



Kerns Capital Management Market Report

October 16, 2008

I like to compare portfolio volatility to a ride at Disneyland. There's the big rollercoaster and there's the kiddie ride.

The market has certainly delivered the big rollercoaster ride over the last few weeks and days. We, because our investment discipline, moved to the kiddie ride several weeks back when the nausea began to set in.

Below, we will discuss:

1. What is causing the extreme volatility in the markets; and
2. What opportunities are being created for wealth building



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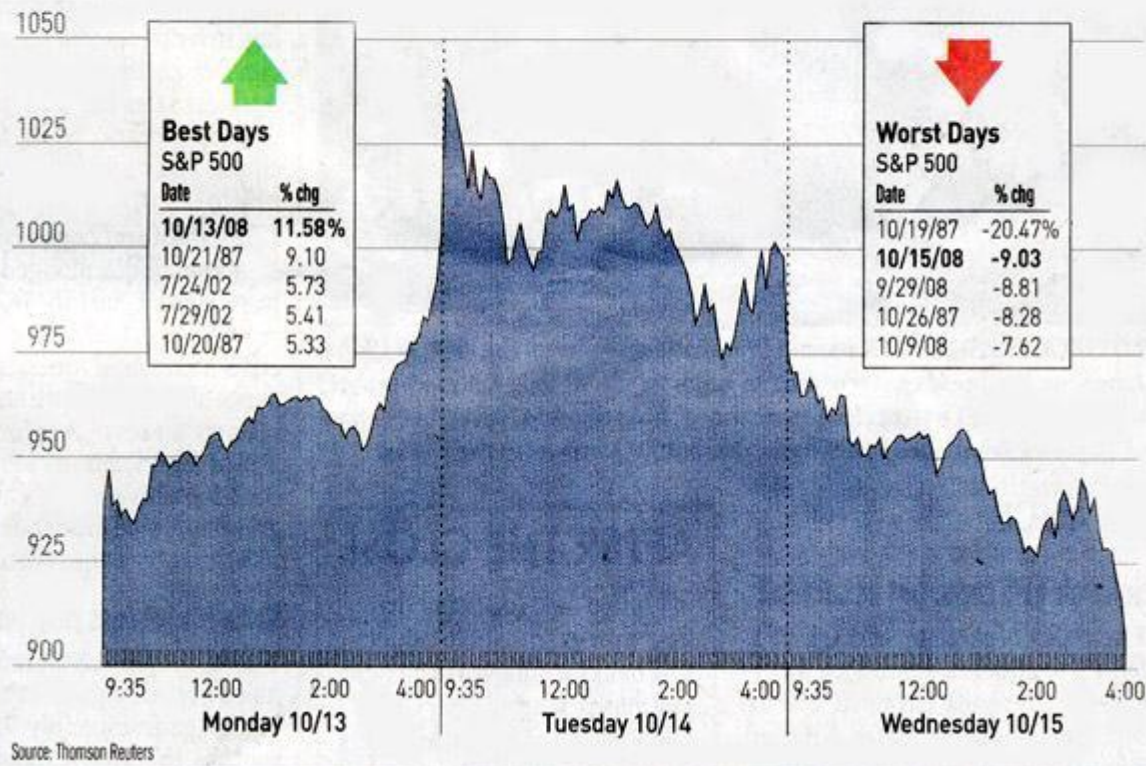
[Why People Usually Buy High and Sell Low.](#)

I cannot think of a better way to illustrate just how scary the market ride has been than to show the following chart from the front page of today's Investor's Business Daily. It illustrates the last three days in the market which include the biggest percentage up-day in the history of the stock market and the second biggest down-day in the history of the stock market.

Fleeting Euphoria

With Tuesday's reversal and Wednesday's sell-off, the S&P 500 has erased nearly all of Monday's momentous gain.

S&P 500



This type of volatility does not make for a good night's sleep. However, our equity portfolios have had one-tenth the volatility of the markets.

I think it is important for each investor to ask themselves, what is my long-term objective for my money? For many in retirement, it is the main source of income for the rest of their life. For younger people it may be their major tool to build wealth.

Whatever it is, it is important to keep history in mind. I have often quoted or compared Warren Buffett, the world's most famous living investor. Today I want to quote Benjimine Graham, his mentor - the man from whom he learned value investing.

