



# DAVID R. KERN

**ASSET MANAGEMENT**  
*Dynamic Asset Allocation Strategies*

[www.davidrkern.com](http://www.davidrkern.com)

## 1st Quarter 2006 Newsletter

### Broad Stock Market Behavior

The S & P 500 Index, a broad measure of the largest publicly traded stocks, has run for the last three years without so much as a 10% correction. This represents the third longest winning streak since 1965 where stock have not dropped at least 10% from their highest point during the period.

This behavior is even more unique when you consider that the index has not corrected even 3% in the last three months. This kind of market behavior happens only about 5% of the time. The market continues its frustrating repetition in making very fractional short-term moves that don't last more than a week or two in either direction. Recently some of the broad market indexes made fractional new multi-year highs that created a lot of excitement in the news. The problem is there is no upside follow through and the new highs last for only a day or two, then they drop back down again.

Below the surface there is a lot more going on with some sectors continuing to rise while others continue to decline. The broad market indexes are hurt by the fact that the financial and healthcare sectors are lagging and they make up a large component of the broad market. Laszlo Biriny Jr., President of Biriny Associates, said in the April 24 issue of Forbes that "the market is ruled by quick-trading hedge-fund types. Big stocks don't move fast enough for them." He's referring to the fact that some of the smaller stocks have continued to outperform the large stocks, while analysts had expected that large stocks would begin to outperform during this period of rising interest rates. Normally, a rising interest rate environment makes it more difficult for smaller growing companies to borrow money, and can negatively impact them relative to the big well-heeled industry leaders.

### Market Fundamentals

The bull story supporting continued equity growth is that the economy is strong and corporate earnings are strong. Investors are generally eager to put their money to work in the market and are frustrated by those managers who exercise caution. As you would expect, things always do look great when the market is close to a top, however, the market anticipates the future, for roughly 6 months or so out, and many investors are currently complacent about the potential declines that may lie ahead.

The Federal Reserve's stated reason for raising interest rates 14 times over the last two years is to ward off inflation. Higher interest rates slow the economy making it more difficult for consumers to borrow and spend, which in turn slows corporate growth and the job market. This takes some of the inflationary pressure off both products and wages. The Fed may also want to take some of the air out of the real estate market by raising the cost of financing a home, and also to improve the nation's deplorable negative savings rate by increasing the interest that consumers receive on savings.

Money market funds may become one of our favorite asset classes as interest rates rise and other asset classes decline.

The traditional buy and hold investor looks at the cloudy horizon and sees a silver lining by remembering that the stock market climbs a wall of worry. A number of fundamental factors may make it more difficult for stocks to advance over the next few months including rising interest rates, rising inflation, spiked oil prices, unrest in the Middle East, high level market "churning", low trading volume, and the chance that past cycle patterns will reappear.

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#### **DAVID R. KERN ASSET MANAGEMENT**

**16616 Lima Road, Huntertown, IN 46748 - (Phone: 260-637-1019 or Fax: 260-637-1373)**

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**David R. Kern, Registered Principal**

There's a market pattern called the four-year presidential cycle, where historically in the second year (which is where we are now) there is a negative period where the broad market can drop from the highs enough to give investors serious concern. This pattern does not always play out, however with difficult economic fundamentals in play, the chance for a decline increases.

The rest of the story is that if there is a substantial decline in the second year of the four-year cycle, it is usually followed by a big gain, even for the conservative Dow and S & P 500.

Many investors feel that when the Fed stops raising interest rates, this can release the stock market to go up because better times are ahead. A recent study conducted by Ned Davis Research Inc. shows that since 1929, any time the Fed has been raising rates and then stopped, the S & P 500 was lower six months later 71% of the time. The problem is that when the Fed has been raising rates to slow the economy and to ward off inflation, their successful effort may mean the economy has slowed too much and is in the recession.

