



# DAVID R. KERN

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

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## 2nd Quarter 2008 Newsletter

### The Financial Markets in Difficult Times

Just when it seems that all the bad news has been reported, another financial institution or major corporation faces severe economic strain as the economy goes through another turbulent period. The Federal Reserve, the government's primary tool to manage the economy, is in a bind. In order to combat the financial crisis in the real estate market, the Fed has lowered interest rates, making it easier for banks to borrow money, and it extended lower rates for those homeowners caught in a refinancing bind. These same steps to fix the housing problems have fueled inflation along with the relentless increase in energy costs. There are few options available for the Fed at his point to deal with the dual problems of inflation and the stresses in the financial system. The central bank could extend its liquidity facilities in the financial sector and support legislation moving slowly through congress to bolster the housing industry. At some point the interest rates will start rising again to address the inflation problem. This means that at least for awhile, fixed investment returns will continue to stay down, as inflation heats up to multi year highs.

For what lies ahead, we can look to the past during periods of inflation to see similarities and differences. This period of higher oil prices and inflation may be different than when oil prices rose in the 1970s, creating a multi year recession. Back in the 1970s when oil prices rose, the prices of other goods and services went along for the ride. This was a deeply embedded inflation problem. At that time employees were able to demand higher wages, creating a self-feeding, upward wage price spiral. At this point, employers seem to have more power to restrain wages, and the prices on many goods and services have not risen to reflect the increase in transportation costs associated with energy. Instead, the spikes in oil and food prices are acting mainly as a tax on the consumer that will eventually douse economic growth.

Looking out over the next couple of years, the result may be the same as in the past where consumers start reducing their spending and energy consumption, bringing prices back down and slowing the pressure on the inflationary spiral.

### Managing Investments in Bear Markets

Our active management strategies have largely avoided the losses to both the equity markets and the debt markets associated with corporate bonds. This applies to both the U.S. markets and most of the international markets, which have declined during the first half of the year. The turmoil and inflationary problems are worldwide, and many of the markets in the developing worlds, notably China, have declined by a greater percentage than the U.S. markets.

I have been reading a number of articles in magazines and newspapers about how investors should handle this current economic slowdown with their investment portfolios. Many of the articles I've read indicate that the investor should hold their portfolio allocations for the long term. These article writers go on to outline the standard investment wisdom that includes diversification, periodic rebalancing to original allocations, targeting investments to future periods of need, and managing emotions to stay the course. The articles usually conclude with a proactive note that the future looks bright and things will get better. One article in the Wall Street Journal by James Zweig was titled "Stop Worrying, And Learn To Love the Bear". The focus of this article was that the drop in the market indexes of about 20% gives you a chance to buy in at lower prices. He acknowledges "this newspaper, and most of Wall Street, has declared that stocks have officially entered a bear market now that the average is 20% below its record high of last October". He goes on to say, "I think that's poppycock. We've been in a bear market for years. The Dow was almost 600 points higher in early 2000 than it is today.

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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**

What about that 10% yearly return that U.S. stocks supposedly provide with near certainty?"

If you are no longer in the accumulation phase, this buy while the markets are down strategy may not be an option. Investors in the distribution phase of their lives may not have new money to invest, and no one knows if the market declines have ended. The 2000 bear market saw the broad market indexes drop roughly 40% from the highs. Those people in the working years, up to even age 55, may benefit from market declines where their periodic investments into their 401K plans and retirement accounts allow purchases at lower costs. Ultimately this dollar cost averaging strategy is seen as the best option for long term investors. Even if you are not planning to retire, once your primary earning years are over you can't afford to lose principal to a bear market. Those who are already retired or taking periodic withdrawals out of their long-term investment programs are hit with a double decline from the withdrawal, and also the loss of principal to a bear market. This is the primary reason we developed our active investment strategies to focus on reducing market risk during periods when the overall decline can be devastating. As we have learned from the most recent bear market from 2000 to 2003, the indexes can lose up to half of their value, and serious damage can be done to a client's portfolio. Our approach is to manage that market risk, and still try to find opportunities for gain, in both down and up markets, and in sectors that may buck the trend. In recent months, energy related stocks have out-performed, and financial stocks have under-performed. These disparities are opportunities for our active management programs, and we hope to continue to provide positive results throughout the year.

### **John Templeton**

Sir John Templeton, founder of the Templeton Funds and the Templeton Prize, died recently in the Bahamas at age 95. "He was a good investor, always looking for a bargain," says Michael Lipper, president of Lipper Advisory Services. Templeton became one of the world's best-known figures, appearing on Wall Street Week and drawing hundreds of investors to the Templeton Growth Fund's annual meetings. He was equally well known for his charitable work, for which he was knighted by Queen Elizabeth II in 1987. His most famous endowment was the Templeton Prize, a nearly \$2,000,000.00 award for research into religion and science. Recipients include Mother Theresa and the Rev. Billy Graham.

A lifelong Presbyterian, Templeton felt that discoveries in science should increase interest in religion, not decrease it. Science would revitalize religion in the 21<sup>st</sup> century, Templeton said, in part by revealing the vastness and complexity of the universe. Templeton also created the John Templeton Foundation, which supports research in such fields as theoretical physics, cosmology, evolutionary biology and cognitive science. It also funds research in social sciences relating to love, forgiveness, creativity and the nature and origin of religious belief.

John Marks Templeton was born in 1912 in Winchester, Tenn., and attended Yale University, where he helped pay his way by selling magazine subscriptions. From Yale, Templeton went to Oxford as a Rhodes Scholar. Templeton founded his own investment firm in 1940 and started the Templeton Growth fund in 1954.

"John was a man of principal, determination, intelligence and wisdom," Charlie Johnson, chairman of Franklin Resources, said in a statement. "His brilliance as an investor was second to none."

Templeton's son, John Templeton Jr. retired as a pediatric surgeon in 1995 to head the John Templeton Foundation. He is also survived by another son, a stepdaughter, three grandchildren and three great-grandchildren.

I had the good fortune to hear John speak on a number of occasions, including at conference for investment advisors who offered the Templeton fund to clients. John was one of the biggest original thinkers in the industry, and he has had a lasting impact on my philosophy for managing money.

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.