



**E-LLUMINATIONS
JULY 15, 2005**

2005 MID YEAR UPDATE TO OUR CLIENTS AND FRIENDS

There is no end to the challenges of managing money in the 21st century. One of the overriding factors has become the constant and nagging fear of the affects of terrorism on the global economy and financial markets. As we draft this section of this report in the early morning hours of July 7, 2005, London has become the latest site of a major attack and global equity markets are poised to sell off sharply at the open.

We can not tell if other attacks will follow, nor can we quantify the long term impact on financial markets. But it is appropriate that we start this report with the mention of this overriding and nagging influence on our lives and our work.

Just as we were on September 11, 2001, today we are appalled by the callous, inhumane, insane use of terror against innocent people. Our hearts ache for the people of London who have suffered through this catastrophe.

It is somehow appropriate that our attention is drawn to Europe this morning. That may be where this report should focus as we try to provide you with some insight to our approach to the markets so far in 2005 and our vision for the remainder of the year.

WILL EUROPE LEAD THE WORLD INTO RECESSION BY 2006?

It is no coincidence that we are currently short two Index Shares (I shares) that represent the British stock market and the German stock market. The "I Share MSCI Germany" (symbol=EWG) represents the German DAX stock index. The "I Share MSCI UK" (symbol=EWU) represents the British FTSE index. We shorted both, in suitable accounts, in April of 2005. That may seem an odd pairing in that the German economy is clearly troubled and one of the weaker in Europe, while the British economy has actually held up much better.

But it is our considered opinion that much of Europe is likely to be in a recession by 2006 or bouncing along at sluggish growth rates that barely avoid recession. We obviously formed that opinion before the attack that occurred today.

Italy is already technically in recession. France is not far behind. The question is whether or not the European malaise is a leading indicator of broader economic troubles that will spread around the globe?

At this point there is little confirming evidence that this is true; but there certainly are early warning signs that the global economy is slowing.

We are reminded that our original 2005 forecast quoted the esteemed UCLA economic forecast calling for “solid but not spectacular growth” during 2005 in the USA and throughout the world; but warning that GDP growth should “slow to 2.8 percent by the second half of 2005.” They also said, “That means rising interest rates, some weakness in housing and consumer durables, but only shaving a bit of normal GDP growth. By 2006 we (UCLA) are talking a recession driven by a plunge in consumer spending on homes and durables.”

At the mid-point of 2005 market mavens appear split, as always, on what we might expect for the economy and financial markets during the coming months. For example Prudential’s lead market strategist came out this week with a recommendation that investors raise their stake in the equity markets to 100 percent. Now that is a bullish strategist. But over the years we have learned to separate the wheat from the chaff when it comes to solid forecasting. Unfortunately in our book Prudential doesn’t fall into the “wheat” category. But ISI does. That is, International Strategy and Investment Group (ISI) who just might have the two best economists and forecasters on the planet as their founders and chief strategists. They would be Nancy Lazar and Ed Hyman.

***Institutional Investor* magazine has ranked Ed Hyman first in economic forecasting for 25 years in a row.**

ISI is currently forecasting a “full blown synchronized global slowdown”, but not a recession in 2006. Here is a summary of their current forecast as told to Barron’s.

- The Fed stops raising rates at 3.75%
- There has been a very sharp slow down in money supply, which suggests that the Fed is tighter than the current 3.25% Fed Funds rate suggests
- U.S. Real GDP growth rate slows to 2.5% in Q3 2005 and possibly 2% by Q4 2005 and remains at 2% through the first two quarters of 2006.
- Inflation rates have peaked for this business cycle and will be coming down. The GDP Price Deflator will average 2% for the next 5 quarters.
- High oil prices are contributing to the general economic slowdown.
- Despite the prospects for an economic slowdown U.S. equity markets could rally as much as 15 percent from April 20, 2005 lows (S&P 500=1137). If that occurs the S&P would rise to approximately 1307.

- The economic slowdown could reveal an otherwise hidden financial crisis. ISI notes that “roughly one year after the Fed has started to tighten there has always been a financial crisis.... Historically, the combination of higher interest rates and a slowdown in the economy puts a lot of pressure on the weaker links.”
- The pending slowdown will be “a full-blown synchronized global slowdown, and some parts of the world will be weaker than the United States.”
- “S&P 500 operating earnings, year over year, could move downward towards zero by the end of the current year.”
- “The Business Roundtable and Duke University business-confidence measures are already starting to weaken.”
- “The case and evidence for slower growth outside the U.S. is even more powerful than it is inside the U.S. There is so much weak foreign economic news from the developed countries, Europe and the UK in particular.”
- We “expect China to remain pretty strong, but even they could experience somewhat of a slowdown (if everyone else is slowing down) because of their huge export market.”
- “To the extent that there is a slowdown from Europe to Japan, maybe the dollar can hold its own, and it has some nice technical support.”
- “Secularly we are going to remain in a pretty low inflationary environment.”
- “Oil prices should move lower—say toward roughly \$45, by the end of the year”...”in part because of the global slowdown.”
- By the end of the year the “10-year Treasury yield moves down to 3.60% and the Fed should be done at 3.75%.”
- ISI is bullish on bonds.

K&A’s skepticism about the current economic climate is well documented in our last two annual reports to investors, so at this point we would have to respectfully discount Prudential’s enthusiasm for equities and fall comfortably into the camp with UCLA and ISI, which to us means a much more broadly diversified portfolio.

If ISI is right, the upshot of all this may be “the pause that refreshes” and allows commodity prices to moderate, including oil. A “soft landing” for the global economy, with 2 percent real growth, could set the stage for the next up tick in the business cycle by the second half of 2006 or early 2007. With that in mind, let’s review many of the current positions in portfolios managed by K&A with an eye to how we should be positioned for a global economic slowdown and eventual recovery.

THE DOLLAR....

We thought it would go down in 2005. It has gone up, approximately 14 percent against the Euro. Geopolitical and economic events have at least temporarily cleared the playing field of any competition for the dollar.

If we were to describe the currency market in baseball terms it would read like this. The Euro could be described as an injured reserve. The Yen is still in the bull pen warming up. The Yuan is negotiating the timing of a trade to the major leagues. All other currencies are still playing in the minor leagues and don't really count.

As we go into the second half of 2005 it is difficult for us to see how other major currencies will become significant competition for the dollar in the near term. We have therefore moved from negative on the dollar at the beginning of 2005 to neutral at this point for the remainder of the year. Let's just say that between being negative six months ago and neutral today we were extremely impressed by the strength of the move upward in the dollar.

