



DAVID R. KERN

ASSET MANAGEMENT
Dynamic Asset Allocation Strategies

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Investment Environment

The famous baseball player Yogi Berra was reported to have said, "Baseball is 90% mental. The other half is physical." In weighing the factors that will influence the markets in the year ahead, the factor most likely to have an outsized influence is interest rates. The U.S. Government issues bonds over different time periods (such as 90 days, 10 years, and 30 years), and bonds for each time period have their own interest rates (also known as "yields"). The Federal Reserve Bank, chaired by Alan Greenspan, directly controls the 1-day interest rate (the "discount rate"), while all other interest rates are set by market demand. A year ago, the 10-year U.S. Treasury bond yield settled at 4.26%, and the consensus was that as short-term rates rose, the long-term rates would also rise. The yield on that same 10-year note finished 2004 at 4.26% in spite of the five Discount Rate (1-day rate) hikes since June 30. Other factors kept the 10-year yield low, such as low inflation and strong demand from international buyers – international buyers bought bonds partly as a way to retain revenues from exporting to the U.S. (everything from oil to electronics).

Discussions at the most recent Federal Reserve meeting centered on concerns about inflation, as the higher price of oil begins to affect the economy. Many oil analysts feel higher oil prices are here to stay, and the adjustment to this, as well as to other rising commodity prices due to increased global demand, could spark more inflation. The Federal Reserve's traditional cure for rising inflation is higher interest rates. One measure of potential inflation comes from the Commodity Research Bureau (CRB) index, which gained 11.2% in 2004, and it has risen more than 38% over the last 5 years. Contrast that 5-year commodity price rise with the S&P 500 Index of large stocks, which is down 17.5% from 5 years ago. The Federal Reserve fights the increase in real asset base inflation by contracting the money supply available for credit, using its control over short-term interest rates as one tool.

Increased interest rates directly affect the bondholders, as the value of previously issued bonds (issued at a lower rate) declines. Stockholders also feel the pressure because the increased cost of borrowing may cut into corporate profits, and because investors may see the new, higher-rate bonds as a safer, more attractive alternative to stocks. Most of the foreign investors who purchased U.S. bonds in 2004 had a problem making money when translated to their own currencies, as the U.S. dollar lost value relative to the other major currencies of the world (with exceptions such as China, whose currency is pegged to the dollar). As the dollar drops in value relative to other currencies, there is further pressure on interest rates to rise to compensate foreign investors for the currency risk.

After a "go nowhere" year through the third quarter of 2004, the last three months offered some gains in the broad market indexes. The Dow Jones 30 Industrial Average, the oldest U.S. broad market index, hit both its low and its high for the year during the fourth quarter. The stock market had a lot to worry about in 2004: rising oil prices, rising inflation, an uncertain presidential outcome, and the ongoing war in Iraq. Even if the market can keep its upward momentum going in the first quarter of 2005, the future becomes less clear as new fundamental factors come into play. "The typical business expansion since World War II has been around 3-1/2 years, and this one is 3 years old. If the market leads the economy down by 6-7 months, that's kind of scary. The other side of the coin is that this economic expansion is 3 years old; very few knew it was an expansion the first year. If we follow the history books, there is good reason to become more cautious about this market because of the age of the economy." Steven Leuthold, "Tough Call," *Barron's*, December 13, 2004.

The unemployment rate in the US is 5.4% today, exactly half of the 10.8% unemployment rate in Germany, according to the Department of Labor.

Dynamic Allocation Programs

So how do all these fundamental factors affect our investment decisions for 2005? Our approach is to look at the actual price of the asset classes we are considering for investment. All of the fundamental issues -- rising interest rates, rising commodity prices, a rising or falling stock market, are reflected in the price of individual mutual funds and annuity sub-accounts. We use technical analysis and statistical analysis to determine where to move and when to move there. An uncertain future calls for an active management style that incorporates multiple asset classes and different allocations. This dynamic approach uses a wide variety of investment strategies found in our management systems.

All asset classes fall out of favor at times, damaging a long-term portfolio's chance of success. Our priorities are first to limit downside volatility, and second to select those investments for which a strong demand can be identified. For risk management, we rely on diversification of both management system and asset class. Our programs incorporate broad market stocks, bonds, real estate, precious metals, industry sector equities, and international stocks, so that at any one time, a portfolio may be invested in 10–15 different funds. Each asset class and equity sector is traded according to one or more independently customized management systems. Our primary objectives are to monitor an investor's portfolio for downside volatility to guard against catastrophic losses, to maintain profitability, and to produce returns that exceed the broad market indexes over time.

According to the Employee Benefit Research Institute, 68% of Americans currently working anticipate they will be engaged in some form of work-for-pay in their retirement years, and 42% of American workers today are not saving anything for their future retirement.

According to the IRS, the maximum elective employee deferral into an employer-sponsored 401(k) plan in 2005 is \$14,000. That amount does not include the \$4,000 in "catch-up" deferrals that an individual aged 50 or greater can contribute.

Asset Class Review – Bonds

Bonds represent an important set of asset classes for our programs. Bond strategies have been incorporated in our systems at all risk levels, from aggressive to conservative. In addition to mutual funds and annuity sub-accounts investing in long-term U.S. Government Bonds, whose values rise as interest rates fall, there are also "short" investments available with the opposite performance, whose values rise as interest rates rise. In addition to "long" or "short" U.S. Government Bonds funds, high yield corporate bonds are another category available in some investment formats. These high yield funds contain a portfolio of bonds issued by companies with credit ratings generally lower than "investment grade" quality. It is the fund manager's job to select bonds for diversification and to monitor credit risk. High yield corporate bonds often behave more like stocks, but without the short-term volatility found during some periods in the stock market. We treat each of these bond-related funds as separate asset classes with their own management programs.

According to a CNN/Gallop poll in *USA Today*, 55% of Americans ages 18-29 are in favor of having the ability to invest some of their Social Security tax dollars in privately-controlled accounts. Only 31% of Americans at least 60 years old feel the same way.

A current copy of our disclosure brochure (Form ADV – Part II) is available upon request. Please call Lisa Everson in our office at 260-637-1019 if you would like to receive a copy.