



DAVID R. KERN

ASSET MANAGEMENT
Dynamic Asset Allocation Strategies

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1st Quarter 2005 Newsletter

First Quarter Review

The very first trading day in January saw a big drop in the stock market indexes, a thud that reverberated for much of the market throughout the rest of the first quarter. The broad market indexes attempted a recovery in February, only to have it roll back over in March. The pattern is very similar to the trading range market we saw for most of 2004; however, certain sectors did well in spite of the broad market.

Energy and basic materials stocks, reflecting the strong demand for commodity-based assets and higher oil prices, led the way. Technology stocks continued to languish, and the tech-heavy NASDAQ Index had a bigger decline than the broader market S&P 500. For the first 3 months of the year, both the Dow and the S&P 500 lost about 2.6% of their value, while the NASDAQ lost about 8.5%. Other asset classes showed big losses, like the real estate index we follow which lost 8.6%, and gold and silver mining, which lost 5.7%. While long-term Treasury bond prices eked out a small 0.4% gain, the shorter-term 10-year notes lost money as short-term Fed funds interest rates continued to rise.

These declines have come in what is often a positive seasonal period for equities, when corporations and individuals fund their pension contributions to meet the tax deadlines. While a bullish case can be made with positive corporate earnings and a historically low interest rate environment, the trend for earnings is down while the trend for interest rates is up; not a good combination for strong equities markets. Energy costs may ease a bit as the moderating temperatures reduce demand for heating oil as well as natural gas; however, it appears that world demand has bumped up against the limits of supply, and higher oil prices may be a fact of life for a long time.

Notes on Our Management Strategy

Most of our accounts saw gains for the first quarter, while a buy-and-hold approach in most asset classes would have seen losses. Our positive results may be attributable to two factors that we built into our active management systems. The first is generally called pattern recognition; an example is the first calendar day of the year the market dropped enough to trigger a sell signal for our long positions from the strong gains the broad market made in late December. Pattern recognition is based on formulas derived from historical data that helps gauge the likely move of the market. We're also quick to change positions as our systems monitor the market throughout the day, and often give signals to reposition money based on the current day's activity, prior to the close of the market.

The second important factor is diversification of strategies, and the asset classes employed in those strategies. On days when the broad market drops, individual asset classes may gain, and our models are designed to find those positions to help diversify and reduce the effect of a decline in any one asset class. Our strategy may also position money in funds that are designed to appreciate as the broad market declines. These funds are used primarily when we are in a down trending market; however, because our systems are diversified, we may have one of our systems' long equities in the sector showing positive strength, at the same time we're in a broad market fund (bear fund) that appreciates as the market declines. These hedging strategies are a natural result of our diversified management systems.

A Time for Everything

Our management systems are designed to deal with the reality that certain asset classes perform better during some time periods than others. Making determinations about how well an asset class will perform in the future is difficult, as most crystal balls are fairly cloudy. Our approach allows us to react quickly to changes we see in the price direction of each asset class.

Generally, the investment industry, led by the mutual fund companies, discourages the notion of trying to time the market. Buying, and holding (with an occasionally rebalancing), of a portfolio diversified among stocks, bonds, and fixed interest is a standard industry approach. There are certain extended periods where holding a portfolio of diversified stocks and bonds produce excellent results. There have also been extended periods in history when this approach has caused investor losses, damaging retirement portfolios.

John Wagoner, a regular columnist for the USA Today newspaper, says in his April 20, 2005 column, "Never have so few lost so much for so many. The average stock fund eked out a 1% gain the past five years. But investors who poured money into the 50 hottest selling funds five years ago are down an average of 42% since March 2000, according to Lipper, the mutual fund tracker". After singling out technology stocks as the main culprit, John goes on to say, "Although most funds encourage investors to hang in for the long term, long suffering investors in some funds will have a long time to wait. An investor who bought Fidelity Aggressive Growth in March 2000 for example, will have to gain 271% just to break even".

Establishing a fixed allocation strategy using diversified stock, bond, and fixed income investments still requires periodic maintenance. A time target must be set to rebalance the portfolio to keep the allocation in the original percentages selected for each asset class. The original allocation is based on risk profiling; this process is called strategic allocation. A recent survey by the American Century mutual fund family revealed that only 2% of the investors surveyed knew that rebalancing a portfolio might entail selling investments that are up and buying investments that were down.

