

MLK CAPITAL
MANAGEMENT, INC.

ADVICE ON THE MARKET



August 1, 2006

To: Friends and Clients of MLK Capital Management

From: Lane Kerns

Re: **When is Good Bad News – Bad Good News?**
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When is Good Bad News – Bad Good News?

Does that sound a little confusing? That is exactly why the market has been schizophrenic since the first of the year. Let me explain. But before I do, let's get the suspense out of the way – We had a good month.

Now back to why we have a crazy, unpredictable and volatile market. The market is in a “decision box”. If the economy continues to slow enough to convince the Fed to stop raising rates, stocks could break out to the upside. But, if inflation remains stubbornly high, the Fed may have to continue raising rates even at the risk of a recession. That would send stocks sharply lower.

The market is hanging its hopes on the Fed pausing or stopping interest rate increases. Any bit of news that might lower or raise the possibility of a pause has had a dramatic impact on the direction of the market. That is why we have seen wild gyrations with prices up 1-2% one day and then down the next.

The latter scenario is the scary one for buy-and-hold investors. It is the worst of both worlds. If the economy slows and corporate profits drop – stocks will drop. The past few times this has happened, the Fed has stepped in and stimulated the economy by decreasing interest rates. So what's the problem?

The problem is - inflation does not appear to be slowing. The Fed considers inflation a worse thing than a recession – and they are right. To stop it, they must raise (rather than lower) interest rates which has the potential to further depress stocks. Such declines are not a bad thing. They are necessary to reset valuations to a level that allows the next bull market to start. The key is to hold our portfolios together until it starts! Our portfolios had gains last month with very little volatility.

Don't be confused by the big up week we had last week. There was no volume. Unless you get the big institutional investors buying, there is no power behind the rallies. This will come – but until it does so, I think the conservative approach we are taking is the best one.

Last week, the Fed's Beige Book report showed a slowing in the economy with little inflation. This was a two-edged-sword. A cooling economy is bad for business, but at least the Fed might not hike rates again. But Wall Street didn't buy it – so the big players were not big buyers in last week's rally.

Without institutional support, the market is vulnerable for a pullback – and that is exactly what is happening this week.

I said last month “At some point the selling will stop - when values become so attractive as to be irresistible. At that same point, there will be a shortage of sellers and an abundance of buyers. . . . Till then we are protecting cash.”

Focus – Focus - Focus

Looking for a cause of the market’s ills can be frustrating. Instead, investors need to focus on how we can navigate the market’s choppy waters. That starts by lowering risk.

Our Portfolio Builder system follows a process whereby we can dial-in acceptable risk based on current market conditions as we see them. We then focus on the areas of the market that are trending up while at the same time reducing volatility with Linear Program risk smoothing. It clearly paid off for us in July.

Our View

Friday’s US second quarter gross domestic product numbers were a good-news-bad-news case in point. At first sight, the slowing GDP threatens the pace of profit growth (bad news) and hints at the possibility of a recession in 2007. But the three main equity indices all gained 1-2 percent for the day. The market gains were triggered by the perception that the US Federal Reserve will use the GDP data to trigger a halt to long-term monetary tightening (good news).

The man on the street small investor bought it but the big players did not. There was actually a slight decrease in volume of shares traded. Until there are strong up days with significant volume that break through prior highs – there will be no solid up market.

Institutional investors are not looking at what is going to happen this week, they are taking a longer view and trying to determine what is going to happen to corporate profits over the next year. Higher interest rates and a slowing economy mean corporate profits have to slow or come down.

In the first quarter, pretax profits for U.S. companies came to 12.1% of gross domestic product – the highest level in 40 years. If this broad measure of profit margins were instead at its 50 year average of 9.1%, total U.S. corporate earnings would be about 25% lower. I smell a bear in the woods. I hope he stays out of our camp.

Corporate profits have stayed high because of high productivity gains. U.S. laborer’s wages have not participated in the good times. That is a result of 40 million eastern European workers entering the free world labor market over the last 15 years after the fall of the Iron Curtain - and hundreds of millions of Asian workers joining the march toward globalization. In spite of this, employment in the U.S. seems to be tightening which should raise wages. We have the lowest unemployment rate in many years which should put upward pressure on salaries. Good news for workers – but bad news for profits!

