

“Illumination”

Annual Report to Advisory Clients

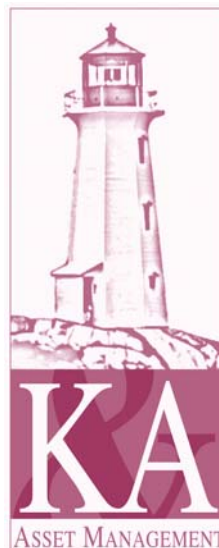
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Introduction and Perspective

This is the 15th year that we have produced an annual report to investors. Eight of those reports were actually produced by Paul Krsek while he was with Edward Jones. This is the 7th report produced by K&A Asset Management, LLC (K&A).

Each year we look back on reports from past years to refresh our perspective. We notice that the tone of our reports really started to change after 1998. From 1991 to 1998 they were extremely bullish. Take this excerpt from the 1991 report as an example, “I believe that this decade will most likely see gains in the markets to match those of the 1980’s.... If we accomplish in the 1990’s what we did in the 1980’s, a rise of 3 ½ times takes the Dow Jones Industrial Average to 10528. Sound crazy; well remember how 3000 sounded when we were at 700 (in 1982).”

Now that is optimism! By the way, we closed the decade of the 1990's with the Dow Jones Industrial Average at 11,391.

Compare that to this comment from K&A's first report in 1999, "We can also make a fundamental case that most stocks providing market leadership are extremely expensive by historic standards. Many of the global economic problems that triggered the collapse of the major averages in October 1998 still exist. We are writing this on January 9, 1999 and believe the broad U.S. stock market to be at least 20 percent overvalued. The question becomes, "So what?" That has been the case since 1995. The markets have continued to rise as investors have generally accepted paying premium prices for quality stocks. Therefore we do suggest caution as investors allocate funds to the market in 1999."

Keep that comment about "extremely expensive" in mind as you read on. We are starting this year's report with a little history lesson to orient you to our point of view for 2005. So bear with us for a moment.

On the day we wrote that report the S&P 500 was at 1272. Today, December 18, 2004, it is BELOW that level at 1194. The NASDAQ Composite index was at 2320 and today is BELOW that level at 2135.

K&A came into being on July 17, 1998; at a time when The Great Bull Market, which began in August 1982, was ending. Yet, hardly anyone recognized this fact as early as 1998. We hadn't yet gone through the last great convulsion of the bull market during 2000. Only in its aftermath did reality start to sink in for most investors.

We have been dancing on the head of a pin regarding the stock market since 1998. We believe that the broad stock market has been overvalued for the entire period from 1998 through the present day. That is the reason that stocks make up a minority position in most portfolios managed by K&A. We have been dealing with this fact for years now and it continuously influences our thinking. Take a look at these excerpts from previous annual reports.

On November 5, 2000 we wrote, "Simply stated, the market is overvalued when compared to historic norms."

On September 20, 2001 President Bush delivered his first speech to the nation after the 9-11 attack on the World Trade Center. That night we wrote our newsletter and in it we said, "The market mavens are all talking about the U.S. stock markets being deeply undervalued.... We disagree. Based on current earnings the S&P 500 and the DJIA are probably approaching fair value—for the first time since 1994.... The NASDAQ is still significantly overvalued, given current conditions in the world and U.S. economies.

On January 6, 2002 we wrote, "The markets continue to be significantly overvalued. Price to earnings ratios remains extraordinarily high for this point in the market cycle.

On January 14, 2003 we wrote, "We remain almost as skeptical about valuations of the overall U.S. stock market as we were a year ago. We expressed that concern last year. In our opinion the U.S. markets are significantly overvalued. Valuation standards have changed dramatically in the past 10 years. What seemed expensive to most people back in 1990-91, now seems quite normal. We frankly haven't made the adjustment. We tried and we didn't like it. Nothing good came out of trying to ignore meaningful rules of valuation."

When we wrote our forecast for 2004 we are finally equivocating by saying, "It is "unknown" yet as to whether the broad U.S. stock market is a little overvalued, or substantially overvalued. It is certainly not undervalued.

Which brings us to the present day, and we just wrote on December 3, 2004 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

If the U.S. stock market is over valued, does that imply there may be investment alternatives that offer greater opportunity for consistent returns? We believe that to be true. Many of our client's portfolios are currently more diversified than they have ever been in the past. The days of portfolios being comprised only of U.S. stocks, bonds, and cash, like those that thrived in the 1990's, have been over for quite some time.

K&A clients now find themselves diversified into foreign stocks, commodities, precious metals, currencies, and real estate.