Alternatives to the standard industry approach include management strategies like tactical asset allocation provided by third-party asset managers, hedge funds, and a wider variety of asset classes, including currencies, commodities, and real estate. Any approach used, whether strategic or tactical, should be comprehensive with the investor's entire financial resources considered, for risk and investor objective profiling.

The problems most investors face with trying to "manage" their portfolio is simply a lack of discipline to follow a strategy, and in many cases, a lack of strategies that will work consistently. Emotion tends to be the biggest factor affecting investor behavior, and this is seen both with the result in personal accounts, and a factor that affects the broad market generally. Unfortunately, quite often the Wall Street brokerage firms and mutual fund managers provide a "do as I say, not as I do" example. Peter Lynch, who was the long-time manager of the Fidelity Magellan fund, wrote a book called *One Up on Wall Street*, where he promoted the idea of holding good stocks for a very long time. His Fidelity Magellan fund, however, had a portfolio turnover that averaged up to 300% a year for years, reflecting an active trading approach. According to Sy Harding's *Street Smart Report Online* ("Markets Can't Be Timed." April 7, 2005), most of the large brokerage firms tell investors that market timing doesn't work, while they have large program trading departments where their own accounts are traded, with enough money that they account for a large portion of the trading volume on many days during the year. "Buy programs frequently send the market higher and suck in more buying, but in positions that are only held for a few hours or days, before equally huge sell programs sweep in." The industry's widely advertised advice to hold for the long term may be a better alternative than investors' attempts to time the market; however, our approach is to offer an alternative investment strategy based on mathematical systems and computer-generated models. While there is no guarantee they will work in the future, these strategies have shown good results when looking in the rearview mirror.

How Do the Rich Get Richer?

In 2003, a joint research project conducted by the accounting firm Ernst & Young, the brokerage firm Merrill Lynch, and the consulting firm CapGemini published the 2003 World Wealth Report. This report surveyed high net-worth individuals, and found that when the S&P 500 got trashed for a 22% loss in 2002, high net-worth individuals on average lost only about 2%. How is it possible that the average equity or mutual fund investor got slammed for bear market losses, but investors with a net worth of more than \$1 million in financial assets had only a slight drop from prior year gains? This report also showed that the ultra-rich, those with more \$30 million in financial assets, saw their net worth go up by more than 3% in 2002. The primary reason, the research found, was that wealthy investors are more conservative and focus on controlling the risk, not focusing on maximized return. High net-worth individuals were more diversified in their management approach, with alternative investments comprising about 25% of their portfolio. Alternative investments include active strategies provided by hedge funds, investments in asset classes such as real estate, and actively managed programs like those offered by third-party asset managers.

Other parts of their portfolio were invested roughly 20% in equities, 30% in fixed income returns, and 25% in cash alternatives. In his book, *The Millionaire Next Door*, Dr. Tom Stanley points out that people don't get conservative after they get wealthy; they get wealthy because they are conservative. The tactical asset allocation strategies, considered alternative investments, are the mainstay of our investment philosophy.

Washington's Market Timing

With interest rates near a 40-year low, the government has announced another major change for Series EE savings bonds, the first time the federal government has changed the way that interest was paid on EE savings bonds since 1982. These savings bonds are a convenient way that small investors can buy government-backed bonds that provide interest income. In the 1970's and early 80's, interest rates hit double digits from the Federal Reserve's inflation-fighting efforts. Until 1982, the bonds' yield had been a fixed rate, set at the prevailing rate at the time of purchase, and remaining fixed at that rate for the life of the bond. In 1982, the government changed payment to a variable rate, which would go up if interest rates went up, or down if rates went down. That year marked the beginning of the extended decline in interest rates. This was excellent timing for Washington, but unfortunate for buyers of EE savings bonds.

Beginning next month, the interest paid will go back to being fixed for the life of the bond. This seems to provide evidence that the government feels interest rates are going to go up, and small investors need to take note, as this may represent an important change for some savings programs.

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.