



# K E R N S

## CAPITAL MANAGEMENT, INC.

### Kerns Capital Management Market Report

December 15, 2009

Clients and Friends,

I have to avoid sounding overly optimistic about the market occasionally. However, I have said for over six months that I felt the market would finish the year higher. It made a new high for the year yesterday!

We have had some volatility, but the uptrend since March is unbroken. It will break eventually - but I do not think soon.

The financial market panic of 2008 was characterized by a huge stampede into cash. At the March Market bottom, money fund balances peaked at \$3.76 trillion dollars. Since then, \$560 billion has returned to help push the markets higher according to analysis at JPMorgan. The balance is still sitting there!

Data released by the Federal Reserve show that private cash holdings by households and companies as a percentage of nominal GDP is just shy of 72%, or about 10.12 trillion as of the second quarter of 2009. The U.S. household sector currently holds about \$7.76 trillion in liquid assets. These cash balances are higher than the previous peak in the 1980's! That was when the 20 year bull market began - the biggest bull market in our country's history.

Color me optimistic for the future!

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### The Bank of Posturepedic

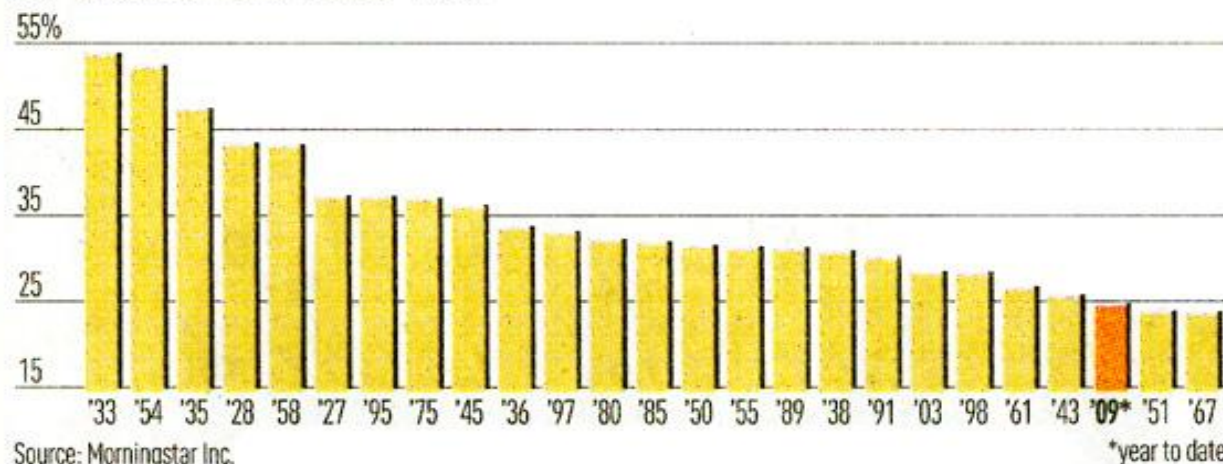
Do you know people who became so panicked they pulled all their money out of the market and, in a manner of speaking, put it under their mattress? Read on.

Through December 10th, the S&P 500 is up 24.9% and 66% since the March low. Now the markets

are beating the stuffing out of the mattress stuffers! The chart below from Investors Business Daily shows that 2009 has been one of the best market years in since 1926.

## How 2009 Compares

Some investors are still in cash despite 2009's 24.9% gain through Dec. 10, which would rank 23rd best among full calendar year returns for the S&P 500 since 1926



Markets always outperform mattresses in the long run.

Unfortunately, buy-and-hold investors still have not recovered and have been better off in the mattress over the last ten years given the Markets negative performance. On the other hand, investors who do not have a proven strategy for getting out and back in often move too late. They end up selling low and buying high - a recipe for lagging returns if not financial ruin. [See the "How Are We Doing" section below.](#)

## Improving Global Economy!

One thing that has forced the stock market higher this year is the huge amount of money governments around the world have pumped into their economies. I say forced because of the circumstances that have prevailed in the U.S.

Last year, the government forced the money center banks in the U.S. to take money. They forced all of the major money center banks to take it even if they did not need it because if they had made it optional, only the weakest banks would have taken it and that would have branded them as weak and could have caused runs on those banks. Additionally, a huge amount of stimulus money was pumped into economies all over the world. No problem so far.

In the U.S., Congress and the American public were told that this would save the banking system and get lending started again. It did save the banking system - a very good thing! It did not get lending started again - a not so good thing. That begs the questions: why has the money not been lent out to American businesses and citizens - and where did the money go?

