



K E R N S

CAPITAL MANAGEMENT, INC.

Kerns Capital Management Market Report

May 15, 2009

Dear Clients and Friends,

Our last letter was the first one that I have not written in several years as Billie and I took time off to attend my high school class reunion. We had a great time and Marty did a great job of filling in by writing the newsletter. He always contributes to it, so it was an easy job for him.

As always, when I write this letter I try to share a few observations of things that are influencing the markets and what our expectations are.

In this letter I will talk about the market's sudden reality check, the outlook for credit (both personal and business), and a book I am reading.



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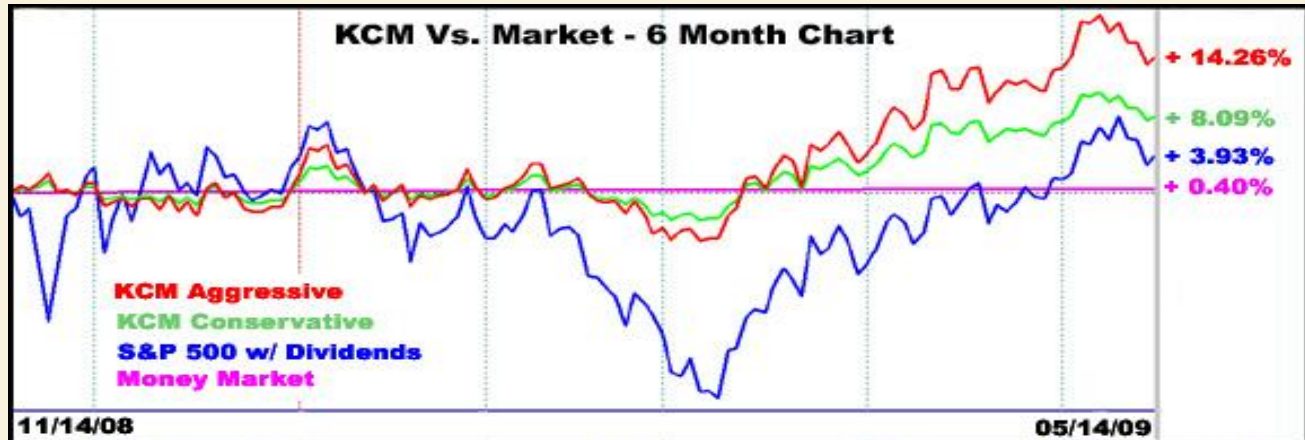
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How Are We Doing?

Our investment strategy is working wonderfully in this market environment. Our draw-downs have been minimal compared to the market and we have participated in the uptrend that started March 9th. The combination of low draw-downs (due to our risk-management) combined with capturing the majority of the uptrend have produced a good return for the year.

Below is a chart of our Conservative and Aggressive model performance compared to the S&P

500 (with dividends) and Schwab's best money market account over the last six months.



Note: For 401(k) plans without self-directed brokerage accounts, please see your Plan's Investment Performance Summary for actual performance.

