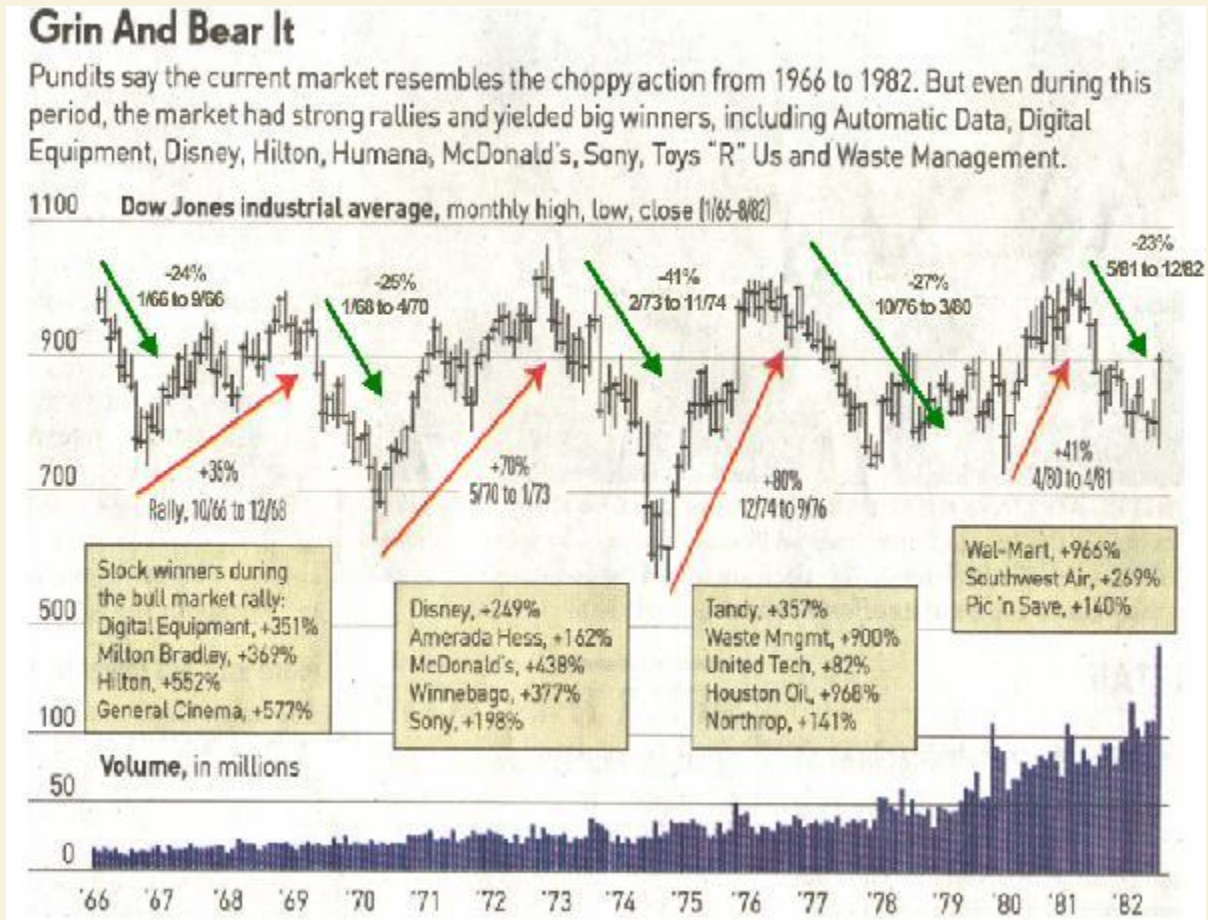
I think it is very difficult for people to keep an optimistic (and realistic) attitude about the stock market with all of the bad economic data the press seems to love to dwell on. Don't get me wrong, the economic data is horrible and it will be at least a couple of quarters before it starts getting better. Just expect it and take advantage of it.

There is much comparison of the current period with the "Great Depression". There are many similarities and risks have been high. However, governments around the world have responded differently this time and (political finger pointing aside) my working premise is that what they are doing will have a much different and more favorable result.

There is also much time spent comparing the market conditions that started in 2000 with the 18 year

period from 1966 through 1984 when the market went exactly nowhere. I DO feel that this is a more valid comparison and the results of the current period may resemble the 66 through 84 period. But that will only be bad for emotional investors and those Buy-and-Hold investors that are left standing.

Below I am reprinting a chart that was in our July Market Report. Please note that even though the Blue Chip Dow Jones Industrial Index went nowhere, there was an immense amount of money made on individual stocks (shown in the boxes). Wal-Mart went up 966% for example. Good stock selection has and will continue to pay off.



Additionally, notice the 70% Bull market from 5/70 to 1/73, and the 80% Bull market from 12/74 to 9/76. Astute investors, that exercised risk management, made lots of money even if they were not great stock pickers. They did it by not giving up all of their gains from the Bull market periods by holding through the subsequent Bear markets!

Risk Management and Stock Picking are the virtues that will be rewarded. Our process is based upon the premise that gains can be made during sideways markets that last for 10 to 20 years. We have the benefit of hindsight to guide us in our money management.

I have previously shown charts and talked about the fact that the price of stocks compared to their earnings declined during the "secular Bear Market" period shown in the chart above. If stock prices verse their earnings declined, how can an investor make money? The answer of course is that they must invest in companies with growing earnings - like Wal-Mart had during the period above!

In the following section I will discuss the great opportunities that have been created by the 55% decline the market experienced from October 2007 through last month.