From The Wall Street Journal this weekend:

"Just eight days before the Dow hit rock-bottom [in 1932] the brilliant investor Benjamin Graham - who many years later became Warren Buffett's personal mentor - published "Should Rich but Losing Corporations be Liquidated?" It was the last of a series of incendiary articles in Forbes magazine in which Graham documented in stark detail the fact that many of America's great corporations were [then] worth more dead than alive.

More than one out of every twelve companies on the New York Stock Exchange, Graham calculated, was selling for less than the value of the cash and marketable securities on their balance sheets. 'Banks no longer lend to big corporations,' he reported, but operating companies were still flush with cash - many of them so flush that a wealthy

investor could theoretically take over and, empty out the cash registers and the bank accounts, and own the remaining business free.

Graham [still in 1932] summarized it this way: '...stocks always sell at unduly low prices after a boom collapses. As the president of the New York Stock Exchange testified, 'in times like these frightened people give this United States of ours away.' Or stated a different way, it happens because those with enterprise haven't the money and those with money haven't the enterprise, to buy stocks when they are cheap."

Similar to What is Happening Today

From 1972 through 1974, the market declined roughly 50%. However, the companies in the S&P 500 had an average earnings decline of only 15%. That set up a situation where there was great value and a bull market followed.

I do not know whether we are at the market bottom - although I suspect we are very near. Over the last two weeks there has been panic selling in the stock markets. I think this selling has occurred just at or near the time many companies offer the best value they have offered in decades and that this is the time to start building our Buy-List!

Let me give you some examples. I have not verified this but I read that Charles Schwab & Company, whom we are very happy to have had a working relationship with for roughly fifteen years, has more cash on their balance sheet than the entire value of the company's stock at its current selling price.

I did a quick screen in Bloomberg this morning to identify companies whose balance sheets show more "cash and cash equivalents" than the entire stock selling value of the company. Out of the top 3000 companies, there were 87 that qualified!

For the ladies among our readers, if you saw a shoe sale that said 40%-60% off, you would probably go look at the shoes. Yet, most investors - instead of looking at America on sale - are putting on the sale by selling at or near the bottom. If you have not sold by now, and you hold good companies, you might want to think twice before selling at this point.

It is time to start wearing your bargain-shopping hat - instead of your "Chicken Little - The Sky is Falling" hat, when you think about the market. It may not yet be time to start buying - but it is certainly time to start shopping. America is on sale!

[Why Has the Market Sold Off So Violently?](#)

My son-in-law asked me for the "Cliff-Notes" version of why the markets have sold off so violently. I guess I usually include too much detail and a short version would be better. Hmmm?

Here is the story of the last few weeks as short and oversimplified as I can describe it.

1. Banks are required to have roughly 8% capital by the Federal regulators. This means their capital must equal at least 8% of their total outstanding loans and investments. In other words, they can loan out about 12 times their capital.

If they can use our checking and savings deposits as capital, for which they pay 0% to 5%, and loan it out 12 times (that's the rule) they can make a lot of money. That's called leverage. It works fine until you have loan losses that exceed the 8% capital requirement.

2. Most non-regulated investment banks and hedge funds don't have virtually free bank deposits to loan out but make huge amounts of money if they can borrow money at a low rate and invest it at a higher rate. However, since they are not regulated, many have been leveraging up to - get this - 30-40 times. It doesn't take very much math to figure out that if I have a billion dollars and can borrow another 29 billion, which I can invest in the market, I can make huge profits on my original 1 billion. Works great if you get it right.
3. The banks have made bad investments thereby eating up their capital and can't loan money to businesses.
4. The banks are calling in the loans to the investment banks and hedge funds because they think those loans are too risky. The investment banks and hedge funds are selling whatever they can sell. This de-leveraging has sucked hundreds of billions of dollars out of the markets. No buyers and all sellers equals a falling market.
5. Federal governments worldwide have stepped in to prop up the banks. It is starting to solve the banking problem.
6. Now the market is beginning to focus on a slowing economy and we may be back to a normal economic slowdown rather than a crisis.
7. The market always anticipates an economic turnaround by six to twelve months and starts scooping up oversold stocks ...

Can't wait!

Lane Kerns

[P.S. New Website](#)

We take pride in providing a high level of personal service. We continually work to earn your trust by investing in tools and resources that strengthen our relationship with you. I'm pleased to announce our latest service - our firm's new Web site. We hope you like it. Please give us your feedback.

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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