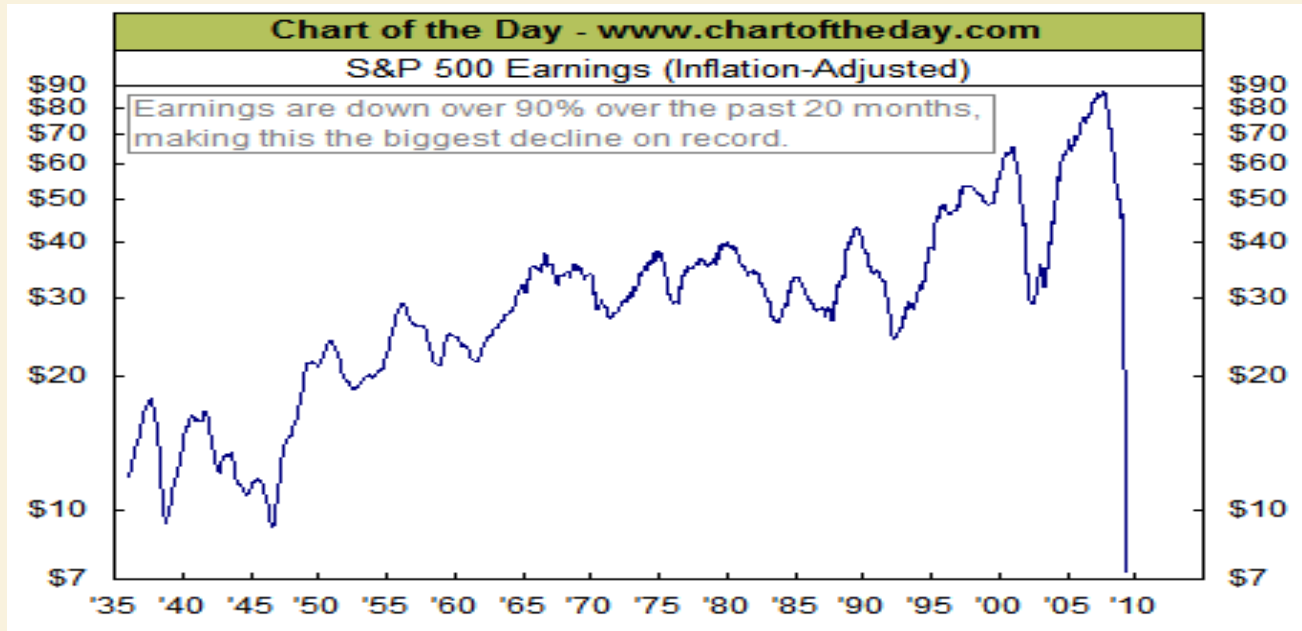
It is easy to understand how some people who were not paying daily attention to their portfolios last year could have thrown in the towel and retreated to a "Safe" money market account toward the bottom of the decline.

As you can see from the chart above, that move would have cost them a great deal of missed opportunity. Schwab's best money market account yielded a return of less than 1% over the last six months. Not only would they have virtually no return on their investment but they would have locked in their losses.

What Does The Future Hold For Corporate Earnings?

The following was borrowed from Chart of the Day - www.chartoftheday.com.

"While the stock market is up sharply since early March, the economy, as well as corporate earnings, continues to suffer. Today's chart helps provide some perspective as to the magnitude of the current economic decline. Today's chart illustrates that 12-month, as-reported S&P 500 earnings have declined over 90% over the past 20 months (with over 90% of S&P 500 companies having reported for Q1 2009) making this by far the largest decline on record (the data goes back to 1936). In fact, real earnings have dropped to a record low and if current estimates hold, Q3 2009 will see the first 12-month period during which S&P 500 earnings are negative."



Question:

If corporate earnings have plunged by 90%, why did the stock market rally over 30% since the March 9th bottom; and why are our models and mutual fund up strongly over the last six months?

There are two answers: one for the stock market and one for our portfolios.

First, the stock market. The market works from expectations. It usually anticipates moves in the economy by six to eight months. Last year there was virtually no good news. Investors collectively feared the worst. The "D" words, depression and deflation, were being thrown around. It appeared that our old administration and the new administration had no clue how to deal with a situation that had not been seen since the great depression of the 1930's.

While the situation was and still is much worse than most people understand, the markets anticipated a worst case scenario and became dramatically oversold. That worst case scenario did not materialize and investors were presented with a situation where stocks were greatly oversold and by March of this year presented wonderful opportunities to buy underpriced stocks! The markets have now rallied back to where stocks are more properly priced and the rally has slowed.

We have to credit the massive response of governments around the world for heading off the worst case scenario by pumping trillions of dollars into their economies. Unfortunately, the medicine administered to the economy will have some very bad side affects - but at least the patient didn't die.

Second, our portfolios. While corporate earnings of the S&P 500 have fallen 90% over the last 20 months, all companies have not had that problem. One of the major selection criteria we use in picking stocks to hold in our mutual fund is growing (not shrinking) earnings. We look at the average projected corporate earnings growth over the next 3-5 years as projected by all analysts that cover a company's stock!

