



DAVID R. KERN

ASSET MANAGEMENT
Dynamic Asset Allocation Strategies

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Investment Environment

The twin headwinds of higher interest rates and higher oil prices threatening inflation made a difficult year for equities as measured by the broad-based indexes. The Dow Jones 30 Industrials were actually down slightly for the year and the more widely watched S & P 500 managed about a 3% gain. Other markets around the world fared much better as they began their recovery from the bear market of 2000 – 2003.

The Federal Reserve has now raised interest rates 13 times in the last year and a half in an effort to contain inflation. While the government has a complex system to determine the consumer price index on which they base increases in social security payments, it's hard to ignore that the cost of a barrel of oil is above \$60, when about four years ago at the end of 2001, it was at \$20 a barrel.

For investors in our diversified risk objective programs the entire year, most accounts showed gains greater than the S & P 500 Index, one of our benchmarks of performance. Factoring in our lower risk approach for these gains, we met most of our objectives. The one objective where we fell short was to have positive quarters every quarter, and the final quarter of 2005 proved difficult for our models. Our programs are not highly correlated with the broad market index, and for the first three quarters of the year we outperformed the S & P 500 Index. A narrow trading range for the broad market, and a pull back in the leading sectors of energy and utilities created a difficult fourth quarter for our programs. Our specialty programs did much better for the year, including the hard asset program focusing on energy, precious metals, real estate and utilities.

The broad market action since the beginning of 2006 paints a bullish picture, and a case to be made that the rising interest rate trend may be coming to an end if the Fed is concerned they will over shoot in their effort to control inflation, and choke off corporate profits. A second, more interesting aspect arises from our review of different market sectors. Since the beginning of the year the technology and financial stocks have shown leadership, and this is normally a bullish sign for the rest of the market. The year 2005 was one of the most difficult years to navigate in a long time, primarily because there was no definite direction or leadership in the overall market. I'm glad to put it to an end, and look forward to a much better investing environment in 2006.

Market Crash Trivia

On the morning of October 19, 1987, the trading day that ultimately resulted in the largest one-day percentage loss in U. S. stock market history, the nation's most widely read daily financial publication ran a front page article with the subtitle "Some Stay Bullish, Believing Downturn is Temporary." The S & P 500 Index fell 20% that day but ultimately did recover to its pre-crash level in just over 12 months. It took many investors a much longer time period to wade back in as their long term investment objective was overcome with short term fear.

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David R. Kern Asset Management, a Registered Investment Advisor, is independent of Questar Capital.*

David R. Kern, Registered Principal

Sector Watch – Gold & Precious Metals

Gold, and our access to this separate asset class using precious metal sector funds, is one of the most intriguing investment options in today's environment. The professional investment advisory industry uses traditional asset allocation models. Over the last 20 years they have allowed little, or no representation of this asset class due to its' extreme volatility, and the difficulty of access to gold bouillon. Direct gold ownership produces no income, and there are storage and expense to consider. Recently financial products have become available making it easier to access this asset class, and there are sector mutual funds that focus on those companies whose stock are included in the gold and silver mining industry. The Philadelphia Gold & Silver Mining Index of the largest companies in the gold mining business are owned by the sector fund.

Historically gold hit a peak at over \$800 an ounce briefly in 1980, and in the following years experienced 50 to 100% moves both up and down, finally reaching a low of around \$260 an ounce in 1999, at the same time the broad stock market indexes were peaking. Gold is currently trading at over \$500 an ounce, and its no coincidence that an index of commodities called the CRB Index has shown a stunning four-year rise representing the increase in broad commodities across the world. For hundreds of years, rising gold prices have been taken as a warning of increasing inflation pressure. In the economic boom times of the 1990's, Fed Chairman Greenspan often noted that inflation was declining and not a threat, citing the continuing decline in gold prices as a confirming factor. Now that gold has virtually doubled in the last four years, the Fed may need to take this market indicator into account in weighing the need for additional interest rate hikes.

Our model for managing precious metals is designed for an environment where only small short-term gains can be anticipated, and as with all of our programs, risk management is our primary focus. Gold movement can be influenced by a change in the dollar compared to other currencies, the general stock market, and interest rate changes. Recently there has been an increase in market demand by rising affluence in other nations that prize ownership of gold above other asset classes.

All these influences tend to change over time, and make managing this asset class one of the most interesting, and difficult propositions for success.

Ask the Experts

The Fed began a series of rate hikes of short-term interest rates on June 30, 2004. Six months after the rate hikes began at the end of 2004, 56 economists were asked to project where the yield on the 10-year Treasury Note would be a year later. From it's year end level of 4.22%, 55 of the 56 economists projected the yield on the 10-year note would rise over the subsequent six months with the average prediction being 4.79%, a ½ of 1% increase. Instead the 10-year note yield fell to 3.9%. Normally rising interest rates would cause bonds to fall, however, the strong demand for bonds from foreign governments and pension plans apparently kept the yield of these long-term bonds down.

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