

MLK CAPITAL
MANAGEMENT, INC.

ADVICE ON THE MARKET



July 18, 2003

To: Friends and Clients of MLK Capital Management

From: Lane Kerns

**Re: Current Market Conditions
Why Most Investors Haven't Made Any Money
Four Things Every Investor Must Master
401k-Investment-Advice.com**

Current Market Conditions

The market has developed a split personality. The widely followed large cap indexes, like the S&P 500 and the Dow have rallied off recent lows, but failed to make new highs. Many analysts have pointed to this as proof that the market uptrend that started in March was a fraud, a rally within a bear market that is destined to fail in dramatic fashion.

On the other hand, the technology sector and a broad range of small cap stocks have continued to trend up as the large caps have stumbled. Because small cap and technology stocks are generally considered to be more risky and aggressive, some analysts see this as evidence that investors have gained the confidence to put their money back at risk, and therefore, the bull market advance is alive and well – and destined to move higher.

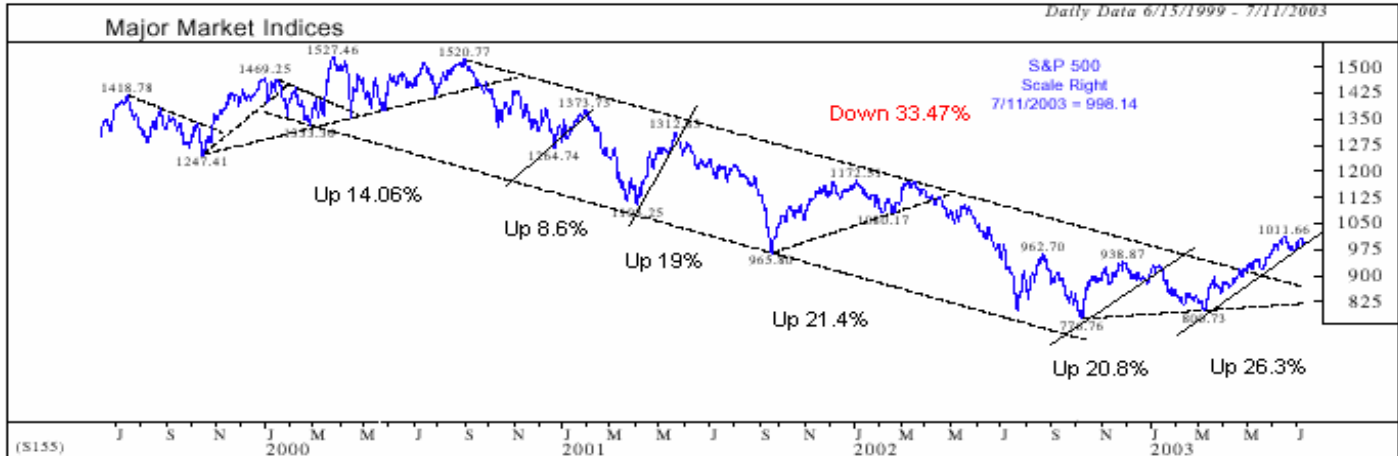
Everyone has their opinion on which direction is correct, but the reality is no one really knows - and it doesn't make a great deal of difference to us. While the S&P 500 and NASDAQ have different technical patterns at this point, it is almost certain that both will be resolved in the same direction. Either both will break to the downside, completing an intermediate top (see chart in next section) or both will resume trending up. On a short-term basis, the market is oversold and due for a bounce, but that won't mean much. Within the next week or so we'll probably find out the direction of the next significant move.

Playing around with market forecasting can be a lot of fun, but that is not what makes an investor successful. Fund selection, trend recognition and risk control is what puts money in the bank. Those are the tools we use to manage accounts and those tools are available for your use on www.401k-Investment-Advice.com.

The range of funds that are trending up is great enough that we can stay fully invested and still have good diversification.

Why Most Investors Haven't Made Any Money

If someone told you that they could guarantee you six rallies from 8.6% to 26.3% in the market over the next three years, you would probably say – Sign Me Up! In fact, that is exactly what we have had over the last three plus years since March of 2000. And yet – most people have lost money. Why? Because the market was down 33.47% during that same period ending 7/11/03. The chart below shows the S&P 500 during this period.



This type of market can be described several ways. Some would call it a Secular Bear Market with Intermediate Term Rallies. The long-term trend is down - but during this down trend - current economic conditions create intermediate or short-term opportunities to make money.

What ever you call it, money can't be made with a Buy-and-Hold or the standard Asset Allocation approach.

No matter how conservative your asset allocation might have been over the last three years, you would have lost money. This was a Trading Market. Your only hope to make money was to try to catch a good piece of each market rally and avoid most of the down trends. Some people would call this "market timing" but we do not feel that market timing by itself is sufficient to navigate this type of sea. We do not consider ourselves "market timers". But we are unwilling to stay invested and lose money if there are no available investments in dependable uptrends.

Four Things Every Investor Must Master

There are four basic questions an investor must answer: "When to Buy?", "What to Buy?", "How Much to Buy?", and "When to Sell?" All of those questions are important aspects of a sound money management system that is designed to achieve decent gains without taking excessive risk, but for this article let's focus on how we answer the "What to Buy?" question.