Now, let's look ahead at the global economy and our expectations for various asset classes during 2005.

What lays ahead in 2005 for the U.S. economy and investment markets?

As we move into 2005 the general "consensus" among economists and market mavens alike is that 2005 should be a year of moderate economic growth in the U.S. and throughout the world. In fact the highly regarded UCLA Anderson Forecast calls for "solid but not spectacular growth."

Citigroup recently increased its earnings estimates for the S&P 500 for 2005 and 2006. They have raised earnings for 2005 to \$72, which is higher than their prior outlook of \$70.25. Still, the revised figure is lower than average analysts' estimates of \$73.19, according to Reuter's data.

The investment bank also raised its earnings growth outlook for 2006 but still sees it at a rate lower than the previous year. Citigroup now expects earnings per share to rise 6.3 percent in 2006, up from its previous forecast of 5 percent.

Assume for a moment that Citigroup is right and that earnings are \$72.00 for next year. At 1250, which is our target for year end 2004, the S&P would start the year trading at 17.36 times 2005 earnings. Not exactly cheap, but by recent standards, maybe not wildly expensive either. It is down from a P/E of over 40 a few short years ago. We hate to be redundant, but the market is still more expensive than we are truly comfortable with, for this stage in the cycle.

But if the mavens at Citigroup are right it should translate into good, but not spectacular, stock market performance. Most market mavens seem to be calling for 5 to 7 percent growth from current valuations. Here are the forecasts from 12 major Wall Street firm's market strategists, as reported by Barron's on 12/10/04.

Strategist	Firm	Dow	S&P 500	10 YR Bond	Best Sector
		Forecast	Forecast	Forecast	Forecast
Abby Joseph Cohen	Goldman Sachs	11800	1325	5.00%	Tech
James Paulsen	Wells Capital Management	11500	1325	5.75%	Tech
Jason Trennert	ISI Group	11250	1325	4.50%	Tech
Chip Dickson	Lehman Brothers	11100	1300	5.00%	Industrials
Tobias Levkovich	Citigroup Smith Barney	11700	1300	4.90%	Health Care
Abhijit Chakrabortti	JP Morgan	na	1275	5.80%	Industrials
Tim Love	Duetsche Bank	11350	1275	5.50%	Industrials
Henry McVey	Morgan Stanley	na	1250	5.00%	Industrials
Richard Bernstein	Merrill Lynch	10915	1205	3.85%	Utilities
Thomas McManus	Bank of America	11000	1200	5.50%	Energy
Francois Trahan	Bear Stearns	na	1200	5.00%	Health Care
Gary Gordon	UBS	10500	1100	5.50%	Financials

Interest rates should rise in the U.S. but not enough to cut off economic and market growth. Bill Gross of PIMCO is forecasting a 10 year Treasury yield of 4.5 percent by EOY 2005, vs. 4.16 today; and a 2.5 percent Fed Funds rate vs. 2.00 percent today. The 12 "strategists" listed above also provided their forecasts for the 10 year Treasury bond yield. Their "average" yield forecast is 5.1 percent for EOY 2005.

The same issue of Barron's ran another article on 12/10/04 called "How will 2005 Rate for Bonds". It featured different analysts than those listed above. In many cases the analysts are from the same firms, but have entirely different opinions on where bond yields will end the year.

The strategists that are highlighted in **RED** differ significantly from their own counterparts within the same firm. Compare estimates from both tables to see what we mean.

2005 Interest Rate Forecasts					
Strategist	Company	Fed Funds 30-Jun	Fed Funds Dec. 31	10 Yr. Treas. 30-Jun	10 Yr. Treas. Dec. 31
R. Berner/D. Greenlaw	Morgan Stanley	3.00	4.00	5.00	5.00
Michael Cosgrove	Econoclast	2.75	3.00	4.50	4.50
Bill Dudley/Jan Hatzius	Goldman Sachs	3.00	3.50	5.00	5.00
Jim Glassman	J.P. Morgan Chase	3.25	4.00	4.50	4.75
M. Harris/J. O'Sullivan	UBS	3.00	4.00	5.30	5.50
E. Hyman/N. Lazar	ISI Group	2.50	2.50	4.00	4.00
Mary Ann Hurley	D.A. Davidson	2.50	2.50	4.25	4.50
Paul Kasriel	Northern Trust	2.50	3.50	4.60	5.05
M. Levy/P. Kretzmer	Banc of America Securities	3.00	3.50	4.60	4.80
Paul McCulley	Pimco	2.50	2.50	4.50	4.75
P. McTeague/S. Stanley	RBS Greenwich Capital	3.25	4.25	3.90	4.20
D. Rosenberg	Merrill Lynch	2.25	2.25	3.80	4.10
J. Ryding/C. DeQuadros	Bear Stearns	3.25	4.50	5.40	5.75
Neal Soss	Credit Suisse First Boston	3.00	3.50	4.65	4.90
Brian Wesbury	Griffin, Kubik, Stephens & Thompson	3.25	4.00	5.60	6.10
AVERAGE FORECAST		2.86	3.40	4.63	4.87
MEDIAN FORECAST		3.00	3.50	4.65	4.90
12/10/04 ACTUAL		2.00%		4.15%	