When we started the mutual fund last August, there were about 2,000 companies that had earnings that were projected to grow at over 12% annually for the next three to five years. These are the cream that will rise to the top. We pick all of our mutual fund holdings from that list. That list has now shrunk to less than 200 companies and we have adjusted our portfolio holdings accordingly. While most analyst's projections miss the mark, by using an average of all analysts that cover a company, we feel that we get somewhere in the ball park. Our fund currently holds about 85 of those companies.

We also want to buy these companies at low valuations and we have had a feast of opportunity as the markets became oversold. One of our rules of thumb is to try to buy stocks at Price/Earnings ratios substantially lower than the earnings growth rate.

These stock picking rules combined with a multitude of others have produced good results and we have some holdings with returns over 80-100%. Of course we have some that have not done so well and we cull those as needed.

Our stock picking approach plus our risk-management (trying to hedge during market declines) has allowed our fund to outperform the S&P by over 30% since we opened it last August. Our mutual fund is positive while the S&P is still down 30%.

A Black Cloud on the Credit Horizon

I was told about two fairly large Houston Public companies this week that have been completely unable to maintain their banking credit relationships. They are not in worse shape but the banks have stopped lending. It is no longer a borrower's market with cheap credit available everywhere. Now it is a lender's market and they are not lending.

This is not the case just in Houston where our economy has done better than most - it is true everywhere! This leaves companies the option of selling off assets or issuing more stock to pay off the banks. This is one reason that there has been a rush of new stock offerings over the last few weeks. It is "do-or-die" for many companies that have large borrowing requirements.

I sat in on a meeting this week with investment bankers and economists and was stunned by a chart presented from the *J.P Morgan Credit Strategy Weekly* that projected over \$1 trillion of US and European debt coming due between now and 2015. Many companies whose banks will not renew the operating debt will be forced to sell their companies or their assets at huge discounts. This will be a great opportunity for investors with cash and a huge loss for those that need it.

I have said in earlier letters that another of our major stock selection criteria is for companies we invest in to have large "free cash flow". Free cash flow is money left over after you have paid all your bills and serviced all of your debt. These are the type of companies that will be less affected by the problem I just discussed.

KCM Macro Trends Fund

Our mutual fund - KCM Macro Trends Fund (KCMTX) - continues to grow both from investment gains and deposits from clients and new investors.

The fund is open exclusively to our Clients, Advisors and Institutional Investors. It is available through Charles Schwab, TD Ameritrade, Pershing, Southwest Securities, and within the next few weeks, Fidelity. For more information go to www.KernsCapital.com

In Closing

I will repeat Marty's closing from last letter. "We continue to feel strongly that the market will end 2009 higher. However, strong rallies like the one we've experienced over the last several weeks cannot continue indefinitely. There will be some pull backs. History shows, however, that for the long-run equities are the only way to grow your money significantly faster than the inflation rate. The object is to manage risk in a way that avoids severe losses and captures a majority of the gains ... and stay in the game".

Have a great weekend.

Lane Kerns

Website

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.

Important Notice & Disclosures

Performance data is historical. Past performance does not guarantee future results. Current performance may be lower or higher than the performance data quoted.

Kerns Capital Management, Inc. ("KCM") performance figures represent a composite of all individual portfolios managed in accordance with the investment category, are after the deduction of KCM's actual management fee, and include reinvestment of dividends and earnings. The composites contain accounts structured with mutual funds that are managed with a view toward capital appreciation. Standard Deviation and Alpha are calculated monthly and then annualized to be consistent with Morningstar®.

Mutual Fund investing involves risk including possible loss of principal. Investors should carefully consider the investment objectives, risks, charges and expenses of the **KCM Macro Trends Fund**. The Fund may invest in small, less well-known companies, which may be subject to more erratic market movements than large-cap stocks; foreign securities, which are subject to currency fluctuations and political uncertainty; and derivative securities, which may carry market, credit, and liquidity risks. These risks may result in greater share price volatility. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling 1-877-275-5599. The [Prospectus](#) should be read carefully before investing. The KCM Macro Trends Fund is distributed by Northern Lights Distributors, LLC member FINRA/SIPC.

The S&P 500 Index is an unmanaged composite of 500 common stocks. This index is widely used by professional investors as a performance benchmark. You cannot invest directly in an index.