Interestingly all the reasons we were negative on the dollar are still in place. They haven't changed and therefore the odds remain long that the dollar will reverse its recent climb in the future; but maybe not this year. Besides the Europeans, and particularly the French, keep surprising us with how inept they seem and without competition for capital flows the Dollar remains king.

How has the move up impacted K&A clients, and how would dollar stability directly impact their accounts? We have purchased shares of Loomis and Sayles Global Bond Fund (LSGLX) and Pimco Foreign Bond Fund (PFBDX) in many of our client's portfolios. Both funds hold the bonds of various foreign governments. Customers who own the funds benefit by receiving the interest from these bonds, payable as dividends from the fund.

However, these funds are not hedged against the U.S. dollar. They are a pure play on the rising or falling dollar. Their share price tends to rise in value as the dollar falls (our original premise) and down in value when the dollar rises (what actually happened).

In a falling dollar environment an owner of these shares can benefit two ways—first by receiving the interest payments and second, by seeing the share value appreciate as the dollar falls. In a rising dollar environment the owner of these shares benefits in only one way—by receiving the interest on the bonds—but is also penalized by seeing the share value decline as the dollar rises. In a neutral dollar environment, where it is neither rising or falling vs. the bond denominated currencies the value of the shares stays relatively stable, and the shareholder receives the interest payments from the bonds. If interest rates fall in the countries represented by the bond holdings the share price of the fund may also appreciate.

Since K&A believes we are now approaching a stable dollar environment, followed by resumption in the fall of the dollar, we will be sticking with these bond funds in the portfolios that we manage. Both funds are extremely well run and should provide our investors with competitive long term rates of return. We will continue to buy them on dips, and they will remain in investor portfolios.

GOLD...

We thought gold prices would continue to rise in the face of a continuing decline for dollar and rising demand for the metal. So far we have been wrong on the dollar, so it would follow that we are also wrong on gold. Gold ended 2004 at \$438 per ounce, and is at \$421.00 as this is being written. That is down 3.88 percent for the year-to-date (July 5, 2005). That price includes a \$6.00 drop today.

It is intriguing that the Dollar has strengthened from .73 Euros on 12/31/2004 to .833 today. That is a change of 14.1 percent vs. the decline of only 3.88 percent in the price of gold. We suspect that gold has held up rather well in the face of the rising dollar, because demand for the metal seems to be holding up.

However, we are less than content with the performance of our gold related positions, and their prospects for a near term turnaround. Fundamentally we are still positive on gold. Our feelings can be summarized by borrowing generously from the work of Claus DeWildt, who is a money manager based in Walnut Creek and who has significant insight into the prospects for this asset class. Claus says, "With gold having a supply deficit over the last 10 years of about 1500 tons per year and the whole universe of publicly traded gold companies available for less than the value of Cisco it will not take a lot to make the price of the gold shares move up when gold hits the radar screen of the public again."

Claus is fundamentally correct. In fact gold could easily be seen as an alternative to ownership of currencies, and should be getting a boost from the absence of good alternatives to owning the dollar. But it isn't so far.

Technically gold has been threatened with breaking down below levels at which we would want to own it. That may seem funny to you. After all you are supposed to buy assets when they are cheap. But often an asset that is cheap, and trending downward, will continue downward. We have learned through plenty of hard lessons, not to stick around when an asset is tumbling. There are no awards for watching an asset fall apart, unless you have shorted it.

Check out this chart of the GLD, a proxy for gold, over the past year. You'll note that it peaked in late 2004 and has made successfully lower tops since then. The good news is that it has not broken below the low points it established in February and April of 2005. If it breaks below either of these previous lows we may have to reevaluate our bullishness on GLD.

STREETTRACKS GOLD TRUST
as of 5-Jul-2005



However, as this report is being continuously edited for final printing, we are reminded today (July 7, 2005) that gold makes a great insurance policy for a balanced investment portfolio. Following the terrorist attacks in London it has rebounded to \$426 on a day when almost everything else that we own is going to open lower. The other exception is the short positions in the European stock markets. They will open up.

Some of our clients own the index share that trades on the NYSE under the symbol GLD. Each share of GLD represents 1/10th of an ounce of gold. Therefore those shares were down exactly 3.88 percent for the year (as of July 5, 2005), just like an ounce of gold.

Many of our clients own a mutual fund called Gabelli Gold Fund (GOLDX). It is down 5.5 percent for the year-to-date (July 5, 2005). We also hold another fund called U.S. Global World Precious Metals Fund (UNWPX) in many accounts. It is down 5.25 percent for the same period. Both of these funds own the stocks of gold mining and precious metals mining companies.

WRONG ON THE DOLLAR (SO FAR); WRONG ON GOLD (SO FAR)

The good news is that is all the bad news about our original asset picks from the beginning of 2005. The rest of our original 2005 picks have done pretty much what we wanted them to do, or at least what we expected them to do.

ENERGY—NAMELY OIL AND GAS AND NOW COAL

Oil and Gas rule the roost right now. Every other investment consideration is taking its cue from the price of these commodities. We recently wrote a special report on “The Oil Patch” which is posted at our website. See <http://www.kaassets.com/illuminations.htm>. It was also recently mailed to all clients of K&A.

We believe that the long term (5, 10 to 20 years) pricing path is upward. In fact today the Saudi's reported to the world that they do not have the reserves to keep up with global demand over the next 15 years.

But, four very credible research analysts have recently written reports that offer solid arguments for pricing at or below \$45.00 per barrel by the end of 2005. They include the ISI report we quoted earlier in this report. We have enormous respect for them, and their forecasts are more often right than they are wrong. So we have to give credence to this forecast. We tend to perceive \$40.00-\$45.00 as the new floor under oil pricing.

Doug Kass is also money manager we admire and often quote. He recently published his Ten Surprises for the second half of 2005. He says of the "surprises" that *"Remember, my surprises are not intended to be predictions, but rather are intended to represent events that might have a reasonable chance of occurring despite the general perception of these events carrying very long odds. I call these "possible improbable" events."*

The interesting thing is that Doug has been publishing 25 possible surprises for each of the past three years. About 50 percent of them actually happen, even though he calls them "possible improbable" events.