The U.S. dollar should continue to fall in value relative to other major currencies, especially the Euro. We have seen targets as extreme as 1.42 to 1.55 against the Euro vs. approximately 1.32 today.

Gold prices should advance. The most bullish forecasts are calling for prices to be significantly north of \$525 per ounce by EOY 2005. However there is a bearish camp that is forecasting gold will fall back below \$350 before the EOY 2005.

Oil prices will hopefully stabilize or continue their downward drift. Optimists see oil at \$30 per barrel by the end of 2005. Pessimists are calling for \$50. OPEC is currently considering trying to stabilize prices at around \$35.00 per barrel for the 7 types of oil they commonly produce.

Opinion seems to be split as to whether or not China can cool its economic growth and enjoy a "soft landing". If they do, commodity prices should moderate. Most "mavens" see China's stock market cooling off in 2005. Bear's are forecasting a significant drop. Bull's are forecasting modest positive performance for 2005.

Japan may finally be getting some traction in its economy after 14-15 years of recession. However, their 3rd quarter GDP growth rate was recently revised downward from .3 percent to an even more anemic .1 percent. They are facing the stiff headwind created by the Yen rising vs. the Dollar.

Europe has a long way to go to get its act together and it isn't helping that the Euro is appreciating against the dollar.

The debate is still wide open as to whether or not the U.S. and especially California are experiencing a "real estate bubble" and whether or not that "bubble" will burst. UCLA's latest forecast says that "California is in a housing bubble, noting that prices have gone up 60 percent since the late 1990's." Yet the UCLA study

also says that, “Home prices are not likely to collapse. In previous cycles prices haven’t actually fallen, but stayed flat for several years.”

Does that about cover the landscape of economic predictions?

Oops, we forgot. There will be “free elections” in IRAQ in 2005. The “war on terror” will continue.

At the end of the year we can all look back and see how accurate these “consensus” opinions turn out to be.

So what are we thinking?

We think that Steve Leuthold, who we are fond of quoting each year, is right when he says, “Hell if I know?” We’ve always liked Steve’s candor. Barron’s reports that Steve admits that “the outlook is unusually cloudy.... There is every reason to be bullish about the economy and the stock market. On the other hand there is every reason to be bearish.”

But our clients are not paying us to equivocate. They are paying us to make investment decisions based on our best perceptions of the market.

Here is our best perception regarding the economy and its impact on stocks.

Right now the economy seems to be on track to continue growing. The question is at what pace? The UCLA Anderson forecast expects domestic GDP growth to slow to 2.8 percent by the second half of 2005. They say, “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.”

We are comfortable with their forecast, but would add a cautionary note that the recession could come faster than 2006 under certain circumstances.

Therefore the market mavens may be right and the “most likely case” is that stocks U.S. should advance again next year—at least into the first and second quarters. But we are not willing to make a heavy bet on that because of our concerns over valuation and other variables that might go wrong. We will enter the year with a “model portfolio” allocation of 49 percent to the overall stock market, including all U.S. and foreign stocks.

The real question becomes which sectors of the market to buy as we allocate to equities?

Healthcare is a good long term bet for patient investors. We will be allocating money to health care stocks and funds.

Utilities are still a great place for long term investment dollars. We’ll be sticking with “da Utes” in 2005 and banking the dividends

Banking and finance stocks have really cooled off lately. They are currently out of favor again. The concern is that they don’t do well in a rising interest rate environment. We’ll be sticking with our allocation to banking and finance and collecting great dividends as we do.

Tech is no longer just “tech”. There are lots of sector bets in “tech”. Internet related services are the most overpriced, but probably still the best bet in “tech”. We will be placing selective bets on specific “tech” trends in 2005.

