



# DAVID R. KERN

ASSET MANAGEMENT  
*Dynamic Asset Allocation Strategies*

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

## 4th Quarter 2006 Newsletter

### Banner Year for Broad Stock Market Indexes

2006 marks the second year in a row where the broad market index did not suffer at least a 10% correction, or pull back. The lack of down side volatility is unusual, and has set a record for the longest period in history without a 10% correction. Generally a 10% decline in the index is called a correction, and it takes a 20% decline to signal a bear market. The last bear market started in the spring of 2000, with recovery beginning in the spring of 2003 during which the broad market S&P 500 index lost about 45% of its value. The S&P 500 broad market index is about 8% away from a fresh peak looking back over the last six years. There are many reasons for continued optimism. Lower oil prices and a Fed on hold from raising interest rates may have been the catalyst to spur the market in the last quarter of 2006, and if those trends continue, there are reasons to believe that stocks can continue to advance, as they are not over valued by historical standards. Also, the supply of stocks is shrinking, with record takeovers of formerly public companies by private equity groups. Demand from private equity groups accounted for more than 25% of all U.S. deals last year. Merger and acquisition deals provided fresh demand for stocks in 2006, and that trend is expected to continue with near record levels of corporate cash continuing to drive corporate repurchase of their own stock. Skepticism also remains high that the market can continue to run up, as market analysts who use seasonal strategies were left behind as the markets spurred ahead through the normally volatile September-November time frame.

This is also the third year of the four year Presidential cycle, which may offer a strong tail wind if history repeats this cycle. Government Bonds may be in demand again after the 30-Year U.S. Treasury Bond declined 3.8% in 2006, and the dollar declined about 8% compared to other currencies.

### Has Fear left the Financial Markets for Good?

Money continued to pour in to financial assets during the second half of the year. Many investors paid little attention to financial risk by increasing exposure to Emerging Market and High Yield Bond type investments. As risk managers, we use a number of gauges to determine how much fear is on investor's minds. One closely watched volatility indicator is the Chicago Board Options Exchange Index, known as the VIX. This index measures volatility by tracking the movement of a range of stock index options. Lower numbers may indicate investor complacency, or the expectation of a higher market in the months ahead. The index fell below 10 on December 15, 2006, near its record low of 9.3 set in December of 1993. Since it began in 1990, the VIX had only closed below 10 on eight occasions, three of which were in the last two months of 2006. Its all time high was 45.7 in October of 1998, following a currency crisis that affected markets all around the world.

The fear gauge reached a three-year high of 22.8 in June of this year, but started falling after the Federal Reserve halted its campaign to raise interest rates. The International political outlook has also calmed since the summer, when Israel was at war with Hezbollah Guerillas.

---

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

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

*Securities offered through Questar Capital Corporation - Member NASD, SIPC*

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

**David R. Kern, Registered Principal**

Oil prices have also fallen from about \$77.00 in July to around \$61.00 at year's end, and corporate earnings have remained strong in spite of the higher interest rate environment, and talk of recession due to an inverted yield curve and a slow down in economic growth.

Apparently there is a lot of capital looking for investment return. According to Federal Reserve Chairman Ben Bernanke, "Over the last decade a combination of diverse forces has created a significant increase in the global supply of saving – a global saving glut".<sup>1</sup> High rates of savings around the world, combined with open global financial markets have created a flood of investment money seeking higher returns. This flood encourages risk taking and reduces the return on risky investments. The spread between High Yield Bonds and U.S. Treasury Securities, for instance, has narrowed to 3.25%, down from a historical average of around 5%, according to Moody's Investment Service.

Capital flows looking for higher yields may explain why the REIT Index, composed of commercial real estate, has out-performed most asset classes in 2006. In spite of concerns about residential housing values, commercial real estate has enjoyed capital appreciation and income derived from rents. This separate asset class has become more widely available with new mutual funds that track the stocks in the index.

Any number of concerns can return to investor's minds to bring the fear index gauge back off its historic lows. Standard and Poor's Equity Research Services projects that corporate earnings growth as a whole is likely to slow in 2007 to about 9% from the torrid pace of 15% in 2006. Slower than expected economic growth, a rise in interest rates to control inflation, a new round of increases in oil prices, or another political crisis could send investors to the sidelines as the fear gauge rises.

### **The Road to Financial Independence**

Flipping the calendar to a brand new year provides a benchmark for thinking about long-

term investment goals, and financial independence.

Spending money in retirement, and investment returns over the years, provide moving targets for goal setting. According to a New York Life survey, 29% of Americans believe they will be able to withdraw 10% of their accumulated saving each year during retirement and not run out of money prematurely. The financial planning industry had currently settled on around 5%, as a safe amount that you can expect to pull out of retirement savings to live on. It also assumes a traditional allocation of assets to stocks, bonds, and fixed income. This allows some accumulation to build up in the capital base to meet future inflation needs, and increase income down the road. Around 70% of Americans realize they will need to accumulate at least one million dollars in saving to enjoy a comfortable lifestyle during retirement. The actual dollars needed may be much larger, depending on lifestyle expectations, and inflation down the road. Investors can also count on longer life expectancies as evidence by a greetings card rack that now has birthday cards celebrating your 100<sup>th</sup> Birthday. Apparently there is enough demand to support this specialty card, and statisticians tell us this is one of the fastest growth age groups in the country. The bottom line, save up!

### **Spending Priorities**

The Government's role in spending our tax dollars has changed over the last 35 years, when in 1970 the National Defense budget was 170% larger than social security. Spending in 2006 on defense is projected to be just 3% less than on social security. This trend is expected to continue, as more baby boomers hit retirement and tap the social security fund for their retirement income.

Please contact David R. Kern Asset Management if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account. Our current disclosure statement is set forth on Part II of Form ADV and is available for your review upon request.

<sup>1</sup> Wall Street Journal, 12/20/2006.  
Article - Financial Risk: Where Has It Gone?