Here is his current "oil surprise"--- *Unocal's (UCL) shareholders vote in favor of the Chevron (CVX) bid for that company in late August, and Cnooc (CEO) drops its bid. Coincident with the vote, the price of crude oil makes a yearly high (of \$65/barrel) and heating oil rises as well (\$1.80), once again proving that markets make tops accompanied by good news (the Cnooc bid). Following the dropped Cnooc bid for Unocal, trade tensions between China and the U.S. mount. Those inflated energy prices are not seen again in 2005, as weakening demand contributes to sizeable energy commodity declines leading to a near panic plunge in product prices by year-end. Crude oil closes the year at under \$40/barrel. The Amex Oil Index (XOI) briefly touches 750. (It currently stands at 928.)*

Doug has recently shorted the XLE. The XLE is an "index share" that represents a bundle of oil and gas industry related stocks. K&A is long the XLE. At this writing, even Doug Kass believes that prices are still heading upward, and he has published a maximum price target of \$65.00 per barrel.

K&A has also purchased ConocoPhillips (COP), Canadian Oil Sands (COWSF), Encana (ECA), Kinder Morgan Partners (KMP) for various suitable portfolios. All these stocks are up significantly from the prices at which we originally we purchased them.

On July 6, 2005 oil prices spiked above \$61 per barrel for the first time, and most oil stocks actually went down. It is an interesting coincidence that we are writing this paragraph today. We have been waiting to observe the first day that oil prices spiked up sharply, yet the oil stocks spiked down. That may be a sign that the run up in the stocks has ended; and possibly well before the run up in the commodity price itself. That would be normal for Wall Street.

Despite ISI's and Doug Kass' forecasts for lower prices, K&A is unlikely to try to short the energy stocks. We will be more inclined to hold them for the long term secular price rise that we are currently forecasting. We'd be more inclined to be buyers on price dips if ISI turns out to be right. This week's terrorist attack on London reminds us that it wouldn't take much to get a serious disruption in oil supplies—and a subsequent and immediate spike to new high prices.

Besides we have purchased a unique collection of oil and gas assets that feature heavy emphasis on North American reserves. In the event of a serious OPEC disruption there will be a significant market and tactical advantage to owning companies like Encana, Canadian Oils Sands, Kinder Morgan, and even ConocoPhillips.

As 2005 was getting started K&A had no positions in the coal industry. Frankly it is not an industry that we understood. We made a commitment to learn as much about it as we could. While we are still learning we have become quite comfortable that we understand it well enough to have made the first commitment by purchasing shares of James River Coal Company (JRCC) for suitable portfolios. This is another stake in energy resources in America. See <http://www.kaassets.com/illuminations.htm> for more on the subject.

THE "UTES" (UTILITIES) AND A LITTLE ON NATURAL GAS, AND NOW WATER

We were bullish on traditional utility companies (energy generators) going into 2005. Many of our clients participate in this sector through ownership of shares of FBR Gas Utility Index Fund (GASFX).

We are still bullish on utilities and would love to buy more of GASFX on dips. The problem is that it rarely dips; at least so far. The only problem with this chart is that it is too perfect over the past few years. At some point there has to be a break in the momentum and we will be watching for that opportunity to adjust positions one way or the other.

FBR GAS UTILITY INDEX FD
as of 5-Jul-2005



We also selected a few non-traditional utility companies for inclusion in suitable portfolios. We like Suburban Propane (SPH) with a dividend yield in excess of 6.8% and Dynegy (DYN) which we bought cheap and may be an excellent turnaround story. We have continued to accumulate both from time to time, and remain bullish on the prospects for both companies.

Among all the sectors we follow, it may be utilities that could keep their momentum for the remainder of the year. There is significant consolidation going on in the industry and the likes of Warren Buffet are accumulating utility positions. These are companies that are never going out of business and in these uncertain times investors are placing a premium on their steady cash flows and reliable dividends.

We have recently started to focus on finding solid investments in “water”. The problem is that the “water” industry is highly fragmented, and divided between the public and private domains. For example, it would be a little tough to buy into St. Helena’s Bell Canyon reservoir or Lake Berryessa. Our focus on water is simple. Nearly 7 billion human beings are using more than we normally have for all purposes from household water, to farming, to industrial and recreational use. That situation isn’t going to improve any time soon.

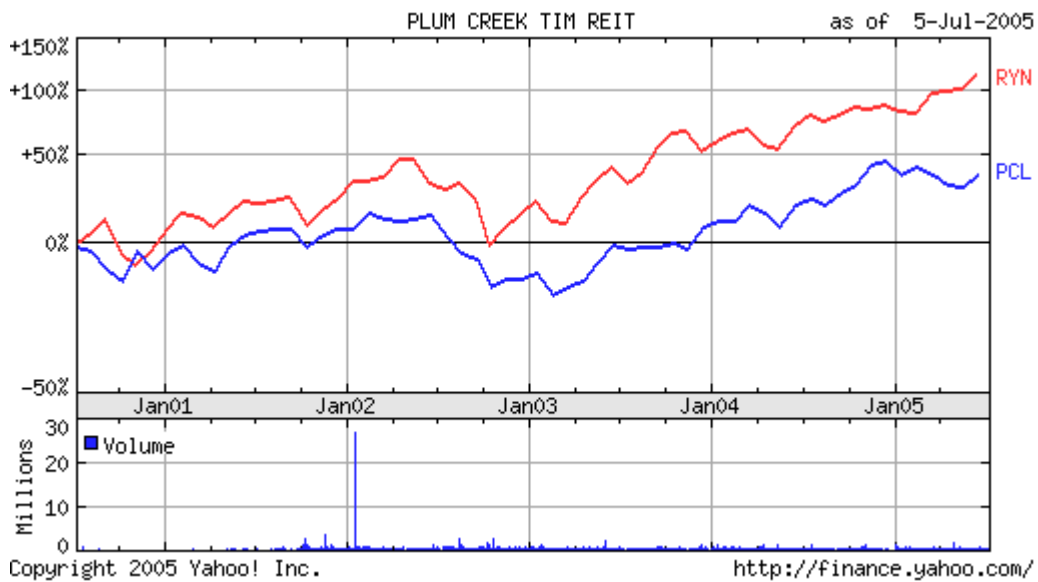
The private sector is learning to make money on delivering water to thirsty populations, farmers and industries that need water. While there are very few “pure plays” in water; there are some significant “private enterprise” players in the industry. General Electric (GE) is emerging as the largest global provider of desalinization services. Suez, Inc. (SZE) is one of the largest and most diversified utility companies in the world. It provides services on five continents. It is one of the largest private global players in the water industry, including within the United States. We own them both in suitable portfolios.