Despite our concerns regarding valuations, small cap stocks could easily outperform large cap again in 2005. We expressed our concern a year ago that small caps were generally overpriced relative to large caps. That may still be true, but it didn’t slow down the best small cap mutual fund managers in 2004, and it

probably won't in 2005. Small companies are just more nimble and can often avoid some of the pitfalls that may hit the general economy and large cap stocks. We will enter the New Year owning several small cap stock mutual funds that have significantly outperformed the markets in recent years.

We hold four "balanced" mutual funds in the various portfolios we manage. All four have superior performance over the past several years. They really stood out during the 2000-2002 stock market debacles, by providing positive real returns right through the cycle. They tend to be allocated about 60 percent to stocks and the rest to cash or bonds. We figure if they got through 2000-2002 in fine shape they are good to go through 2005.

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.

China may stumble in 2005, but if it does it should be a very temporary stumble. 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.

Western Europe is an investment mess. We'll be skipping it.

Eastern Europe and Russia could be great "wild card" bets for long term players. We don't make too many "wild card" investment bets so we'll be waiting for better times there.

Latin America is overpriced. We will pass.

Australia is the one place we wished we had put money in 2004 that we didn't. Now we will have to wait for a pullback or selective opportunities. We will be getting more familiar with that market and looking for those opportunities.

There are many "overpriced" stocks and sectors in this world and we remain concerned about "valuation". Therefore we intend to be "short" overpriced stocks at all times during 2005, even when we are "long" other equities that we believe have significant value. This is a major new policy for K&A. Heretofore we have shorted occasionally and very selectively.

Our thoughts on bonds

Last year we quoted Steve Leuthold who said that he wouldn't be touching bonds with a 10 foot pole. This year he is saying that he wouldn't touch them with a 15 foot pole—even though he was wrong in 2004. They went up in value in 2004!

We are really on the fence about this one. If the pundits are right, bond yields should rise and bond values should drop. Therefore we are going to start the year owning Treasury Inflation Protected Securities (TIPS) in some accounts. Any California tax free muni-bonds that we currently hold in accounts will stay there, but we won't be adding new positions. The bonds we hold are sufficiently "laddered" and short enough in duration that any increase in interest rates, within the magnitude that is probable, should not significantly impact current portfolio values.

But if our worst fears about the economy are realized the U.S. may be in a recession by the end of 2005 or early 2006. It bothers us a lot that long term interest rates are not rising in step with the action of the Fed regarding short term interest rates. The Fed is raising the "Fed funds" rate because of their perception that the economy is growing quite nicely on its own. If it is, why aren't long term rates rising too? Is the bond market trying to tell us that the economy isn't as strong as everyone would like to believe? History has taught us to pay attention to the bond market, and it isn't telling us the same story that the stock market is. It certainly appears to be signaling that the "mavens" are wrong about "moderate growth" forecasts.

Therefore, there is a significant chance that long term interest rates in the U.S. will be the same at the end of the year as they are now, or even lower.

Which takes us to foreign bonds and currencies

The dollar should continue its adjustment downward. We say that even in the face of President Bush's announcement on December 15, 2004 that he favors a "strong U.S. dollar". We would advise investors to ignore what Bush says in favor of watching what his administration is actually doing. Right now the administration and the Fed are cooperating to flood the world with dollars.



We concede that the dollar may consolidate and could rally in the short term. The chart at the left, provided by someone more bullish on the dollar than we are, depicts the dollar's slippery slope. Its movement downward is extended and counter cyclical rally's often occur within the context of any secular movement. We'd speculate that any rally may take the dollar back up to the "blue line", or "moving average". But we remained convinced that the longer term direction for the dollar is downward. This is a function of two major forces.

First, there are way too many dollars in circulation and the U.S. government seems to have no intention of changing that. Too much supply of anything can lead to its price declining.

Second, there are competing "reserve" currencies for the first time in many decades. People simply have other choices including the Euro, Yen, and Yuan. Competition also tends to lower prices.

Therefore we will be entering 2005 intending to increase our client's participation in "Predictive Growth and Income, LP (PGI). This is the "market neutral" currency investment strategy that we pioneered in 2002. Frankly PGI is designed to work whether the dollar rises or falls against other currencies.

We will also be entering 2005 with unhedged foreign currency denominated bond funds in many of our investor's portfolios. They are pure plays on a falling dollar strategy. They are also yield oriented investments, providing us with current return in uncertain market times.

Speaking of uncertainty, is there a real estate "bubble"?

The highly respected UCLA Anderson Economic Forecast calls the current state of affairs "**the bulked up Housing Bubble.**" On Sunday, December 12, 2004 the San Francisco Chronicle ran a major feature on California real estate which concluded there is no such thing as a bubble. How is that for definitive?

