

MLK CAPITAL  
MANAGEMENT, INC.

# ADVICE ON THE MARKET



May 1, 2007

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

**Re: Health of the Market and the Economy**  
**An Explanation About Performance Numbers**  
**We Are Growing**  
**Managed Account Performance Verses Market Indices**  
**Current Portfolio Holdings**

## Health of the Market and the Economy

The broad US markets remain in clear up trends as the major indexes have traveled nearly due north since the Nasdaq started its uptrend on March 21<sup>st</sup>. We have participated nicely in that uptrend.

The Dow has logged just 3 down days in the past 22 sessions. This is abnormal and underscores just how much stronger the economy and corporate earnings have been than most analysts expected. It also can't go on forever. If it kept climbing at the rate it has gone up since mid March, it would be up 85% over the next year. This rate of growth is clearly unsustainable and some slowing should be expected.

There are many things to fear if one wants to look for them. Things such as the need for the slowdown in growth mentioned above and the seasonal affect of the traditionally weak months between May and November. However, there are many things that have moved the markets upward and, in our opinion, will continue to do so. I will elaborate on a few of them below.

Predicting market direction is a fools game and I will not attempt to do so here. It has been said that there are two kinds of "market predictors" – those that don't know and those that know they don't know. Let me say up front that I think I fall in the latter category.

However, there are enough factors in the big picture that make me think that the markets may be stronger this summer than most people have been willing to bet on.

1. Very few people bet on first quarter corporate earnings coming in at over double the rate projected by the experts. Although the rate of growth has slowed, it has greatly exceeded expectations and will probably keep doing so.
2. Personal income rose both in February and March at a rate of 0.7% each month. If it kept that up for a full year, it would show personal income growth of over 8%. This is exceptional and could support strong buying in the economy and, by definition, significant corporate profits.
3. The Core PCE Deflator, (the inflation component of the April Midwest Business Activity reports) showed zero inflation for the month. Over the last twelve months, inflation has only been about 2.1%. Almost down within the Fed's preferred 1-2% range. If we have another month or two at these levels, the Fed could start reducing interest rates to re-stimulate the economy. That would set off the first up leg of the next economic cycle in the US. Lower rates would be extremely bullish for the stock market and would set up the opportunity for strong gains.

The worry over the last few months has been that inflation might not be slowing down even though the economy would. That would have created a “stagflation” situation similar to the 1970’s, where the Fed would be forced to increase interest rates to stop inflation. Stagflation is the worst of both worlds – a stagnant economy with inflation. This would most likely push the US into recession and be very hard on the stock market. The risk of this happening seems to be decreasing dramatically.

4. This week’s Institute of Supply Management report (for the entire nation) showed significantly stronger US growth than anticipated.
5. The world economies are very strong! China is hot. So hot that their central bank raised rates again this week from 10.5% to 11% (the seventh time since June) in an attempt to slow down the country’s growth. They are one of the world’s biggest buyers of almost everything. In other words, they are not only growing - but their purchases are stimulating other economies around the world. Japan now exports more to China than it does to the US.
6. Europe is the strongest it has been in many years. Most dramatically, the German VDMA Engineering Association report (their equivalent to our ISM report), reported orders in March that were 47% higher than a year ago, highlighting the industrial rebound of Europe’s largest economy.
7. One reason the Dow 30 Industrials have been so hot this year after underperforming for several years is the weak US dollar. A weak dollar makes it cheaper for foreigners to purchase from the US. Large US companies that do business worldwide earn profits in appreciated foreign currency and then convert them back to an increased number of US dollars. This has increased the earnings of the large multi-national US companies significantly this year.
8. As I have said many times over the last few months, the world is awash with liquidity and there does not seem to be anything on the horizon to make it go away. This creates tremendous buying pressure as this money is invested around the world.
9. Even though the US has enjoyed strong economic growth and high employment (thus creating increasing spendable income) there are less opportunities in the US in which to invest it. That may sound strange, but there are actually less shares of stock in which to invest, this year than there were a year ago. That is due to the number of shares being created by new companies going public has been exceeded by shares being taken off the market because of corporate stock buybacks and companies being taken private.

When a company goes private, that means that some one bought the entire company and its shares are no longer available for the public to purchase for investment. That means that we have more and more dollars chasing fewer shares – a sure recipe for increasing stock prices. There is a lot of money looking for a home.

As you can see, there are a lot of good things happening to support our markets and world stock markets. Does this mean that we will not have a slowing down in the rate of market growth we have seen over the last few weeks or even a correction? No. I do not think there is any guarantee that one or both of those will not happen. They probably need to happen to set the stage for the next big market rally that will come. If we just get a slowdown, we need to stay invested. If we get a correction, we need to make sure we do not participate in any big drawdown in our portfolios. If the economy picks up and the new economic cycle starts a new market rally, we need to be ready to leverage the strongest sectors. Our job is to make these things happen for our clients. We believe we have the tools to do that job.

