



MLK Capital Management, Inc.

Mid-Month Market Report

Monday - September 18, 2006

What is Happening in the Market?

The market has had an uncharacteristically good September. Credit that almost entirely to the drop in the price of oil from almost \$80.00 per barrel to the \$60.00 range.

In the last letter, I gave ten reasons why I think the economy (and therefore the market) will do better than many expect it to do over the next few months. That story remains intact. You can review those ten reasons at <http://www.MLKerns.com/MLKerns/newsletters/>.

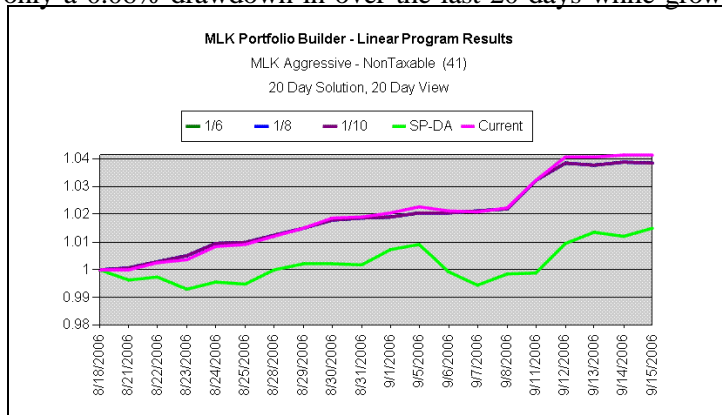
The biggest cause for the rise in the market over the last two weeks has been the drop in the price of oil which could remain soft. However, if we have an event which causes it to rise look for the market to react negatively.

Although market breadth indicators have not been negative - they have not been strong enough for us to think we should increase our risk exposure. We remain fully hedged with a slight upside bias.

What Does A Hedged Portfolio Look Like?

I have included a chart below that shows what our current holdings in Aggressive have done over the last 20 days compared to the S&P 500. The Current (Pink) Line is Aggressive and the Green line is the S&P 500.

The significant thing about this allocation is that it has had only a 0.06% drawdown in over the last 20 days while grow-



ing by 3.85%. That compares to the S&P which has had 1.45% drawdown while growing only 1.49%.

And this is our Aggressive model! We dialed in even less risk for our Conservative and Moderate models. Even though we think that the US economy will probably have a “Soft Landing” without a recession next year, we still feel that the bottoming process has not been decisive enough to obtain an explosive rally.

Until enough economic news reveals itself for us to be willing to take more risk we will continue with a hedged approach. When you look at the individual holdings in your portfolio, you might wonder why your investment manager would buy that particular holding. The answer is that we are buying a package of holdings that hedge out volatility. We would not hold many of them by themselves in this market environment - but as a group they produce the kind of results seen in the chart you see to the left.

We just went to this allocation last week and although there is no guarantee that it will do as well over the next 20 days as it has over the last 20 days, market relationships do not change very quickly. All our holdings are in easily tradable funds which can be replaced within one day if the market dictates a different mix.

Why do we Think Caution is in Order?

To put things in perspective, consider the typical market cycle. During normal “bull market” periods, the total return for the S&P 500 has historically averaged about 27% annualized (for a period of about 3.75 years), followed by a “bear market” portion with losses averaging -27% annualized (for a period of about 1.25 years).

Compound the two together and the S&P 500 normally achieved overall full cycle returns of about 10.6% over an average 5-year market cycle.

Of course, every cycle is different, and the lengths have a good deal of variation. The median tends to be closer to a 4-year cycle, but some cycles have been longer, which produces an average market cycle of about 5 years. The current bull market is already beyond the median length for past bull markets, and is among the longest stretches the S&P 500 has ever gone through without a 10% correction.

The best thing that could happen to us right now would be for the market to have a 10% correction (while we are in a

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fully hedged position which might actually make us a little money while the market is declining). Then, when the market bottoming occurs and the US economy moves into a new cycle, we take off the hedge, and get more aggressive!

Performance

Since 2000, our models are up from 52.13% to 63.27% while the S&P is up only 8.65% through 8/31/06. Yes that right, we have beaten the market since 2000 by 43.48% to 54.62%. Imagine how much that means to our clients who are now about to enter retirement. We have accomplished that by not taking big risks and controlling our losses. Unfortunately that conservatism has created some underperformance over the last few months. Yes, we don't always beat the market. However, we have never gotten it wrong for very long in the past.

We started intermittent hedging four years ago to reduce volatility. However, with the recent completion of our Portfolio Builder Linear Program software, we now have an enhanced tool to add precision to the process of our portfolio building. There are more parts to what we are doing than just linear programming and we are excited about the potential for greatly reduced volatility and increased performance! These new tools combined with the Global Macro-Economic approach that has achieved market beating performance over the last few years should yield huge dividends to our clients.

Lane Kerns

Ted Cackowski, J.D., Ph.D.

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