COMMODITIES—OTHER THAN OIL, GAS, GOLD—INCLUDING TREES!

If you haven’t noticed, we are nine pages into this report and we haven’t even mentioned traditional stocks yet. There is a reason for that. We think that investors have to own commodities and other alternative assets in the 21st century. Gas, oil, coal and gold are all finite assets. They aren’t making anymore—and we are using them up. Electricity is a renewable resource, but we need more and more of it all the time—and we use up our finite supply gas, oil and coal to generate it.

Water keeps us alive, and pure water is a tougher and tougher commodity to supply to a population that is fast approaching 7 billion people world-wide. With municipal and government systems stretched to nearly the breaking point, more and more private providers will be finding their way into this business.

Then there are the trees. Have you noticed a real estate and construction boom around the world? Have you figured out that China and India are importing all the wood they can, and will likely continue to do so for as far into the future as we can see? K&A owns Plum Creek Timber (PCL) with a dividend yield of 4%, and Rayonier (RYN) with a dividend yield of 4.4%, in suitable portfolios.



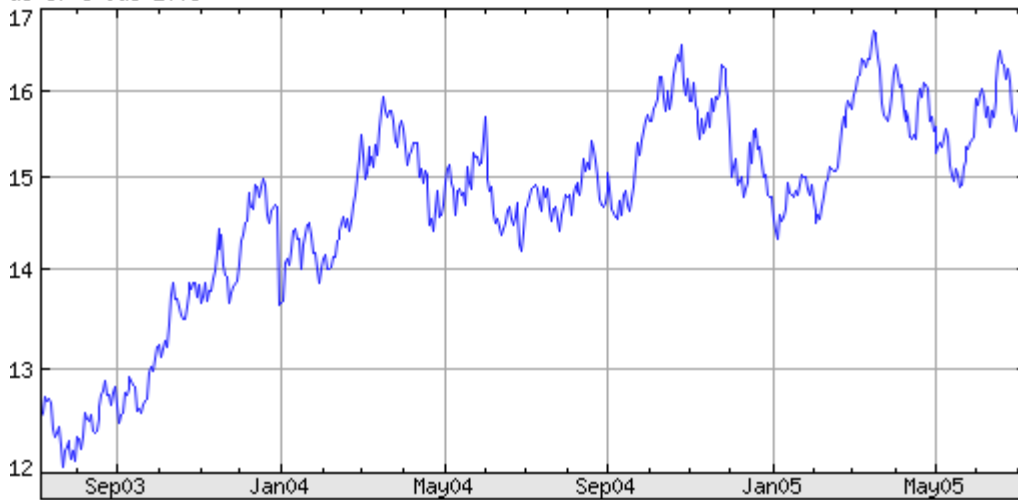
“Commodities” is an awfully broad asset class, and we can’t cover it all. So we sought out an investment option that could provide our clients with exposure to the broad commodity markets, and the expertise to take advantage of the upward and downward movement in prices. The Pimco Commodity Real Return Fund (PCRDY) was our first choice.

The fund attempts to achieve performance similar to the Dow Jones-AIG Commodity Index which is currently weighted as follows: Energy 36%; Livestock 9%; Grains 18%; Industrial Metals 18%; Precious Metals 7%; Softs 9%; Vegetable Oil 3%.

PIMCO manages Commodity Real Return Strategy by combining a position in commodity-linked derivative instruments backed primarily by a portfolio of inflation-indexed securities (TIPS). This provides a double real time response to inflation rates and changes in inflation. Other fixed income instruments may also be used tactically in the portfolio.

Let us interpret that for you. In a nut-shell it means that PIMCO invests in commodities through derivatives when they think they can make money in a commodity. Otherwise the cash in the fund is invested in bonds. We like the fund because it combines the benefits of the commodity markets with the potential for additional real returns, at lower volatility of relative performance than is commonly associated with fully active commodity management styles. If active management of the fixed income portion of the portfolio outperforms, PIMCO generates an incremental return over the commodity markets.

PIMCO FDS PAC INVT MGMT SER COM
as of 5-Jul-2005



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As you can see from this picture the ride has not necessarily been smooth, even with the dampening effect of the bonds. But the trend is in the right direction.

If there is a problem with this strategy, it is that we are not the only ones to discover it. Lots of money has poured into commodity investments recently. The pace has accelerated in 2005. Like all good things commodities have attracted a crowd. The question becomes “is too much money chasing too few opportunities”. One of the things we like about the fund is its ability to shift between various commodity markets and from commodities to bonds. Both factors provide us some comfort that the fund can avoid some of the problems inherent when too much money is chasing a good thing.

THE CHINA FACTOR

No discussion of investment strategies is complete these days without consideration of China’s emerging economy. It has been growing at phenomenal rates since Deng Xiaoping took the reins of the economy in 1978. Yet it is only within the past three years that “investing in China” has become real for many U.S. investors. That includes here at K&A.

China is an incredibly complex country, society and economy. It would not be easily understood by most Americans even if they took the time to understand it. One of the problems is that most Americans have taken no time to understand it. Only recently has the American media started to provide some in depth coverage of China. Unfortunately most American media and political coverage are still xenophobic and exhibit very little understanding of China’s culture, its people or its economy. Worse still, is the fact that the U.S. Congress seems to be doing its best to paint China as our next big adversary.

American media and financial journalists have focused on China’s relative inexperience with global capital markets, their fragile banking system, and their rapid growth to almost universally proclaim that China’s economy will surely crash.

The reality is that it might, or it might not. We suspect that it won't any time soon. Certainly it will have cyclical characteristics, like all national economies. China's phenomenal growth rate is challenging all financial markets and many resources throughout the world.

Our belief is that China is in the midst of a long term secular growth trend that will not end for many, many years. We repeat, China will not grow at a constant rate. It will have cyclical turns up and cyclical turns down. But the current fascination with forecasting when it will crash is ludicrous. The U.S. economy has been in a secular growth trend since before we were a nation. Doesn't it follow that someone else might be able to accomplish that too?

Many Americans are fond of pointing out that Japan's growth trend came to a grinding halt, by way of predicting that China's will do the same. They tend to forget that Japan grew from 1945 to 1989, in almost a straight line pattern before succumbing to recessionary pressures. That was a 44 year period. China is currently 27 years into a secular growth trend, and China is very different from Japan in more ways than we can write about within the context of this newsletter.

At the present time there are no real indications that China's economy is slowing dramatically. There is only the xenophobic conjecture that it is.