### **An Explanation About Performance Numbers**

I have received some questions as to why our non-margined accounts seem to perform better than our margined accounts. Actually, they don’t. Let me explain. Many of our clients have multiple accounts with us. Some have large retirement plans or IRA accounts. Because retirement money is tax deferred, it makes sense to leave the money invested as long as possible. It is the last money you want to spend. Also, by law, those accounts can’t use margin. Therefore, the only accounts that can have margin are the non-retirement accounts.

Since it makes sense to not take money out of the retirement accounts until you are required to, most people pay their investment management fees from their non-retirement accounts. Those that do so pay all fees (for both their retirement

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and their non-retirement accounts) out of their non-retirement/margin accounts. Since all of our performance is calculated after all fees are taken out, the margin accounts have shown lower performance for that reason. An extreme example is one individual with a \$1.5 million dollar IRA and a \$300,000 margin brokerage account, both of which we manage. If we take all of the fees for both accounts from the margin account, it greatly distorts the performance of the margin brokerage account.

## We Are Growing

I can not tell you how excited we are to have Martin L. Kerns, II join us as Vice-President. Marty has left his position as partner with a 100 plus lawyer law firm to work with our clients and staff. Marty's initial time will be spent in business development, client relations and management as he integrates into our investment management process.

## Managed Account Performance Verses Market Indices

PERIOD ENDING 4/30/07	PERFORMANCE						RISK	
	One Month	Last 3 Months	Last 6 Months	3 Years Annualized	5 Years Annualized	Since 12/31/00 Annualized	3 Yr. Standard	5 Yr. Deviation
<b>Equity</b>								
Dow Jones Industrials	5.85%	5.48%	9.19%	11%	8.02%	5.38%	7.84%	12.62%
NASDAQ	4.27%	4.54%	6.69%	9.84%	8.56%	0.48%	12.88%	17.61%
S & P 500	4.48%	5.09%	8.47%	12.31%	8.57%	3.67%	7.08%	12.02%
MLK Conservative - 401(k) Plans	3.51%	-0.20%	6.25%	11.85%	12.50%	9.86%	9.17%	8.40%
MLK Conservative Growth	2.65%	2.08%	5.62%	10.62%	11.76%	9.28%	9.37%	8.54%
MLK Cons. Growth Margin	2.63%	1.94%	4.7%	11.01%	N/A	N/A	11.12%	N/A
MLK Moderate - 401(k) Plans	3.81%	1.62%	5.49%	12.80%	11.57%	9.05%	10.77%	10.03%
MLK Moderate Growth	3.05%	2.70%	5.48%	11.50%	10.79%	8.44%	11.57%	10.54%
MLK Moderate Growth Margin	3.02%	2.68%	5.15%	13.09%	N/A	N/A	13.50%	N/A
MLK Aggressive - 401(k) Plans	3.88%	3.63%	7.37%	17.61%	13.67%	11.13%	11.26%	10.70%
MLK Aggressive Growth	3.51%	2.74%	5.69%	13.94%	11.53%	9.45%	11.93%	11.08%
MLK Aggressive Growth Margin	3.51%	2.46%	3.75%	12.68%	N/A	N/A	14.37%	N/A
<b>INCOME</b>								
LB 1-3 Yr. Govt. Bond	-0.01%	0.66%	0.15%	1.62%	2.33%	1.62%	1.00%	1.39%
3 Month T-bill	0.41%	1.70%	2.60%	3.74%	2.73%	2.65%	0.40%	0.47%
MLK Stable Value 401(k)	0.69%	1.14%	4.74%	6.98%	5.07%	5.09%	3.33%	2.88%
MLK Stable Value	0.49%	1.77%	2.75%	6.50%	4.79%	4.87%	3.16%	2.77%

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. <sup>1</sup> Standard Deviation is a measurement of risk and smaller numbers indicate less volatility or risk.

## Current Portfolio Holdings

We are currently just over 100% invested in our Aggressive models and slightly under 100% in our other models. Although I think they have great potential, we have sold our Emerging Markets and Basic Materials holdings to reduce exposure and volatility. If things take off, we will probably buy them back.

Our holdings are all sectors that have shown better relative strength than the markets as a whole.

Got your summer vacation planned? If not now, When?

Lane Kerns

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DATED MATERIAL

### **401(k) Investment Advice**

If you are managing your own money, [www.401k-Investment-Advice.com](http://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](mailto: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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