At the same time the government was forcing the big banks to take money from it to "strengthen their balance sheets", they were telling the banks to build capital. Capital increases only come from two sources: profits and additional investments into the bank from the outside. Since no one wanted to invest in banks last year in the midst of the banking crises, banks had to resort to actually making profits and the government gave them a guaranteed way to do it - invest all that extra money back into government treasury bills and bonds!

Wait a minute, I thought banks were supposed to loan out the money? That would have been nice, but in order to build capital more rapidly, they decided that making loans to you and me and American business was too risky in a recessionary economy. Additionally, the banks do not get to count 100% of the loans they make as assets on their books (capital) because some people and businesses may get in trouble and not repay their loans. Banks do however get 100% credit for any Treasury bills or bonds they own because the government never defaults. Easy choice for the banks - loan to the government or to people with perfect credit who don't need it!

All of that money being poured into the financial markets to buy bonds has kept interest rates down. Low interest rates have kept corporate profits climbing which in turn has pushed up the stock market. It has **forced** the market up.

There will be a turning point where the banks will find it more profitable to loan to us than buy government securities. That will happen when the government raises the interest rates it is charging the banks to use its money. That is the Fed Funds rate which is currently set at zero to .25%. Governments around the world whose economies have recovered sufficiently have already started doing this.

We think interest rate increases in the U.S. will be sooner rather than later. For one thing, there is a continued recovery in global trade. Over the last three months U.S. exports have risen by 31.4% at an annual rate, while imports are up 17.4% on the same basis.

Without getting any deeper into economics, just let me say that the Fed and the Treasury have a tight rope to walk as they start this process. They will not start until they think the economy is sufficiently strong. If they get it wrong and start too early, they could kill the recovery. If they wait too long and keep money loose, they will light a fire under inflation and create government debt that we may never be able to repay. This surfaced last week in Greece, Spain, Portugal and Ireland!

While inflation is good for commodity investments, it is not a good thing for the average wage earner. Let's hope they get it right. Either way we are positioned to take advantage of the situation in managing your portfolio.

## How Are We Doing?

We're having a great December with our Aggressive Model up about 2.46% for the month through last night! This is .70% ahead of the S&P 500.

While it is nice to be ahead for the month, looking at short time performance can be misleading. It is better to look at longer periods of time which include both up and down markets. Below is a chart which begins on the date we made our first trade in our mutual fund (KCMTX) KCM Macro Trends fund (Aggressive has been invested 100% in KCMTX since then). For more information on the fund see the next section.

There are two sets of numbers on the chart. You will notice that part of the chart is shaded in yellow. This is the period of time the market was declining. During this period, the S&P 500 declined 47.32% (even after adding back dividends). Our Aggressive model declined, but only 1/3 as much. Conservative declined by roughly 1/5th as much! Just to recover back to break-even from a 47.32% lose, an investor must earn roughly 90% on what is left of his portfolio at the market bottom!



For the period as a whole (both yellow and white on the chart), **the S&P 500 is still down 11.71% while Aggressive and Conservative are up 13.68% and 9.68% respectively.** This is a difference of 21.39% to 25.39% after all fees and expenses!

The moral of the story is that we try not to lose any big money. This lets us recover without having to take big risks.

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

## KCM Macro Trends Fund

The **KCM Macro Trend Fund (KCMTX)** is an out-growth of the model portfolios we have been successfully managing for our clients for more than 15 years. It is a proprietary fund open only to our clients and Investment Advisors (for their clients) via Fidelity, Charles Schwab, TD Ameritrade, Pershing, Southwest Securities and Trust Company of America.

For more information about the Fund, including its objectives, strategies and performance, please give us a call at (800) 945-2125, or click on the following direct links: [KCM Macro Trends Fund](#) or [2009 3Q Fund Fact Sheet](#) (FINRA reviewed).

## In Closing

The market seems on pace to have one of its better years in a long time. Our performance has been good. Two more weeks to go. Kerns Capital Management has had a good year and we are growing.

As we go into the Christmas season I feel blessed that we have been able to add value for our

clients, our employees and ourselves.

Everyone at KCM wishes a Merry Christmas and a Happy New Year to all of you.

Lane Kerns

#### **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. The Fund may also engage in short selling activities, which are more risky than "long" positions because the potential loss on a short sell is unlimited. 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. **The Dow Jones Industrial Average** is a price-weighted average of 30 of the largest and most widely held stocks traded on the New York Stock Exchange and the Nasdaq.