



DAVID R. KERN

ASSET MANAGEMENT
Dynamic Asset Allocation Strategies

www.davidrkern.com

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Fundamental Overview

In a little more than two years, the cost of oil has roughly doubled. This should have a lasting impact on the economy over the next few quarters, and may represent a longer-term change with a significant impact. Gasoline for our cars accounts for roughly two-thirds of the total oil consumption in the United States, however, a wide variety of important products are derived from oil. These include plastics, fertilizer, clothes, and cosmetics. At this point higher energy prices have been slow to influence the cost of these other goods and related services, but at some point they could impact price inflation significantly. The price of everything from corn to palladium is higher this year in dollar terms, and commodity prices in general have been rising, which can put pressure on inflation.

While the last couple of years saw a weakening dollar compared to other currencies, this year the dollar has been stronger, which has the effect of making imported goods more expensive, and can cause price inflation as well. One broad-based index measuring commodities is the Reuters Jefferies Commodity Research Bureau (CRB) Index, which has risen about 11% so far this year. Historically, gold and precious metals have been considered hedges against inflation, and the Philadelphia Gold & Silver Index of mining shares is up over 25% in the last six months. This index can be very volatile over short periods of time. As winter approaches, residents of the northern climates may be in for a shock, with the price of natural gas up considerably from a year ago. Estimates put prices 30 – 90% higher than last winter, and your electric bill may also show a shocking increase as power companies use primarily coal and natural gas to create your electricity.

Some of these increases are a result of the two hurricanes that struck the southern coast of the United States and caused serious damage to petroleum and energy-producing facilities. The hurricane effect may be short term; however, energy costs were already rising well before the hurricanes struck, and it appears that energy demands around the world may be outstripping supply. The long-term effect is unknown, but without a slow-down in economies around the world, this supply/demand imbalance means higher prices.

Sector Review – Real Estate Investment Trusts

A number of our investment formats include a mutual fund that invests in Real Estate Investment Trusts (REITs), which offers a separate asset class, as well as an important investment option that is not highly correlated with those of other asset classes (their prices do not always move in the direction of the general stock market). The market capitalization of publicly traded REITs ballooned from \$8.7 billion in 1990 to more than \$400 billion today. The number of publicly traded REITs swelled from 119 in 1990 to 189 today with the top six now included in the S & P 500 Index of large company stocks. Over the last five years, REIT stocks have out-performed the broad stock market, as measured by the S & P 500 Index, and have contributed to investor portfolio returns in our Dynamic Portfolio Allocation Programs.

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*Securities offered through Questar Capital Corporation- Member NASD, SIPC
David R. Kern Asset Management, a Registered Investment Advisor, is independent of Questar Capital.*

David R. Kern, Registered Principal

Investor interest in REITs in recent years is a result of a number of factors, including the ability of an investor to use a pooling vehicle such as a mutual fund, which provides liquidity and diversification in the real estate sector. REITs also pass through income distributions that allow investors to avoid double taxation of investments; and because they are required to distribute at least 90% of their taxable income as dividends, REITs also enjoy a high degree of stability in cash flows and earnings based on predictable long-term leases. What may be more important, Ibbotson Research shows that as an asset class, REITs offer some of the best risk-adjusted returns of any investment product. Dividend yields currently average more than 5%, and some investors see real estate as an excellent inflation hedge.

Investing in a REIT mutual fund can include a number of different types of real estate, but commercial real estate is the key component in each REIT owned by the mutual fund. REITs can include retail shopping centers, industrial buildings, office and health care facilities, apartments, and hotels; mortgages can be packaged in a REIT as well. REITs generally do not include home builders or private residences, but are subject to some of the same economic factors that can impact supply and demand, like the cost of money based on the interest rate environment, and general consumer spending, which has remained remarkably strong in light of the debt load carried by the average worker in the United States.

While we were able to access a diversified mutual fund that invests in REITs in our actively managed programs, the individual stocks in the REIT category are considered alternative investments, and are not included in the traditional portfolio allocation that would buy and hold a mix of stocks, bonds and money market funds.

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.

Also enclosed with this newsletter is a copy of our 2005 Business Continuity Planning Statement.

Most 401k plans, for example, do not offer a REIT option, but rather focus on index funds or managed funds that represent the broad stock market or a management style including growth or value, or market capitalization size, looking at large cap, mid cap, and small cap stocks. With diversification being an important risk management factor for long-term investors, 401k plans may be adding REIT funds, and thus help fuel continued demand for this important asset class.

Managing Change

The importance of diversification and professional management come to the forefront when investors face an environment of inflation, recessions, and crisis in confidence. Our Dynamic Portfolio Allocation programs offer a variety of asset classes with potential for investor gains in a number of fundamental investment environments. During periods of inflation, certain stocks, real estate, commodities and inflation index bonds may outperform other asset classes. With the Fed raising interest rates to moderate demand, and fight inflation, the danger is that they will go too far and throw the economy into a recession. As the environment changes and the Fed reverses course to discontinue their tightening measures or start reducing interest rates, bonds including long-term governments, municipals, high-quality corporate and high-yield bonds may benefit. Treasury bonds and gold stocks have also been a safe haven during periods of crisis dealing with loss of confidence, a terrorist attack, a currency crisis, or worries over U.S. debt levels. In addition to mutual funds representing each of these asset classes for the various threats, money market funds offer a safe haven from market risk of all kinds, and they become the default safe place to park an investor's monies as other asset classes decline in price. Our active approach is designed to mitigate the market risk associated with downside volatility in any of the asset classes available in our trading platforms.