Our position on investing in China is simple. We are currently doing it through the Matthews China Fund (MCHFX). They are absolutely one of the best money managers operating in the China markets, and in this case 'we are leaving the driving to them'.

MATTHEWS DRAGON CENT CHINA I
as of 5-Jul-2005



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This long term chart depicts that it has not necessarily been easy to make money investing in China, despite its booming economy. That is because the Chinese business community and government are not only managing the fastest growing economy in the world.

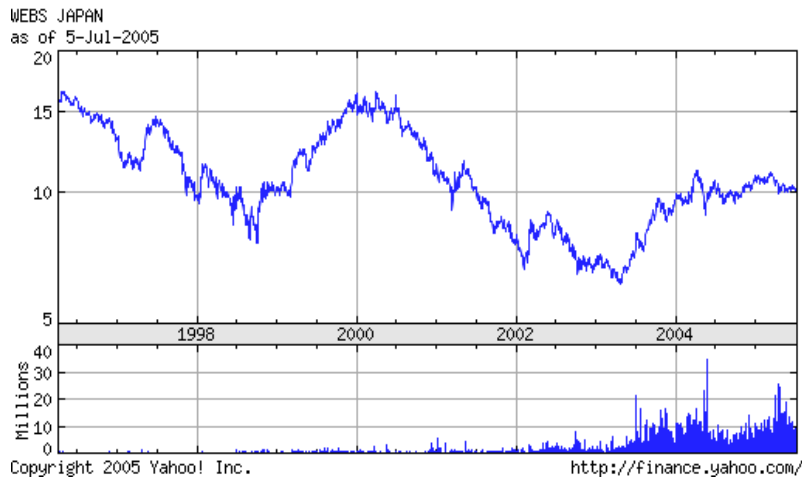
They are managing the first ever successful transition from a totally Communist central-authority-management-system to hybrid system in which central government authority shares power with private enterprise. That has simply never been done before. There are many characteristics to this transition that do not readily meet the eye, nor would they be obvious to most lay investors. An exhaustive analysis of the opportunities and problems related to investing in China is not possible in the context of this short discussion.

You can see the high volatility in the years 2000-to-early 2003. You can see the steep run up during the last 3 quarters of 2003, and the consolidation since then.

We said in an earlier report that “Investing in China today is like investing in the U.S. in 1880. There may be wild swings up and down but we want to be dollar cost averaging into their equity markets for the next 5 to 10 years.”

JAPAN

Going into 2005 we were saying “Japan should be alright and continue its slow, but hopefully steady recovery from 15 years of stagnation. Japan is worth a market bet. One of our favorite hedge fund managers thinks Japan’s market may be the number one performer in 2005.”



Going into 2004 we were saying that “Japan should continue working its way out of a 15 year bear market”.

The fact is that they are, but it has not been reflected in any significant economic growth, nor has their stock market moved up recently. In fact the Nikkei 225 has been

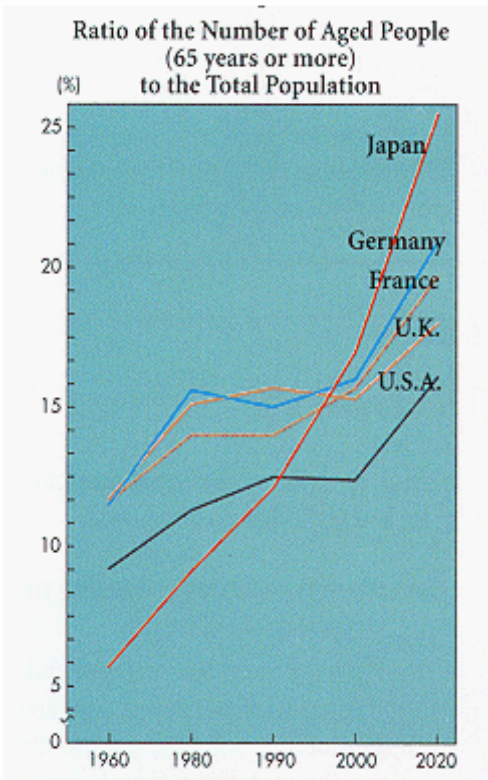
almost flat since the last quarter of 2003, and is still technically in the long term declining trend that dates back to 1989.

Japan is also facing a significant economic and social problem that is almost unique. Its population is shrinking and aging dramatically. If one looks in a rear view mirror and thinks how Japan was once the mighty economic juggernaut of Asia, it is easy to extrapolate how we could all believe in their comeback. But it takes people to create new jobs, and to grow an economy. There is more and more evidence that Japan does not have them now; nor will it in the future.

With 127.1 million people, Japan is the ninth most populous country in the world. In 1970, the population stood at 104 million. At the current growth rate of 0.2 percent annually, the population would double in 347 years.

Because the total fertility rate is 1.3 births per woman, considerably lower than the replacement level of 2.1, however, the rate of growth will diminish each year as the gap between births and deaths narrows. Infant mortality is currently 3.4 deaths per 1000 births, one of the lowest in the world. If the trends of the last few decades continue, the population is expected to begin declining after 2015, return to 124 million by 2020, and drop to 120 million in 2025 and to 101 million by 2050. (Population Resource Center)

Japan's potentially shrinking population is also aging faster than any of the other major industrialized economic powers. This graph depicts the path of aging for Japan, Germany, France, the U.K. and the USA.



Japan's problems are simple. It is tough to grow a competitive economy with a shrinking and rapidly aging population.

Therefore, unless Japan does something to dramatically alter these trends they should fall farther and farther behind the traditional economic powers included here—and will be at a significant competitive disadvantage to the likes of Korea, China and Taiwan, India, Singapore, Indonesia, Thailand, and Australia.

While it is still true that Japan's current cyclical recovery could continue, we suspect that the longer term secular trend will be flat to downward. Therefore one of the significant action steps that we will be taking, coinciding with the publishing of this report, is to eliminate all "Japan only" investments from portfolios managed by K&A. This includes all shares of EWJ, the I-share proxy for the Nikkei 225 and Fidelity Japan Small Company Stock Fund (FJSCX).

YOU THINK CHINA IS IMPORTANT IN THE CURRENT INVESTMENT CLIMATE; LETS TALK ABOUT REAL ESTATE NEXT...

Is there a real estate bubble? The latest issue of *The Economist* puts it this way, "The total value of residential property in developed economies rose by more than \$30 Trillion over the past five years, to over \$70 Trillion, an increase equivalent to 100 percent of those countries GDPs."