Mutual funds marketers tout funds based on their past performance. They group funds according to their objective – growth, value, small cap, large cap – and then rank them based on their 3-year, 5-year, and 10-year returns. Morningstar, a recognized leader in the fund ranking world, assigns a star rating to funds, with five stars being best and one star being worst. Brokers and financial planners place a great emphasis on these star ratings in their sales process, not so much because they think it means the fund will go up more than other funds, but because it gives them something to hide behind if the fund performs poorly. Ben Stein, the noted economist and TV personality recognizes the fallacy in this approach in his new book, *Yes, You Can Time the Market!* when he says, "Have you noticed that you can lose a fortune investing in Morningstar Five-Star funds?"

It is true that some funds are consistently better on a relative basis than other funds within their peer group. But in the real world that's not very helpful to investors. For example, in the late nineties, *growth* funds were the place to be. They were racking up incredible gains as the NASDAQ soared to stratospheric heights. We certainly enjoyed riding the wave from early November 1999 to late March 2000 when we captured more than 50% gain in funds like Invesco Small Company Growth and PBHG Growth. In contrast, *value* funds were very much out of favor during that period and their returns paled in comparison.

Over the past few years those same growth funds have taken a beating, while value funds delivered better returns. Does that mean the growth fund managers were brilliant in the late nineties but turned stupid March 10, 2000? Absolutely not. No asset class, and therefore, no fund is good all the time.

The cover story in the April 7, 2003 edition of *Barron's* was "Free the Managers", and it questioned the conventional thinking that fund managers should stick to their style box regardless of whether they are losing money or making money. If they beat their peers (or some index benchmark) on a relative basis, they've done their job. Buy-and-hold investors are tired of hearing that the fund they own is doing great because it *only* went down 20% while the index went down 25%. As they say on Wall Street, "You can't eat relative value." It is *absolute* returns that matter. So *Barron's* was suggesting that fund managers should be freed from those constraints, and allowed to invest in the best asset class right now.

Don't bet on that happening anytime soon. Even though mutual funds have seen mass outflows of money from their funds, they are still stuck in the ruts that were created by an 18-year bull market.

So what is the answer? The industry's answer to this problem is diversification. A passive asset allocation approach whereby you invest a portion of your money in all the different asset classes, and hopefully on average you'll come out okay. That approach works academically, but can be a tough sell in the real world. It's like telling someone to put one foot in a bucket of ice water, the other foot in a bucket of boiling water, and on average they should feel okay.

We take a very different approach. Our philosophy is to measure how the funds are actually performing on an intermediate term basis so we can concentrate the portfolio in funds that are doing well *right now*. We don't care if a fund is ranked number one in its asset class for the past 10 years, if it's not getting the job done in July 2003 we won't own it.

Also, we identify the funds to own with our proprietary ranking system that measures three things. Our "Trend" measure tells us if a fund is in an uptrend or a downtrend. It's so simple it almost sounds trite, but we only want to own funds that are trending up, and we want to avoid funds that are trending down. Our "Manager Rating" measures how well a fund manager is doing based on the risk he or she is taking relative to the market. In other words, are they adding value over and above what the general market is doing. Our "Ulcer Index" measures a fund's *downside* volatility. Most standard deviation measures consider total volatility, but we think it's foolish to punish a fund for going *up*. It's downside volatility is what causes ulcers.

Ultimately, we combine all three of these important factors plus current market performance into an "Overall Rank" that clearly lets us identify the funds that are doing well at any given time. We don't consider the fund manager, the long-term past performance, or what's in the underlying portfolio. We don't waste any energy on "why" the fund is going up - we just want to recognize that it is going up. And we never fall in love with any fund. If a fund we're holding begins to under-perform we will "trade-up" to a better performing fund. This type of objective, disciplined fund ranking system allows us to keep our clients in the right funds at the right time.

Bottom Line

Although we are very risk averse, we are also very attuned to what is happening in the market and do not have our assets setting on the sideline during the time of opportunity. **Our three Equity Models are up from 9.78% to 11.47% year to date.** The Dow is up 9.84% and the S&P is up 11.72% during the same period.

But wait – there is more. Question - If you invested \$100.00 and it goes down by 50% and then back up by 50%, how much money do you have. Answer - \$75.00. Your average rate of return was zero, but you actually lost 25% of your money!

So lets look at the period of time starting with 12/31/2000. Our three Equity Models (Conservative, Moderate & Aggressive) have outperformed the S&P 500 by 19.74%, 21.72% and 19.3% respectively for the period ending 7/17/03! Our stable account is up by 28.55%! **That means that a person investing \$1,000,000 with us on 12/31/2000 would have from \$197,400 to \$285,500 more in one of our accounts than they would have had with a Buy-and-Hold S&P 500 index fund.**

If you are managing your own money, www.401k-Investment-Advice.com would have told you that it was time to become more aggressive and what funds to buy and when to go to more conservative holdings. Or, if you prefer not to do it yourself, we can manage it for you. Check it out.

Any investment manager that cannot get you at least 1% better return than you can get (even after paying their management fee) should be fired. That includes your stock broker!

401(k) Investment Advice

Our <http://www.401k-investment-advice.com/> website is being very well received. Assets under management are up 58% year to date. It gives users the tools that we use in managing client portfolios. Once you log in, go to Investment Advice – Actively Manage. You can also get a view of the Current Market conditions by going to Current Market Conditions. If we do not already do so, we can manage your 401(k) account – as well as your personal and IRA investments.

*Our Stable, Conservative, Moderate and Aggressive models
have all significantly outperformed the S&P for the last 1, 3 and 5 years.*

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 will be 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 over 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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