



DAVID R. KERN

ASSET MANAGEMENT
Dynamic Asset Allocation Strategies

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2nd Quarter 2007 Newsletter

Market Movers

It's been 11 months since the Fed last changed interest rates, providing the longest stretch of time without any Fed changes since an 18-month period with no change that ended in September of 1998. One of the more important engines of the current bull market has been relatively low interest rates worldwide. These low rates have fueled investment and consumption, and made it highly attractive for private investors to use borrowed money to arrange corporate buyouts. Prior interest rate cycles reveal that in four separate rate-hike cycles implemented by the Fed since 1990, the 5.25% that the Central Bank has currently paused at (for the last 11 months) is less than the peak interest rate in the previous three cycles. The other three high points achieved before the Fed began cutting interest rates were 5.5%, 6%, and 6.5% according to the Federal Reserve.

According to the Wilshire Financial Times, companies in the S&P 500 Index have a total market capitalization of approximately 14 trillion dollars today. The corporate balance sheets of these companies have combined cash balances of 2.8 trillion or 20% of their stock values. These high savings rates by corporations can be used to fund stock buy backs, and attract private equity buyers who use corporate assets as collateral for debt. U.S. Market gains have been accompanied by the International markets, enhanced by the rise of the numbers in middle classes in the developing world, and increases in productivity all across the globe.

While recent gains in the markets have lead major indexes like the S&P 500, and the Dow Jones Industrials to new highs, it has taken about seven years to recover from major declines beginning in the 2000 bear market. Generally corporate profits remain strong, although the rate of growth has been decelerating over recent quarters. All of these factors have provided a positive backdrop for equity appreciation over the last year or so.

If there are storms on the horizon, it may be in the form of higher prices for both food and energy. When the government releases inflation figures, they generally focus on the core rate of inflation excluding the cost of food and energy. The unfortunate truth is that crude oil is now above \$74.00 per barrel, almost 50% higher than just six months ago. The Department of Agriculture reported a 7.3% increase in food prices in the first quarter 2007, and an increase of 6.1% for the full year. This leaves the real rate of inflation including food and energy at rates that are unacceptable to the Fed. Recent comments by members of the Federal Open Market Committee indicate they feel inflation pressures will moderate, however the cost of food and energy are very much a part of our world, and cannot be ignored for long.

Aside from rising concern about mortgage default rates, debt held by investors who use margin accounts to borrow money and buy securities is higher today (more than 300 billion) than it was at the peak of the stock bull market in March 2000 according to the NASD reports. If the stock market does start a correction to the down side, it could be exacerbated by the need to cover margin calls.

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David R. Kern, Registered Principal

Living Larger and Longer

Not only are life expectancies improving because of medical and nutritional breakthroughs, but according to the Fidelity Research Institute, nearly two out of five American retirees (39%) are spending more money in their retirement years than they did before they quit working. Another study by the National Association of Realtors published in the L.A. Times indicates that of the 78 million Americans born between 1946 and 1964 (i.e. The Baby Boomers), 25% anticipate they will never retire. These trends point to three risks for the long-term “big picture” of retirement.

The first is longevity risk where retirees live longer than expected, and experience a shortage of funds in the later stages of retirement. The second risk is behavioral risk when investment decisions made under the stress of uncertainty can lead to disappointing and unanticipated investments returns. The third factor is the sequence of income and expense providing a risk where market downturns coincide with loss of retirement savings, in addition to withdrawals needed for living expenses.

These risks call for a combination of strategies for investment monies that may include active managed strategies and a broader range of diversification options, in addition to passive asset allocation.

Long Term Risk Perspective

In my early years of economic studies, Nobel laureate Paul A. Samuelson co-wrote a number of textbooks I read in postgraduate studies. One of the things I remember about his perspective concerning market risk is that the longer you own stock, the greater the risk of a significant loss. This is one of the primary concerns that lead me to develop active management strategies. These strategies are designed first of all to mitigate market risk by focusing on managing downside volatility, and secondarily to provide a return in proportion to the amount of risk taken by an investor. In some calendar quarters the passive allocation strategy will be better, and in others the active programs will outperform.

Active strategies should provide protection against participating fully in a bear market that can slash portfolio values an average of about 32% when considering all the major bear markets over the last century. This is according to Dr. Bryan Taylor, in his article “Bull and Bear Markets Past and Present” (Source: Global Financial Data, Inc.). No one has a crystal ball to know when a bull or bear market has begun, however it’s important to have some assets positioned to avoid major downside volatility.

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.