Not only does this dwarf any previous house-price boom, it is larger than the global stock market bubble in the late 1990's (an increase over five years of 80 percent of GDP) or America's stock market bubble in the 1920's (55 percent of GDP). In other words it looks like the biggest bubble in history."

We started the year by saying, “We think it is time to be incredibly selective when making real estate investments. We have already sold all the individual REITS that we had owned during the period from 2000 to early 2004. Our only remaining “pure” real estate related investment is Cohen and Steers Realty Shares (CSRSX). We will be sticking with a very small allocation to this fund as we enter 2005. We agree with the UCLA forecasters who think that real estate may cool off. It is difficult to tell whether the “cooling off” will mean a leveling off of prices or an actual drop in prices.”

The graph that follows depicts its relentless climb as CSRSX has benefited from the tremendous run up in real estate values across the nation. You will also note that in the top far right corner of the chart a “double top” may be emerging. Could that be a sign that CSRSX is about to “give back” a little. We’ll know that for sure in six months. What we know now is that during the past six months real estate prices and the price of CSRSX have been climbing.



Only last month did real estate prices start to level off in a broad cross section of markets. So is there a real estate bubble? At this point we’d say unequivocally yes. Will it burst any time soon? We have no idea. We hate to be so equivocal but it could end with a whimper or a big bang. Frankly if interest rates remain low, and we think that is likely, the real estate bubble could perk along for quite some time—barring some other external shock.

The aftermath could easily turn out to be a long slow grinding “workout” of the bubble that could last for a decade or two (see the Japanese stock market)—or it could just tumble (see 1929).

What we do know is that caution is warranted. Therefore we are maintaining no more than a 3 percent allocation to Cohen and Steers Realty Shares (CSRSX) in most portfolios. We are also well aware that most of our clients have significant exposure to real property holdings outside their financial portfolios, and are therefore much more exposed to this sector than their holdings at K&A would reflect.

If you would like to read more about our concerns relative to the potential for a liquidity crunch and the problems that could force a contraction in the real estate bubble, please refer to the section labeled “*What is there to worry about?*” in our annual report at <http://www.kaassets.com/pubs/2005Annual/2005Annual.htm>

You should also be aware that it is conceivable that the “real estate bubble” could persist in certain regional markets for years to come. As previously stated, the odds of this happening increase significantly if interest rates stay low.

We have developed a theory, that only time will prove out, that resort and destination markets may actually be in the earlier stages of a huge and disproportionate run up in prices. They may be hard to believe in the face of \$1 million to \$2 million homes in the Sylvaner neighborhood of St. Helena. But we think this to be possible.

We have identified markets like the Napa Valley, Lake Tahoe, Carmel, Santa Fe, Jackson Hole, and the Kona Coast, among others, as markets that may have years of “bubble” left in them. These markets have two things in common. They are unique destinations where wealthy people congregate and each community significantly limits the supply of housing available. Wealthy people are less susceptible to economic downturns and limited supply usually translates to higher demand for the limited resource.

FINALLY WE GET TO THE BROAD EQUITY MARKETS

K&A has approached the broad equity markets through the use of mutual funds, as well as individual stocks. We started out the year by saying that, “*at 1250 the S&P would be trading at 17.36 times 2005 earnings. Not exactly cheap, but by recent standards, maybe not wildly expensive either.*”

“We have gone from ‘overvalued’ to ‘significantly overvalued’ to ‘not exactly cheap’ over the course of 7 years. Despite wild moves upward and downward, we have never felt that the broad stock market has ever gotten cheap enough to provide investors with an excellent entry point. As far as we are concerned that last cheap entry point into the U.S. stock market was in 1994. It isn’t that investors haven’t been able to make money in stocks since 1998. They have. Certainly we have. However the path to success has not been easy. Neither has it always been obvious.”

It is now mid-2005 and we’d have to say of that statement “DITTO”. The markets still present few screaming values.



We have already mentioned utility companies and the fund GASFX as a winner for us. Two other funds that have significantly outperformed the markets this year are Fidelity Select Medical Equipment (FSMEX) and ICON Healthcare (ICHCX). We still like utilities and we still like healthcare.

Here is a pair of two year charts of the movement of the funds' share prices.

In addition to the two funds we have purchased shares of the old line pharmaceutical companies, including Bristol-Myers (BMY), Merck (MRK) and Pfizer (PFE). These stocks are frankly dogs, and wildly out of favor.

Maybe that is why we like them. Besides they are paying dividends of 5.63%, 4.97% and 2.69% respectively. So our clients are being paid significantly to wait for them to return to favor.

LET'S REVIEW SOME OTHER SEGMENTS OF THE MARKET SECTOR BY SECTOR

BANKS

We like some bank stocks. We know that banks tend to be out of favor when the Fed is raising rates, and they are. Just because we like the stocks doesn't mean they are all going up right now. In fact only one is currently experiencing gains currently. That is Capitol Bancorp (CBC), the parent company of Napa Community Bank. The dividend yield is currently 2%. It is one of three favorites for us in the banking sector. Another is Bank of America Corp (BAC). They seem to be doing everything right, and they pay a 4.07% dividend—which they are raising again next month for the 26th year in a row. Our third favorite is actually ING which is traditionally known as a Dutch insurance company. But they are much more than that. They are a fast growing diversified financial services firm, which just happens to be the biggest "internet" banking firm in the world. Their dividend yield is currently 4.8 percent.

Our second tier of banking stocks includes Citigroup (C), a regional holding company called First Horizon (FHN) and Washington Mutual (WM). Frankly these stocks are probably dead money until it is perceived that the Fed is done raising rates. Then they should take off. But they pay dividends that equal 3.63%, 4.89% and 4.46% respectively.

VIDEO GAMES, GAMBLING, LIQUOR, WINE, AND COFFEE

Now there is a combination for you. We didn't know how to sum this up other than to say we like some companies, and their stocks, who could do well even in an economic downturn, and which are in industries that should continue to grow through good times and bad. This line up includes Electronic Arts (ERTS), International Game Technology (IGT), Diageo (DEO) and Starbucks (SBUX). They are each leaders in their respective fields of video games, gaming and slot machines, wine and liquor and "destination-designer coffee." We think that speaks for itself.

TECHNOLOGY

Here is a quiz for you. Other than being "old" tech companies, what other characteristics do Microsoft, Dell, Intel, and Cisco share in common? The answer is that they are all sitting on gigantic stashes of cash (\$63.8 billion combined); they have no debt; they have gigantic operating margins; huge return on equity; and mountains of positive annual cash flow; and their stocks are going no where. But we think they will, and we have been nibbling away at all of them. These companies are all just getting more and more dominant in the things they do.

