



DAVID R. KERN

ASSET MANAGEMENT
Dynamic Asset Allocation Strategies

www.davidrkern.com

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How Do We Know What To Do?

We are often asked what kind of tools we use to determine when and what to buy or sell in our investor programs. We use indicators that belong to three general categories. The first category, technical analysis, follows the price of the mutual funds we monitor. The second, fundamental analysis looks at the overall investment environment. The third, statistical analysis, applies statistical tools to our funds to develop trading models. The intent is to find indicators that identify periods of time and asset classes with a higher than normal probability of being profitable. The funds we buy and sell represent multiple asset classes, and we use multiple indicators on each fund according to predefined priorities to determine when and what to invest in.

An example would be applying our systems to a Real Estate Investment Trust (REIT) fund, which represents the real estate asset class. This mutual fund buys REITs that trade like stocks on the stock exchange, however we consider real estate a separate asset class because its values rise and fall independently from the general stock market. Technical indicators tell us if the fund is in a long-term trend or in a trading range. Short-term indicators show if the price is over-extended or over-sold and ready to rebound if the fund price has been dropping recently. Fundamental indicators tell us if interest rates, inflation, or profits in that sector are supportive to the fund price appreciation. Statistical models give us direction from past price movements of this type of asset class. We bring multiple indicators to bear on each asset class, and we use a

consensus approach where multiple indicators must agree before we buy a fund. When we buy a fund, our holding period is determined by the indicators. For an asset class experiencing a long-term upward price trend, we may remain invested in an individual fund (such as an energy sector fund) for weeks or even months. Under different conditions, we may sell that fund in a few days if the price moves in the wrong direction. In all cases, we balance our pursuit of high returns with the desire to manage risk, avoiding downside volatility. The primary tool to strike this balance is a diversification of indicators, models, and asset classes.

Record Oil Prices

Early this year, the consensus among oil analysts was that the price of crude oil would stabilize around \$40 a barrel. Instead, on July 6, 2005 the price of oil set an all-time closing record at \$61.28 a barrel. Just one and a half years earlier, on 12/31/2003, the price of a barrel of oil was \$32.52. The price of oil nearly doubled in a year and a half. Going back to the beginning of 2002, crude oil has more than tripled from \$18.60 a barrel.

Mid-Year Stock Results

Through the 6 months ending 6/30/05, the S&P 500 Composite Index, the NASDAQ, and the Small Cap Russell 2000 Index have all declined in value. The broad foreign stock index that measures the developed countries called the EAFE (Europe, Asia and Far East) is also down more than 1% halfway through the year.

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David R. Kern, Registered Principal

Interest Rates and Bond Yields:

Long-term bond yields continue to decline despite another discount rate hike at the end of June by the Federal Reserve. While the Federal Reserve has raised short-term interest rates nine times over the last year, from 1% to 3.25%, the yield on the ten-year Treasury has dropped from 4.6% in March 2005 to below 4%. Analysts compare the interest rates for bonds with different maturities (different time periods) using a yield curve. A year ago, the two-year Treasury note yield was 2.5%, while the ten-year Treasury yield was 4.5%. Now, the two-year yield is over 3.5% while the ten-year yield is barely above 4%. Today's yield curve is much flatter than last year's yield curve, meaning that the difference between two- and ten-year yields is smaller now than it was then. While the economy may remain healthy in the near future, past economic slow-downs and recessions have been associated with an "inverted" yield curve, where short-term bonds have higher yields than long-term bonds. Because there are a number of variables that play out during the economic cycle, no two eras in history are the same in terms of cause and effect. This time around the Federal Reserve has raised interest rates at a measured pace, while long-term rates have dropped. During past interest rate tightening cycles, longer term rates have gone up along with short rates.

Bond prices are inversely related to the yield. As interest rates rise, investors with new money can get a higher return on a new issue, compared with past purchases at lower yields. Reduced demand depresses the market price of the previously issued, lower yielding bond. The total return when investing in bonds or bond funds includes both the yield and the change in market price.

There are a number of reasons long-term U.S. Government bond demand has remained strong, keeping the yields down. Asian central banks have continued to pour money into U.S. Treasuries, which offer some of the safest investment options anywhere in the world. Interest rates offered by other developed countries are not higher than here in the U.S. Another reason may be that economies around the world are beginning to slow down, with concerns about Europe possibly on the brink of recession, and rising oil prices and interest rates affecting the global economic picture. Another reason may be that pension funds are investing in Treasuries for stability and ultimate liquidity as the aging baby boom population starts to withdraw money for retirement income. Nobody knows how long these trends will persist; however demand has been reasonably strong in the face of the Fed's short-term interest rate hikes.

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.