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. 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. That depends on various factors you will read about in the section of this report entitled "**What is there to worry about?**"

We still own one specialty REIT in some portfolios and that is Plum Creek Timber (PCL). They specialize in one thing, growing and selling timber. While PCL is organized and operated as a REIT, we see it as a commodity investment.

What about commodities and oil, gas and the stuff of wars?

The word "commodities" represents an incredibly broad investment spectrum. In fact, it is too broad an investment spectrum for us to focus on. We will enter 2005 with three investments in the world of commodities. We think the price of timber will remain strong into the foreseeable future, therefore the investment in Plum Creek Timber (PCL).

We think the price of gold will continue to go up. Therefore we have made investments through two mutual funds which own the shares of gold mining companies. We will continue to hold them as we enter 2005.

As we are writing this report most industrial commodity prices are in retreat after a big run up in 2004. Industrial commodity prices may be in for a year or more of drifting sideways. Yet we think that the “opportunistic” investor will find plenty of opportunities to make money in commodities over the next several years, regardless of price direction. Therefore we will enter 2005 holding one mutual fund that trades commodities for profit using an opportunistic strategy. The fund itself “combines a position in commodities, typically through swap agreements, backed by a portfolio of inflation-indexed bonds and other fixed-income securities. The commodity position aims to capture the total return of the commodities market”. The fund targets the Dow Jones AIG Commodity Index as its benchmark. When fund management is not trading commodity related instruments they park cash in “TIPS”. We want to own “TIPS” anyway.

Gas and oil are commodities but we treat them as a separate asset class. Not only are they “commodities” they are “political commodities” which takes them out of the world governed by pure supply and demand functions. They are the stuff of wars and global tensions. Think IRAQ!

If we could predict the price of oil we could have skipped everything we have written so far and simply gone long or short oil—depending on that prediction. But we can’t. In fact we can’t think of anything more uncertain than reliable data on supplies and therefore the direction of prices. We think it is a reasonable bet that prices will remain manipulated, and high. Therefore we will enter 2005 with a portfolio allocation to oil and “energy” of three percent.

Therefore our model portfolio looks like this

<i>Asset Class</i>	<i>Target Allocation</i>
Cash	3.00%
Tax Free Muni's or TIPS	15.00%
Convertible Hedged Securities	5.00%
Core Balance Mutual Funds	10.00%
Core Large Cap Value Stocks/Funds	10.00%
Utility Stocks/Funds	3.00%
Energy Related Stocks/Funds	3.00%
Health Care Related Stocks/Funds	4.00%
Internet/ Tech Related Growth Stocks/Funds	2.00%
Telecommunications/Networking Stocks/Funds	2.00%
Banking & Finance Related Stocks/Funds	4.00%
Small Cap Stocks/Funds	5.00%
Japan Stocks/Funds	2.00%
China Stocks/Funds	3.00%
Foreign Stock Funds(focus on small cap)	3.00%
Foreign Stock Funds(focus on large cap)	2.00%
Real Estate Related Stocks/Funds	3.00%
Commodities Related Stocks/Funds	3.00%
Gold Related Stocks/Funds	3.00%
Foreign Exchange Trading Fund (PGI 3)	5.00%
Emerging Markets Bonds/Non-US Dollar	5.00%
Total Long Positions	95.00%
Short Positions (cash when not short)	5.00%
Total Portfolio	100.00%

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What is there to worry about?

Last year we answered this same question by expressing our concern as to whether or not American consumers could keep up the pace of spending needed to support continued economic growth. The American consumer did—somewhat to our surprise.

Yet we still worry that the whole global economy is hanging together primarily on the strength of the U.S. consumer. We have been saying for years that if the American consumer ever slows down, watch out! This is one factor that could lead us back into recession by the end of 2005 or sometime in 2006.

We also raised concerns regarding the falling dollar last year. We quoted the Blue Chip Economic Indicators Newsletter, “Others worry that the decline in the value of the U.S. dollar could become disorderly rattling stock and bond markets.” That hasn’t happened so far. The same newsletter reported, “It is said that the dollar’s decline and faster growth abroad should further boost export growth, and perhaps by the end of this year (2004) begin to reverse the sharp widening trade deficit witnessed over the past several years.” Oops, that didn’t happen either. So we go into 2005 worrying about the same things that worried us in 2004. Including the one item we called “unspeakable” last year—terrorist attacks on the U.S. and Great Britain.