We don't think the next big tech move will take place until at least 2007 and current talk of an imminent rally is quite premature as far as we are concerned. But by then we would like to own significant positions in all these companies and others with similar characteristics as well.

John Dvorak, writing for Marketwatch.com, recently summarized his version of the catalysts that are forming up to fuel a rally in 18-24 months (his timetable).

"The triggering mechanisms and trends to watch are as follows:

- 1. Wireless -- There is no question that wireless technologies will dominate the next decade and the most important change comes into play near the end of 2006. This is the high speed 802.11n LAN standard that should deliver a reliable and long distance 240 Mbps-plus data rate. This should combine with WiMAX, a potential competitor to DSL and cable connections, to create quite an exciting moment. All the wireless router companies such as Cisco ([CSCO: news](#), [chart](#), [profile](#)), D-Link, SMC as well as Buffalo and Belkin should benefit greatly from 802.11n as well as any chipset companies making 802.11n product.*
- 2. The threat of independent WiMAX providing city-wide and inexpensive high speed wireless connectivity will force the phone companies and cable companies to upgrade their offerings.*
- 3. Thus the U.S., which has slipped to 16th in the world in general broadband uptake, should get improved services and speeds at lower costs. This means more online action for all e-commerce plays. New companies should emerge in this market.*
- 4. IPTV -- This refers to delivering video over the Internet. And by this I do not mean crummy streaming videos but high resolution, even HDTV feed from the Net*

- directly to your TV. While there is a minor buzz about IPTV today the momentum should be intense in the next 24 months. Many observers think that all TV will be delivered by this mechanism in the not too distant future. There are a lot of companies involved here. I'm personally quite excited about this technology and I have compiled and maintain a list of the major players. [See it here.](#)*
- 5. The Mac-Intel -- By 2007 the switch of Apple ([AAPL: news, chart, profile](#)) to the Intel ([INTC: news, chart, profile](#)) architecture will be complete and the Mac OS will gravitate to the traditional PC users who will have to upgrade their systems to take full advantage of using the new OS. The additional user base should trigger interesting developments and new software concepts missing from today's moribund market.*
 - 6. Microsoft Longhorn -- The new Microsoft operating system will be released around the same time triggering an upgrade cycle that will be doubly powerful as the MacOS becomes a threat to Microsoft ([MSFT: news, chart, profile](#)) dominance forcing it to become more competitive.*
 - 7. Dual-core and subsequent quad-core processors that will allow computer processing speed to double or quadruple rapidly to take advantage of any process intensive software developments. Both Intel and AMD ([AMD: news, chart, profile](#)) will be going in this direction.*
 - 8. Miscellaneous minor initiatives such as the emerging U3 standard designed to make USB memory sticks work as program executable modules. The implementation of GPS technology into most phones and portable devices. Voice over Internet protocol (VOIP) should also become more prevalent and 802.11n may actually find its way into mobile phones too. The emergence of xVid and other video compression standards which are already triggering an MP3-like trading market for TV shows and movies amongst enthusiasts.*

The effect of all this, and more, happening at once, should be to create a genuine tech rally. And while everything on this list is in play, none of the full potential is close to realization. It's simmering. So will any premature rally.”

MAKING A FIELD BET THROUGH MUTUAL FUNDS

K&A learned a long time ago that we can't do it all. But one thing we can do is find managers who can. We have used a variety of mutual funds to provide our clients with expertise and results in areas of the market that we can't cover in their entirety. We really like the following funds, and consider them to be all-stars in their respective disciplines. You will find many of them in most portfolios managed by K&A.

DOMESTIC BALANCED AND LARGE CAP STOCK FUNDS

Dodge and Cox Balanced Fund (DODBX), Oakmark Equity Income Fund (OAKBX), Balanced Fund of America (BALFX); Dodge and Cox Stock Fund (DODGX), Excelsior Value and Restructuring (UMBIX), Clipper Fund (CFIMX) and Schwab Hedged Equity Fund (SWHEX).

SCHWAB HEDGED EQ FD SEL SHARES
as of 6-Jul-2005



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SWHEX actually represents the single largest position that K&A has taken for our clients. It is in more of our portfolios, in larger amounts, than any other asset. The only accounts that don't own it are the ones that are too small to meet the fund's minimum investment. It is the only large cap

mutual fund that we use that takes positions both on the long and short side of the market. Through May 31, 2005 the fund is up 3.2 percent this year vs. a market that is down. The fund was up 17.44 percent in 2003 and 22.87 percent in 2004. It is not even three years old, and would not normally qualify for consideration at K&A. But we are so impressed with the strategy, management and results so far that we have made a significant exception to our normal policies.

The rest of these funds represent many of our largest positions in broadly diversified large cap funds. Unfortunately DODBX, DODGX, and OAKBX are closed to new investors.

FOREIGN BALANCED AND STOCK FUNDS

Another large position in our portfolios is the Tweedy Browne Global Value Fund (TBGVX), a small to mid-cap foreign stock fund. This all star fund is up 3.67 percent through May 31. We also own First Eagle Global Fund (SGENX), up 1.81 percent through May 31. Both are up in a down year. Both are closed to new investors.

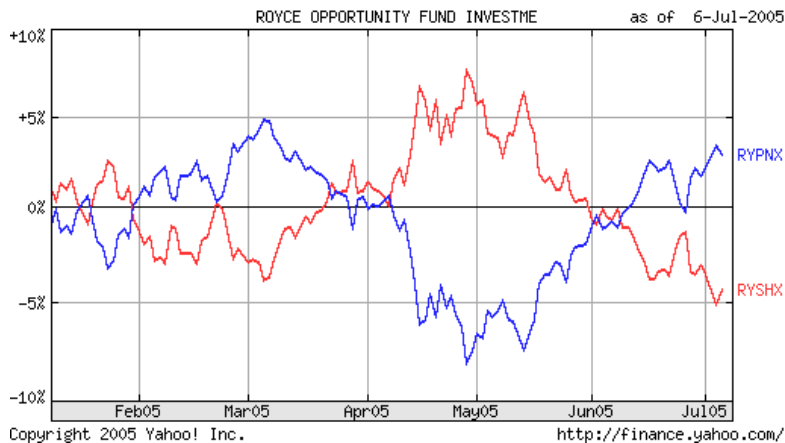
The only other broad based foreign fund we currently use is Capital World Growth and Income Fund (CWGFX) from American Funds. It is open to new investment and has been a great performer for many years.