The global economy is beginning a transition to an environment of tighter monetary policies and reduced liquidity. History tells us that in such a world it will be much more difficult to earn the high returns on risky assets that investors have enjoyed in recent years, and that some degree of risk reduction is appropriate.

Even though the world is entering a tighter monetary policy environment, the U.S. is farther along in the process. We think that some foreign markets look less risky than the U.S. markets. That combined with the probability of a weakening dollar makes us think that a higher percentage of non-US investments properly hedged to reduce risk offers promise.

Managed Account Performance verses Market Indices

PERIOD ENDING 7/31/2006	PERFORMANCE					RISK	
	One Month	Last 12 Months	Since 12/31/03 Annualized	3 Years Annualized	5 Years Annualized	3 Yr. Standard	5 Yr. Deviation
Equity							
Dow Jones Industrials	0.52%	7.62%	5.06%	9.10%	3.52%	8.48%	14.26%
NASDAQ	-3.71%	-4.27%	1.69%	6.44%	0.63%	13.50%	22.42%
S & P 500	0.66%	5.39%	7.42%	10.82%	2.82%	7.69%	13.57%
MLK Conservative Growth	0.78%	5.08%	11.72%	14.54%	11.07%	9.60%	8.43%
MLK Cons. Growth Margin	1.16%	0.75%	11.64%	N/a	N/a	N/a	N/a
MLK Moderate Growth	1.10%	4.14%	11.23%	13.97%	11.69%	11.69%	10.52%
MLK Moderate Growth Margin	1.00%	2.14%	11.82%	N/a	N/a	N/a	N/a
MLK Aggressive Growth	1.18%	6.46%	14.26%	17.07%	10.76%	11.97%	10.98%
MLK Aggressive Growth Margin	0.57%	2.01%	13.29%	N/a	N/a	n/a	N/a
INCOME							
LB 1-3 Yr. Govt. Bond	0.36%	-0.99%	-1.17%	-0.93%	3.23%	1.39%	1.72%
3 Month T-bill	0.38%	4.05%	2.72%	2.53%	2.30%	0.41%	0.36%
MLK Stable Value	0.45%	4.65%	6.29%	6.17%	4.87%	3.15%	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 hedged close to a market neutral position. We intend to trade more frequently to stay better in sync with the markets. If there is a trend, it is down. Until that changes we will continue to use what is making money in this environment. What our performance does not show is that we had almost no drawdown.

Personal Thoughts - According to a WSJ Online, Harris Interactive Poll – Nearly 2 in 5 retired adults (37%) underestimated the amount of living expenses they would have in their retirement years. According to the Society of Actuaries – 35% of retirees believe they would deplete 100% of their life savings and have nothing left to be passed onto their heirs at death if they were to live just 5 years longer than they expect to live.

These numbers indicate to me that many people look at their retirement income as coming out of their investments (thereby reducing them) rather than earnings on their investments. When people go to low earning investments to “play it safe” they may be taking the biggest risk of all - living longer than their money does.

Some risk is necessary to have the opportunity for gains. The key is risk management. Managing losses to an acceptable level while retaining the opportunity to participate in bull market gains both preserves wealth and grows it.

I spent last Saturday at an investment meeting. Over half those attending were professional money managers. I was pleased to have five people come up to me and say that they read this letter regularly. Four of the five were Investment Advisors. Thank you for the compliment.

Lane Kerns and the MLK Capital Team

MLK Capital Management, Inc.
Galleria Financial Center
5075 Westheimer, Suite 1177
Houston, TX 77056
www.MLKerns.com
www.401k-Investment-Advice.com
Address Service Requested

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401(k) Investment Advice

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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:

**Lane Kerns
MLK Capital Management, Inc.
(713) 993-0949 ext. 106 or (800) 945-2125 ext. 106
E-mail: LaneK@MLKerns.com**

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