



K E R N S

CAPITAL MANAGEMENT, INC.

Kerns Capital Management Market Report

March 16 , 2009

There is lots of good news in this letter. Don't get me wrong, the economy still has head winds but last week was the best in months.

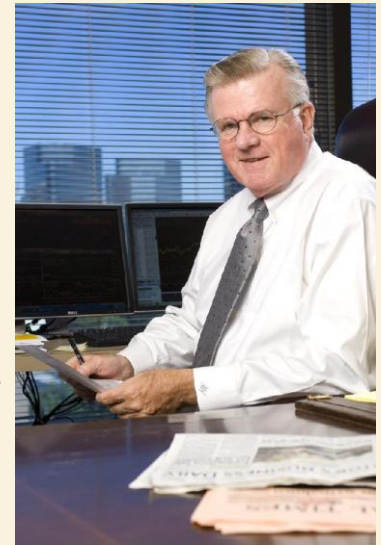
We have had a great month - especially when compared to the major market indexes and even bonds. (See Chart Below)

After a rough beginning for the month during which the major indexes hit 12-year lows, investors are growing more optimistic that the market slide that began in October 2007 is nearing a conclusion.

In this letter, I will discuss whether we agree with that the market slide is behind us - how our clients have done compared to the markets - talk about why we are outperforming the market so substantially and talk about the mathematics of making and losing money. (This will be really simple math, because so many investors did not learn the lesson from the 2000-2002 market crash.)

I want to repeat three sentences from our last letter because I think their value and importance will become more clear in this letter.

"Our stated goals are to miss three-fourths of the major declines and catch three-fourths of the major advances. We have accomplished it for a number of years now. If you do the mathematics on that type of performance, it produces remarkable results."



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A Little Market Math

Investor's Business Daily had an article in today's edition that would be timely in any type of market. It is entitled "**How Hard Is It To Reach Break-Even?**"

I suggest you don't gloss over this section. It will change the quality of your life in retirement if you take it to heart!

I am going to paraphrase the article to get to the point, but if you take the paper, I suggest you read the entire article.

The market had a great week last week - its best in months. Is the market bottom behind us? Whether it is or is not, understanding the following points, which are the basis of our investment philosophy here at Kerns Capital Management, will help you conserve and build your wealth.

1. "Making up a loss requires a gain larger in percentage terms than the loss was. The bigger the original loss, the bigger the relative size of the gain vs. the loss must be."
2. "The S&P 500 is 48% below its peak, but it must rise 109% to get back where it was." By using an active risk management strategy KCM has avoided such a huge loss so we will return to the profit column much more quickly. (*See our performance chart in the section below.*)
3. How long it will take to return to break-even depends upon the amount of your loss and the rate of return you will earn to return to break-even. "The S&P 500's average annual gain from the start of 1926 through Feb. 28 was 9.34% according to Morningstar. At that pace, a \$100,000 portfolio becomes \$109,340 after one year. That higher balance grows into \$119,552 after the second year. After three years its up to \$130,718."
4. "But if you want to be on that 9.34% train, you'd best be onboard soon."
5. "The biggest rallies occur right after a bear market ends and a new bull market begins. Miss some of the early stages and your average annual return could be well below 9%." I do not know if the bear market has ended or if we are just having a bear market rally. Either way we have been very quick to remove our hedge and become more invested. We will be just as quick to become re-hedged if the rally fails.
6. **RULE OF 72** - "How long will it take your portfolio to double from where it is now? A quick, back-of-the-envelope way to calculate that is by using the rule of 72...." 'Dividing 72 by the rate of return earned by an account tells you about how long it will take that account balance to double.' I have seen accounts of people not using our models in their 401(k) accounts down significantly. Let's use an example: Suppose an account was down from \$212,000 to \$100,000. If it grows at 9% a year on average from now on, it will double in roughly eight years, bringing it back to \$200,000.