## Investment Strategy and Performance

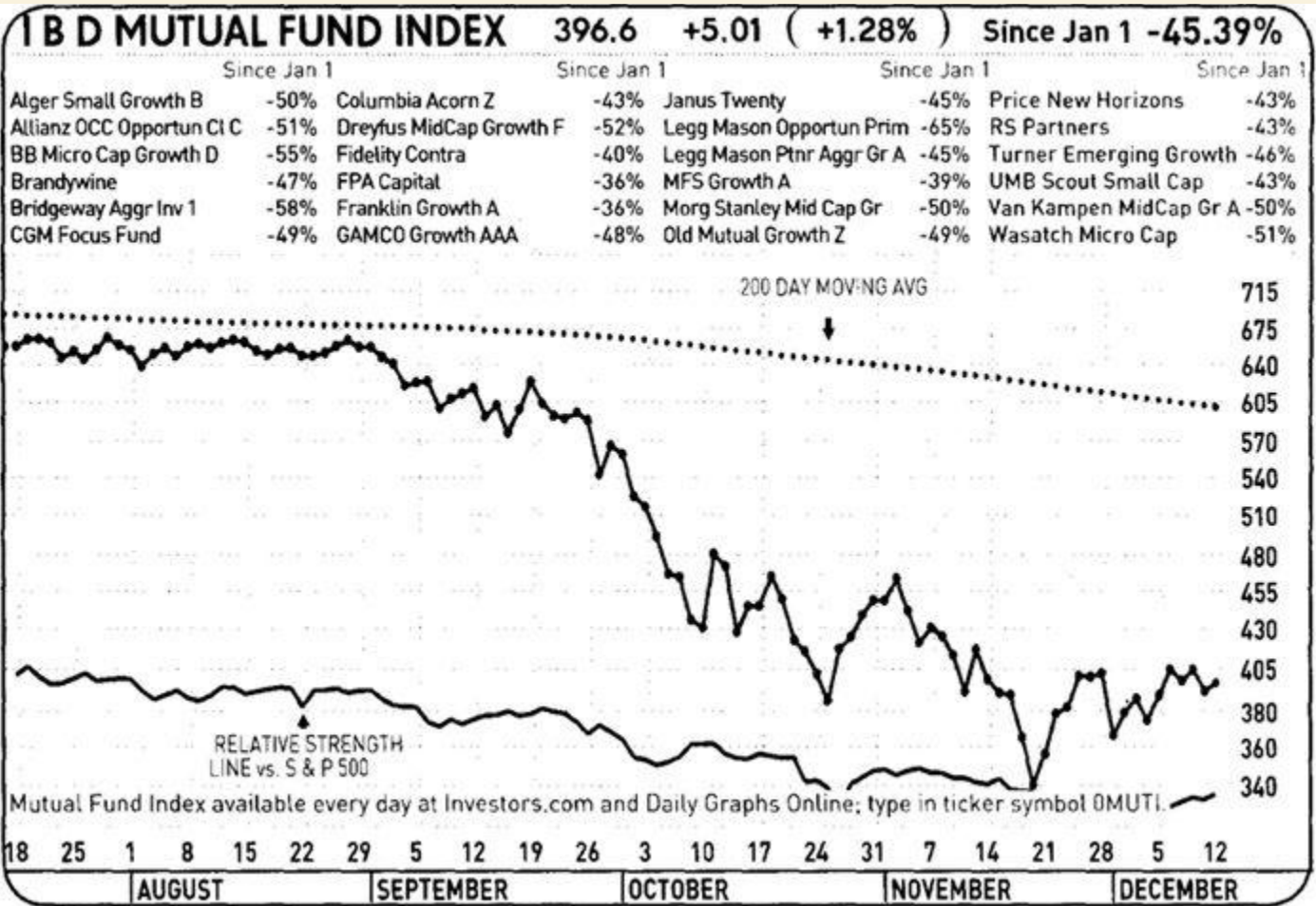
In our mutual fund, KCMTX, we have a two pronged strategy. First, our stock selection process is very specific in what we are willing to buy. Second, in order to hold those stocks long enough to benefit from their good fundamentals, we actively exercise "risk-management" by hedging in market declines with the use of options and inverse ETFs.

In our stock picking among the criteria we are using, we require an earnings growth rate that exceeds the stock's Price Earnings ratio. The higher the earnings growth rate and the lower the P/E ratio the better. Additionally, we want a high rate of sales growth. This is very hard for companies to achieve in a slowing economic environment - so the list of available candidates is only a few hundred stocks. These stock types are always rewarded, either sooner or later.

We also want a high "free cash flow" - money that is not required to pay overhead or reduce debt. That leaves money for dividends, stock buybacks and purchases of other companies. It also reduces the need for bank borrowing, a very advantageous thing in today's financial environment.

This process is rewarding our performance. One of the programs we use to chart investments is Investor's FastTrack. When I rank our fund performance from August 11th through last Friday night against their "All Equity" category, KCMTX is number 52 out of 6444 equity mutual funds they track! That puts it in the top 1/10th of 1% of the group!

The Investor's Business Daily chart below from today shows a year-to-date list of the major funds they include in their IBD Mutual Fund Index. Please note that these are all long only funds. That means that, unlike our fund, they have very limited ability to exercise risk management. They are all DOWN from 36% to 65% YTD. Our models are down but only a fraction of that amount!



**This is important - If your portfolio is down 65% you have to earn 285% just to get back to breakeven!** I can't do that for someone over the next couple of years. **If you are down only 10%, all you have to earn is 11% to get back to breakeven!** We have a very high probability of doing that and more based on past history (which of course is not a guarantee of future performance).

Many stocks are oversold and experiencing a bounce. Many others will. We enter this holiday season thankful that we have survived with our clients portfolios mostly intact and our business growing. The next letter will come after Christmas and the New Year.

All of us at Kerns Capital Management thank you for your trust and confidence and look forward to a Happy and Profitable New Year.

Merry Christmas,

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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