Let’s look more closely at potential problems

We don’t mean to imply that U.S. consumers fuel the global economy alone. They don’t. But the amount of consumption by Americans is so disproportionate to the size of our population that every producer of goods and services on the planet is likely to benefit from U.S. consumer spending, and to suffer if that spending slows down. The table shown below helps to put our point into perspective.

Region	Share of World	Share of World
	Private Consumption	Population
	Expenditures	
United States and Canada	31.5	5.2
Western Europe	28.7	6.4
East Asia and Pacific	21.4	32.9
Latin America and the Caribbean	6.7	8.5
Eastern Europe and Central Asia	3.3	7.9
South Asia	2	22.4
Australia and New Zealand	1.5	0.4
Middle East and North Africa	1.4	4.1
Sub-Saharan Africa	1.2	10.9

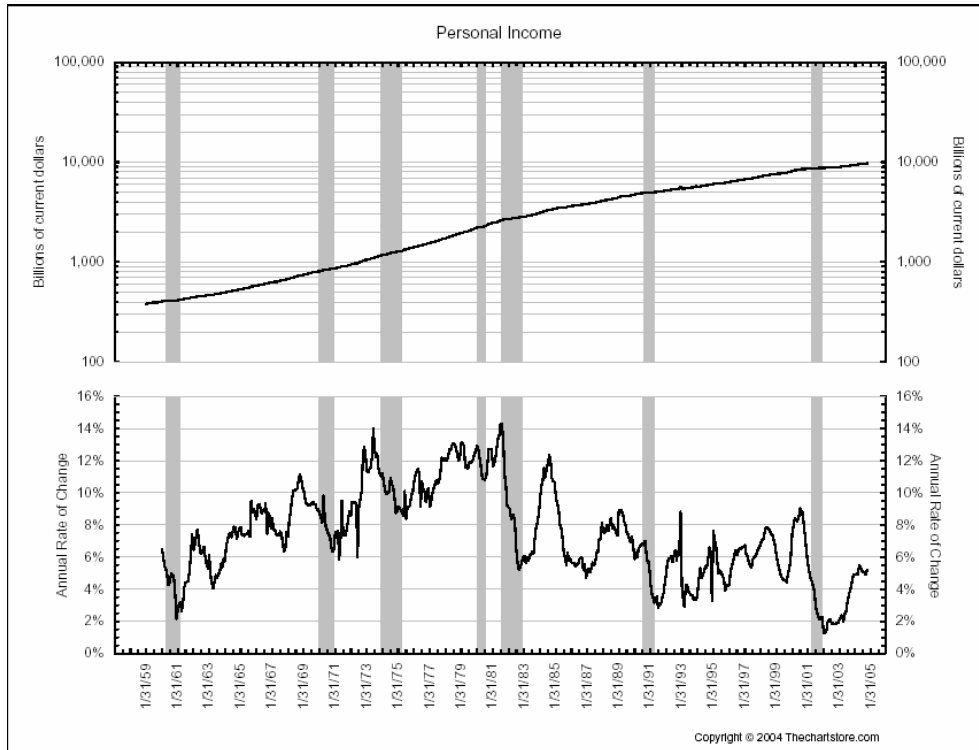
Renowned investor and money manager Bill Gross, of PIMCO, puts it another way. Here is a recent quote.

“The U.S. spends too much, eats too much, drinks too much; TOO MUCH, (thank you, Dave Matthews). And we pay for it with our debt and 80% of the world’s excess savings. In so doing our creepy-crawly balance of payments deficit has inched its way up to 6% of GDP—a level never seen in the U.S. and reflective of third world nations in financial crisis. The imbalance has been tolerated by those nations on the surplus side of the ledger—read “Asia”—in a strange sort of mercantilistic Faustian bargain that promises China and Japan the benefits of a strengthening economy **now** for the perfidy of falling-dollar-denominated Treasuries bonds **later**, an arrangement that once again will prove that there is no free lunch, or that hell often follows heaven on Earth.”

Frankly we are amazed that U.S. consumption has continued to grow at a steady pace for the past few years. We simply do not know how this growth rate will continue. At some point the American consumer is simply going to run out of money, and when that happens the global economic growth rate has to slow down.

One of the key reasons is that personal incomes are growing at slower and slower rates—and they have been for over 20 years now. Look at the “annual rate of change” (ARC) section in the chart below. Notice how the ARC was rising from 1959 through 1982. In those days people were not only making more money every year, but the rate at which their income was growing was actually increasing. They were making more money FASTER AND FASTER. No wonder times felt so good during President Reagan’s second term!