Reasons To Be There			
The S&P 500's run-ups in the 12 months following the worst 12-month declines are vital parts of longer-term average returns			
Date	Return past 12 months	Return next 12 months	Avg. annual return next 5 years
Sept. 1974	-38.9%	38.1%	16.8%
Sept. 2001	-26.6%	20.5%	7.0%
March 2003	-24.8%	35.1%	11.3%
May 1970	-23.3%	34.7%	7.3%
Aug. 1988	-17.8%	39.0%	15.8%
Oct. 1962	-14.9%	35.3%	14.3%
July 1982	-13.4%	59.4%	29.7%
Sept. 1966	-12.0%	30.6%	8.7%
Dec. 1957	-10.8%	43.4%	13.3%
Sept. 1990	-9.3%	31.3%	17.2%

In the chart to the left - "Look at the 12 months ended September 1974. In that time the S&P 500 lost 38.9%. In the 12 months after that, the market soared 38.1%. During the five years following September '74, the market's average annual gain was 16.8%."

In the next section I will discuss why we think our investment philosophy and our mutual fund have the best ability to conserve your wealth and grow it.

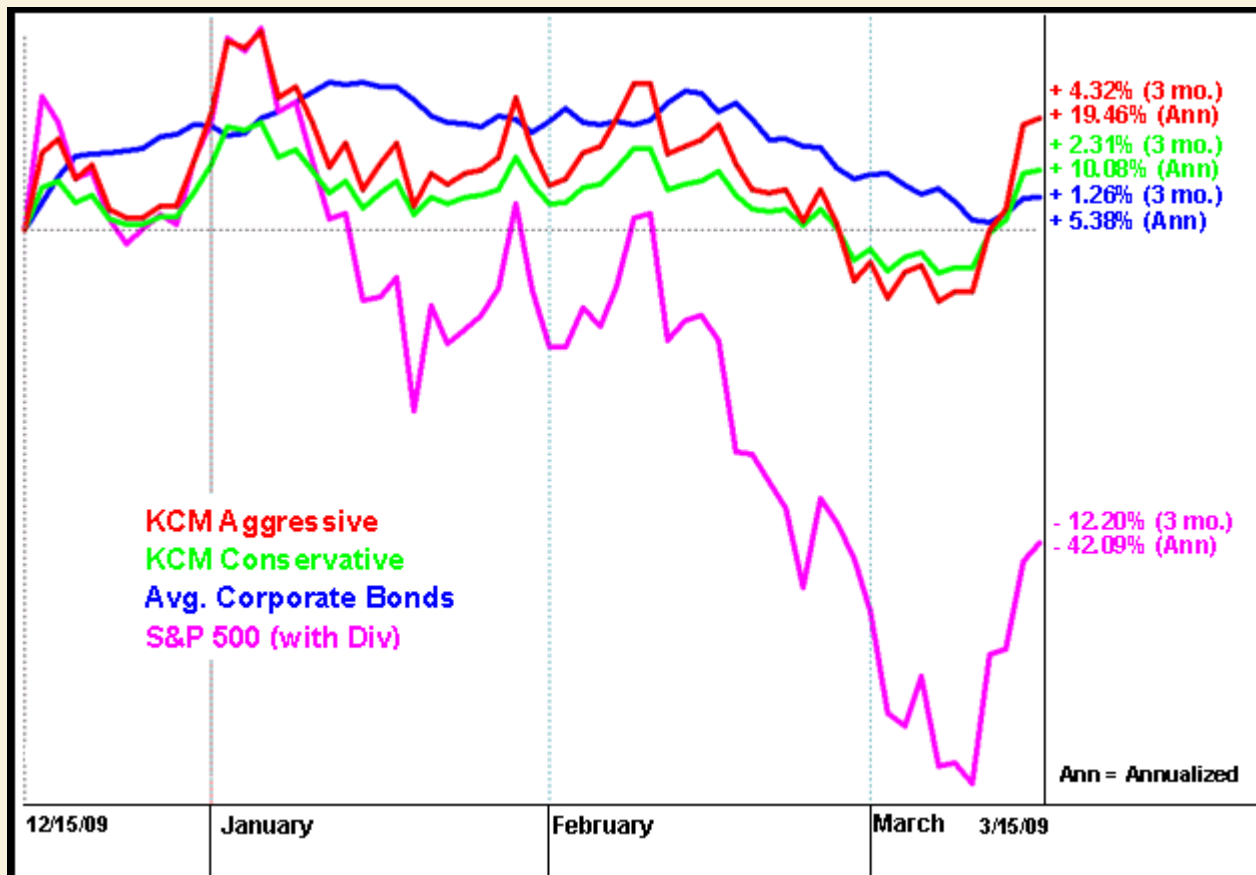
KCM Performance vs. The Market

In the section above I talked about how long it takes to get back to break-even when you have lost money. I also talked about how the answer to that question depends upon not only how much money you lost but what your rate of return is after you lose it.

The Chart below covers the three month period from 12/15/08 to 3/15/09. First of all notice that the S&P 500 took such a big drop during the period that last week's huge rally was not enough to get it back to break-even. It was still down 12.20% for the period. Notice also that is an annualized rate of decline of 42.09% - nothing any of us would want to experience.

That is why most Buy-and-Hold so called Long-Term investors almost always bail out when the pain gets to be more than they can handle. Imagine the possibility of another 42% loss on top of what many of those people have already lost!

Our mutual fund picks companies that we intend to buy-and-hold for the long run in order to obtain the tax efficiency of long-term capital gains taxation, but we hedge the risk of market declines. You can see the results. When the market turned up last week, we didn't have to buy stocks at higher prices to get back into the market because we were already there. All we had to do was make one trade to close out our hedge.



Now let's look at the top three lines on the chart. The red and green lines represent our Aggressive and Conservative models. (I have regretted naming them in that manner because all of our models are just varying degrees of conservatism.) The Blue line is the average return of corporate bond mutual funds.