## **International Markets – Japan**

International markets have been the real story over the past year or so, and we have made provisions in our broad based risk managed program to include more international exposure. While the U.S. markets have been generally lackluster, with a few exciting areas, many of the international markets have experienced substantial gains. Money has moved into Japanese equities as many of the old banking system practices have been reformed, and investors feel more confident that the Japanese economy is finally gaining ground. The Japanese have been tremendous savers, and the postal systems government sponsored savings programs are being reformed, and this year a great deal of money will move into quasi-private accounts. While there is an extraordinary amount of inertia built into these savings vehicles, even as the Japanese government has offered negligible returns with their government bonds, it is expected that savers will redirect an increasing percentage of these monies to non-domestic investments including bonds, equities, global fixed income securities, and mutual funds that invest in these asset classes.

Investors from outside of Japan may have purchased Japanese equities because their relative valuations were low when compared to domestic stocks. With these vast sums being unleashed this year, Japanese investors may also want to move more into their own stock market. The Japanese Nikkei stock index peaked in 1989. For the last roughly 17 years, the Japanese market has been in a series of secular bull and bear

markets rising and declining from 10 – 50%, giving investors heartburn keeping money invested elsewhere. The fundamentals may have changed enough to attract long-term investors to that market; however, not only Japan, but also many international markets have experienced tremendous investor interest because of their relative value. Many emerging markets, which are Third World countries with rapid economic growth, are producers of many of the natural resources that have seen a great increase in value as commodities have risen, not only oil but manufacturing basic materials and natural resources. The natural resource sector has been one of the hottest growth areas, and growth around the world has been reflected in a run up and increase of market prices. As we gather data and develop new models, many of these markets will be a part of our broad-based management programs.

## **A Review of our Management Approach for New Investors**

*"It's not what you gain in a bull market that counts, it's what you keep after the bear markets do their damage"* James Stack, InvesTech Research.

Our priorities in managing your money are first, risk management to control the negative volatility inherent with any market based asset class. Over the long term this is very important because, if your investment drops 20%, you need to gain 25% to get even. The bigger the drop, the more work your investment will need to do just to break even. Traditional buy and hold allocations are subject to large draw downs from their high value. During the bear market in stocks from the spring of 2000 to the spring of 2003, the broad based market indexes like the S & P 500 lost almost half their value. Recovering from such a loss makes it difficult for a portfolio, especially a retirement portfolio, where money is being withdrawn to provide living expenses, to prosper long term.

Our second objective is asset class selection, being in the right fund at the right time.

To accomplish these two objectives we use a quantitative (non-discretionary) approach that uses both traditional and non-traditional asset class selection criteria. Dynamic Asset Allocation uses a multi-tiered approach with diversification among different asset classes, including non-traditional asset classes like real estate and commodity-based stocks.

Our quantitative approach seeks to identify underlying factors that have outperformed the market over long periods of time. Our model design includes data from extended market periods and our software targets pattern recognition as well as traditional technical analysis for buy and sell decisions.

It's important to understand that our skill is in designing management systems to recognize these market patterns and act on the changes. Market behavior changes over time and our models do not perform equally in all time periods. For example, in some quarters we may under-perform our risk-based benchmark of comparison. For example, a capital appreciation risk objective may use the S&P 500 index as a comparison benchmark, while a moderate risk objective might use 50% S&P 500 index and 50% Treasury Bond index. Over the long term, the objective is to outperform the benchmark most suitable for the risk level an investor has chosen.

One of the non-traditional parts of our asset management approach is to use hedging strategies, selecting funds that rise as the broad market stock or bond index falls. This allows us to take advantage of opportunities when the market is declining as well as advancing. We may hold a "bear" fund for the market decline, while also holding a long position in a sector like energy or real estate.

We have learned over the years that our investor's expectations include outperforming the stock market in bull markets when prices are rising, and maintaining a "real return" that is positive when markets are in decline. Over the long term (3-5 years), this is our objective; however reality is such that we don't meet these two objectives every quarter. We appreciate a longer term perspective, and patience from our new investors.

**A copy of our Business Continuity Plan and Privacy Policy are enclosed for your review.**

**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.**