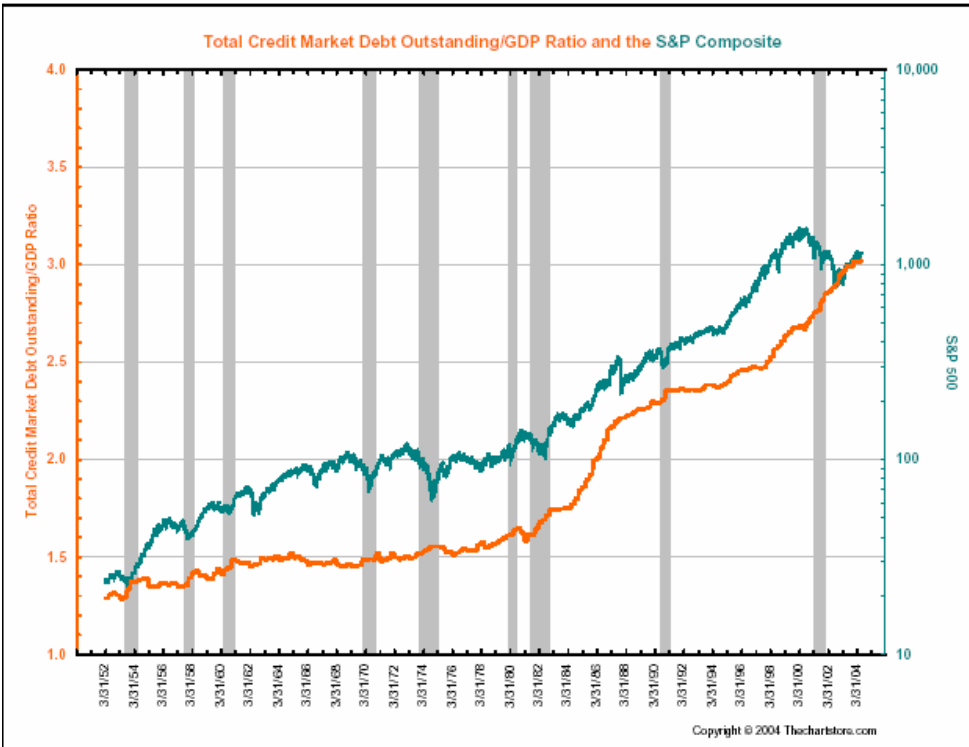
Since 1982 the trend has reversed. The ARC is declining. Sure people are still making more money each year (on average) but it is harder and harder to do so. Most American households now have at least two wage earners who are working unbelievably hard to maintain their standard of living.



“Maintaining their standard of living” is the key phrase. For most American households that means substituting debt for lost increases in wages. And, it is not only American households that are substituting debt for wages. Every level of American government is doing it too.

Look at the chart below, which compares the rise in total credit market debt to the rise in the S&P 500.

(See chart on the following page)



A chart like this makes you wonder what will happen if U.S. households and governments run out of ability to borrow? If you look closely at both tables, you will notice that the rate of borrowing started to accelerate in 1981-82. That is the same time that the rate of growth in incomes started to slow down.

That leads us to another observation about the U.S. and global economy. The U.S. consumer is spending all he or she makes and therefore the U.S. savings rate has been dropping for years. Others will contend that we are wrong about this.

Bullish analysts keep coming up with new statistics to explain why the American consumer is still extraordinarily healthy and that we shouldn't worry about them running out of purchasing power any time soon.