Notice that at one point during the three months our models had a small loss going - but it was so small that we easily made it up and ended the period with a gain of 4.32% in Aggressive which is an annualized rate of return of 19.46%. While we will certainly have different rates of return over the next few quarters, you can see that our risk management philosophy certainly allows one to sleep better.

I think it is also important to notice that for the last two months of the period, Bonds (Blue line) were declining. They returned less than our equity models. Why would bonds be going down during a period when S&P 500 equities were falling also? There are several reasons but I will touch on three briefly:

1. With the government printing massive amounts of money that has the potential to create inflation, bond interest rates are rising in anticipation of inflation. Since bond prices go in the inverse direction of interest rates, bond prices are declining.
2. Many of our major corporations (General Electric for example) have had their credit ratings cut. Lowered credit ratings equal lower bond prices.
3. For those of you that are regular readers of this letter you will remember that I often talk about the six phases of the business cycle and the fact that during one of those six phases (the one we are in now), bonds decline along with equities and commodities. The good news is that the next two phases are the ones where it is easiest to make money in stocks!

Other Thoughts

Every coin has two sides. When we hear investment news - good or bad - it is always a good thing to turn it over and look at the back side of what we are hearing. I have heard and read that there are trillions of dollars in cash setting on the sidelines, much of which will return to the stock market when things improve. This will create huge buying pressure.

This weekend, the WSJ reported that companies in the S&P 500 stock index hold almost a trillion dollars in cash and marketable securities on their books. As I have pointed out previously, one of the major things we look for in picking stocks for our mutual fund is that companies must have high free-cash-flow.

The WSJ reports that over the last 12 months, companies with high cash balances (you have to have high free-cash-flow to accumulate high cash balances) have outgained the S&P 500 (ex-financials) by about 7%. Throw financials back into the indexes and the difference is even more astounding.

Picking stocks with High free-cash-flow is one of the things that has helped us outperform the market indexes.

Have a fun St. Patrick's day! Remember to wear GREEN. All of us here at KCM think green every day.

Lane Kerns

Website

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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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