SMALL CAP STOCK FUNDS

We own three small cap funds that have served investors extremely well for years, including Royce Opportunity Fund (RYPNX), Robeco Partners Small Cap Fund (BPSIX), and Aegis Value Fund (AVALX). However, they are all struggling this year. They are all down for the year.

We have become quite schizophrenic about owning them in the current environment. They are among the best managed small cap funds and we love them for their past performance. We hate them for their current performance and what we perceive as their near term prospects.

The reason they are all down is that small cap stocks have probably moved to a point in the cycle where they will under perform large cap—after many years of outperforming large cap. This situation will be exacerbated if the ISI forecast is accurate.



So why do we keep them? They are all closed to new investors, and if we sell out, we probably can't get back in. These are managers that we want to be with for the long haul.

So we have done what we believe is the next best thing. We have also taken short positions in small cap stocks in order to balance out the potential negative performance from these funds. We hope to ride through this portion of the cycle. We have done this through the use of an I-share (IJR) and the Rydex Inverse Small Cap Fund (RYSHX).

Here is a picture that demonstrates what we mean. The chart compares the latest six month movement of the price of Royce Opportunity Fund (RYPNX) vs. the Rydex Inverse Small Cap Fund (RYSHX). As you can see they almost perfectly hedge one another.

This type of “paired mutual fund trade”, being long one and short the other creates a “dead money” situation for the amount of money that is “paired up”. But we see that as better than taking a very likely hit in the small cap sector.

LAST, BUT CERTAINLY NOT LEAST WE GET TO BONDS

We have already commented on our foreign bond fund positions. We currently hold bonds for suitable clients in six other forms:

- Laddered individual municipal bond portfolios with maturities between 1 and 10 years.
- Laddered individual Treasury bond portfolios with maturities between 1 and 10 years.
- Laddered corporate bond portfolios with maturities typically less than 7 years.
- The I Share (AGG) Lehman aggregate bond fund which owns short and intermediate term treasury and agency bonds

- The I Share (TIP) Lehman Treasury Inflation Protected bond fund which features inflation protected treasury bonds.
- Pimco Real Return Fund (PRRDX) a mutual fund which features inflation protected treasury bonds.

As we right this report we are seriously rethinking the TIP position. If we are indeed past the worst of this inflationary cycle, TIP's could easily under perform fixed rate bonds. We anticipate selling out the TIP position and replacing it with laddered bond portfolios.

No discussion on bonds, or interest rates would be complete without mention of Bill Gross's current take on the situation. After all, right or wrong, he is the biggest bond manager in the country. The truth is he got that way by being more right than wrong.

Here is an excerpt from his current report to shareholders.

1) The current rather mild U.S. recovery has been driven by asset appreciation/consumption and not employment or capex (capital spending) growth.

2) Future growth is dependent on additional asset appreciation in real estate and stocks if Asia continues to absorb much of our investment and many of our jobs.

3) Recent asset appreciation has been set ablaze by several fiscal/monetary pumps displayed on page 2 with 5-year real rates being the central driver/gasoline can. (This simply means that he doesn't believe real asset growth can continue. He expects growth rates in stocks and real estate values to decline sharply. Remember I said "growth rates" not "growth". Bill still concedes that prices could keep going up in the foreseeable future, particularly if mortgage rates, and other long term rates continue to decline. But he thinks the days of outsized gains in real estate are numbered and that the most likely case is that prices will fall at some point in the future. He feels the same way about stocks.)

4) Tax cuts are a thing of the past and 5-year TIPS yields can theoretically decline only 60 basis points or so more.

5) The reason why intermediate/long TIPS have an interest rate floor is that if we approach potential deflation, investors risk losing money on a government guaranteed investment. The same concept applies to homes, stocks, and other inflation-adjusting assets without government guarantees.

6) The Fed may soon be out of fuel, despite hints of Bernanke-style helicopter money. Stocks and houses are already at low yields and high prices reflective of European economies nearing Japan-style liquidity traps.

If the asset pumps run dry and the kerosene cans empty, the inevitable path of the U.S. economy will reflect slow growth at best and recession as a realistic alternative. Inflation then would return to low 1% levels in the ensuing years and be pressing the deflationary crossover line. Nominal Treasury paper would enter the 3-4% zone for 10-year maturities and lower still for shorter intermediates. Such an analysis argues for capturing yield via duration extension now in the face of admittedly artificially low current yields.

SUMMARY AND CONCLUSION

If you haven't figured it out already we can tell you that K&A currently sees itself as an asset allocator. Our "model" portfolio includes cash; commodity related investments; precious metals; currency related investments; real estate; a highly diversified equity portfolio that ranges from energy, to tech, to banking, to leisure, and which takes us all over the world; and a variety of bond related instruments. We have developed a real fondness for dividends and interest payments.

The first decade of the 21st century has not been an easy one to navigate. The investment climate has dramatically changed in the new century. Five Hundred years of European and Atlantic-centric economic hegemony seems to be coming to an end. Indeed within the next decade or so it may become very clear that Asian countries, including China, will emerge as the dominant economic players for the next century.

Fortunately for the USA, we are a "Pacific" power, as well as an "Atlantic" power.

Even so, the foreseeable future will look nothing like the past in that we no longer live in an era of "empires" in the sense we came to know them. There will be no more carving up the world between the dominant naval powers of a time. Nations will spread their technological and economic influence around the globe rather than their naval and military power. And as they do, we will all continue to become more and more economically interdependent.

Surely in today's world if the USA catches an economic cold, it will spread throughout the globe in an instant.

We started our investment careers as "value—buy and hold" thinkers. We have become much more fluid and flexible in our investment style over the years. We still believe very much in the "value" oriented style of investing, but nothing gets held beyond its useful life in a portfolio these days.

We remain optimistic and hopeful about the future of our investments, our nation, and this little planet we live on.

We must admit that we worry a lot however. We also live in a time during which any other person on the planet could invade this computer on which we are writing at the present moment. Similarly we live in a time that any person on the planet can set off a bomb in our car, subway, or office building. Borders have fallen all over the world. Economic conditions could turn on a dime related to the effects of events that we have absolutely no control of.

In the mean time we continue to seek out solid, often defensive, and profitable investment opportunities for our clients and we try to build portfolios that are designed to weather economic storms. We look forward to a solid performance for our current portfolio models during the second half of 2005.

K&A Asset Management, LLC
July 15, 2005