

MLK CAPITAL
MANAGEMENT, INC.

ADVICE ON THE MARKET



July 1, 2006

To: Friends and Clients of MLK Capital Management

From: Lane Kerns

Re: **What a Difference a Day Makes**
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What a Difference a Day Makes

For investors, the second quarter was a boom-to-bust story. It began with the markets extending the first quarter rally, chugging along on the expectation that the outlook was clear. But everything changed on the afternoon of May 10. That day Federal Reserve Board officials made it clear that they would raise interest rates more than the markets expected and that inflation had become an increased concern.

Within 24 hours both stock and bond markets were off the tracks. From that point the S&P 500 dropped 7.5% within the next 24 trading days. Emerging markets dropped over 25%. Energy stocks dropped 15% and the Nasdaq dropped 11%. There was no place to hide for seven weeks.

The ironic thing was that the hardest hit were the corners of the market that provided investors with the biggest gains over the past several years. The average emerging market fund is up an average of 30.7% per year over that time span.

The sector that held up the best was the one that had been the worst performing category among broadly diversified stock funds – large-cap growth.

The only thing to do in the type of dynamic market reversal and change in phase of the economic cycle is control your losses. Do not take big drawdowns. We try to stop our losses at no more than 7%. This does not mean that in a fast moving market we won't have drawdowns slightly higher than 7% - but that is where we apply the brakes.

Many people try to control risk by diversifying (holding investments in different sectors of the market). Diversification helps most of the time - but when all sectors of the market become correlated (move in the same direction at the same time) and that direction is down – there is no place to hide and your choices are to: a.) take the losses and hope for the best (not our approach) or b.) sell or hedge (what we did).

A New Dawn

Things were so bad that one of the headlines in the Financial Times on June 29 was "Market Turmoil Wipes Out Fund Gains". As you might expect, when the headlines are the worst – the market is usually the most oversold and due

for a bounce. It just needs a reason to bounce. That reason came last Thursday – the day of the headline – in the form of another Fed meeting statement that acknowledged that “economic growth is moderating from its quite strong pace earlier this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices”. The market exploded for its biggest one day point gain in over three years of 1.99% for the Dow and 2.89% for the Nasdaq – both on heavy volume. Investors business daily declared that we were now in a confirmed uptrend.

To the casual observer, the Fed’s statement may not seem that obvious. But to the financial markets – which put a spin on every word or missing word – this signaled a possible slowing of interest rate increases and that is what the markets wanted to hear.

Our View

Although things have gone essentially nowhere since the big up-day on the 29th, we think there is a possibility for a further gain in the markets between now and the end of the year. Remember, we do not invest on what we think should or is going to happen. We invest on what *is* happening. However, most of our work is to gain enough insight into why things are happening so that we have a set of expectations as to whether it is safe to go into the water. That set of expectations may lead us to be more aggressive or more conservative. We have been ultra conservative for the last few weeks but are becoming optimistic that things could improve dramatically. Here’s why:

The economy is not slowing as much as anticipated – U.S. growth in the first quarter was revised upward to a 5.6% annual pace. Much higher than historical averages. While second quarter growth is expected to be slower, signs of strength keep popping up. Housing is slowing – but not nearly as fast as many predicted.

The global economy seems to be doing quite well – The latest data from Europe and Asia show accelerated manufacturing activity. Japanese capital spending will increase 11.6% this fiscal year and their jobless rate has dropped to an eight year low. Manufacturing growth in Europe is the fastest in nearly six years and U.K. factory growth hit a two year high.

Corporate earnings will come in higher than expected - Analysts forecast that total earnings for S&P 500 index of large companies will be more than 12% higher than in the second quarter of 2005, helped by strong balance sheets, stable margins and lower labor costs. Typically, several companies beat Wall Street predictions which could lead to an overall profit growth of about 13-14%. Based on these forecasts, the S&P 500 is trading a P/E multiple of 14.5 times – below historical averages. This does not mean that it can’t go lower – but it does indicate that the market is not seriously overpriced and may actually be somewhat of a bargain.

This would be the 12th consecutive quarter that profits at US companies have grown by at least 10% - a three year streak that has only occurred once before – and that was during the 90’s.

Personal income and spending in the U.S. are up - According to the Fed these both rose by 0.04% in May after April’s upward revision to 0.7%. If high oil prices are supposed to be slowing us down – it sure hasn’t happened yet.

Unwinding of the carry-trade may become a re-winding - Over a three year period, Japan had flooded the market with 300 Trillion Yen of excess liquidity and reduced their interest rates to zero. This killed deflation and got their economy running again. They then sucked that 300 trillion back out of the economy over the last few months. Their economy has shown signs of re-weakening and their markets dropped dramatically. Over the last three weeks, they have pumped 150 Trillion of excess liquidity back into the economy. This may give the world markets another shot in the arm!

Has the Correction Further to Run? – It is difficult to say if the process is complete.

Managed Account Performance versus Market Indices

PERIOD ENDING 6/30/2006	PERFORMANCE						RISK	
	One Month	Last 6 Months	Last 12 Months	Since 12/31/03 Annualized	3 Years Annualized	5 Years Annualized	3 Yr. Standard	5 Yr. Deviation
Equity								
Dow Jones Industrials	0.04%	5.20%	11.08%	5.01%	9.96%	3.48%	8.59%	14.38%
NASDAQ	-0.31%	-1.51%	5.60%	3.29%	10.19%	0.10%	13.83%	22.60%
S & P 500	0.15%	2.69%	8.62%	7.38%	11.20%	2.49%	7.73%	13.66%
MLK Conservative Growth	0.75%	-0.87%	9.31%	11.37%	15.15%	10.66%	9.62%	8.47%
MLK Conserv. Growth Margin	-0.63%	8.77%	16.40%	15.24%	n/a	n/a	n/a	n/a
MLK Moderate Growth	-0.33%	-1.82%	9.30%	10.74%	14.47%	9.34%	11.72%	10.62%
MLK Moderate Growth Margin	0.38%	-3.93%	4.46%	11.12%	n/a	n/a	n/a	n/a
MLK Aggressive Growth	-0.20%	-1.55%	11.68%	13.72%	18.09%	9.79%	12.05%	11.13%
MLK Aggressive Growth Margin	-1.48%	-4.68%	7.69%	13.04%	n/a	n/a	n/a	n/a
INCOME								
LB 1-3 Yr. Govt Bond	0.12%	1.40%	1.98%	n/a	1.50%	3.30%	1.39%	1.72%
3 Month T-bill	0.44%	2.04%	3.90%	6.76%	2.42%	2.28%	0.40%	0.35%
MLK Stable Value	0.89%	1.50%	5.75%	6.10%	5.96%	4.88%	3.17%	2.85%

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

Current Portfolio Holdings

All our models are still either heavy in cash or hedged close to a market neutral position. I said last month - "If we get a strong up "event-day" on heavy volume – we may assume that we have been too conservative and re-enter sectors that are showing strength in the recovery. If that happens we will miss out on the initial stage of the next advance. If the market heads lower, we will have avoided what could have turned out to be substantial losses." We got the "event-day" on the 29th and missed out on the rally that day. However, it has not maintained its momentum since then.

One thing we will probably re-enter sooner rather than later is energy. It now appears that West Texas Intermediate oil futures contracts are priced to remain above \$70.00 through 2010. Don't count on gas prices coming down. While oil & commodities took a big hit in the pullback, I think we may have been wrong to exit – but remember our stop-loss.

A bit of philosophy. This weekend someone close to us was having some health problems. The comment made was "What have I done to deserve this?". Obviously she had not done anything to deserve it, anymore than all of us deserve the good fortune of being born in America instead of one of the world's hell holes. Warren Buffet says he is a member of the "Lucky-Sperm" club. He was lucky to be born in a country at a time when someone with his skill and talent could flourish. When things get tough – just remember that we are all a member of Warren's club or we would not be fortunate enough to have money to invest.

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401(k) Investment Advice

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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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