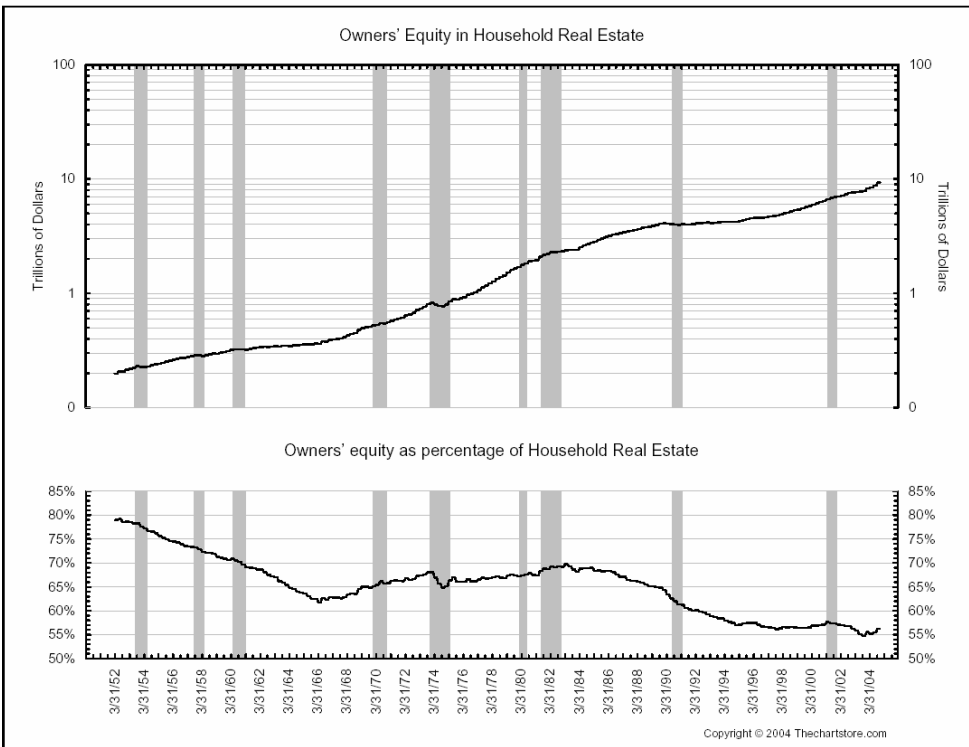
One such bullish opinion was recently offered by Tony Crescenzi, the chief bond market strategist at Miller Tabak + Co., LLC, and adviser to institutional investors on issues related to the bond market, the economy and other macro-related issues. At the request of the Federal Reserve, Crescenzi is a regular participant in the board's Livingston Survey of economic forecasters.

Here is a quote from Mr. Crescenzi's recent column on RealMoney.com, "On the whole, consumer fundamentals are fairly good and recent data on bankruptcies and delinquency rates suggest that concerns about a strapped consumer are bunk. Solid income gains, low interest rates, high lending standards, tax cuts and rising home values have helped to fortify the household's balance sheet. While it is true that some of these factors are likely to be somewhat less friendly to the consumer in 2005, they do not pose substantial risks to consumer spending. Perhaps the greatest risk to the consumer would be a decline in home prices, but this seems unlikely, and even if one were to occur, it probably would be shallow and short-lived."

We acknowledge that the U.S. consumer has seemed bullet proof so far.

The rise in home prices has strengthened personal balance sheets. But we observe that even as home prices have been rising, percentage equity has been falling. That is because there has been so much refinancing through which people are taking equity out of their homes and simply spending it. They are wasting their equity to maintain their standard of living!

DATA AS OF 3/31/2004



Just look at these graphs and ask yourself what is wrong with this picture? The top half shows the rise in owner's equity in household real estate since 1952. That is a pretty impressive change from less than \$1 trillion dollars to \$10 trillion dollars. There is no arguing that point.

But look at the bottom half. Owner's equity as a percentage of their household value has fallen from nearly 80 percent equity to just over 55 percent. That is the part we worry about.

One could easily make the argument that this hardly matters. It would stand to reason that since interest rates are low, most people are refinancing and locking in a good low rate, and therefore protecting themselves from future rate increases and higher debt service payments. But that is not the case. More and more people are refinancing by using Adjustable Rate Mortgages (ARMS).

As housing prices have been increasing, so has the share of ARMS. We suspect that people are opting for the ARMS because they can't afford the payments on fixed rate loans. What is going to happen if these same people suddenly find themselves facing the higher rates they were trying to avoid?



Mr. Crescenzi and other bulls say “the greatest risk to the consumer would be a decline in home prices”. No, that is not the greatest risk. The greater risk is that homeowner’s are squeezed by rising interest rates on their ARMS at the same time the price of their house is falling.

Our next worry is the falling dollar that was supposed to reduce the current account deficit

The dollar has fallen approximately 35 percent against the Euro and 24 percent against the Yen over the past three years, yet the deficit

continues to increase. The plan (if there is one) is clearly not working, and it can’t. Calamos Investments points out, “The U.S. is not going to gain a competitive advantage over India or China by having its currency depreciate 30 or 40 percent when they have a 20 to 30 to 1 cost advantage over us in labor. We would have to depreciate our currency by 95 percent to pick up some advantage there.”

So far the falling dollar has appeared to be good for U.S. stocks and many American based multi-national corporations. But we are in the camp that fears that a continuing fall in the dollar can really turn around to hurt U.S. interests.

There are lots of pundits arguing that our current account deficit and the fall in the dollar don’t matter. In fact Calamos Investments is pretty sanguine about the falling dollar. We beg to differ. We borrow generously from a recent article in the Economist to explain:

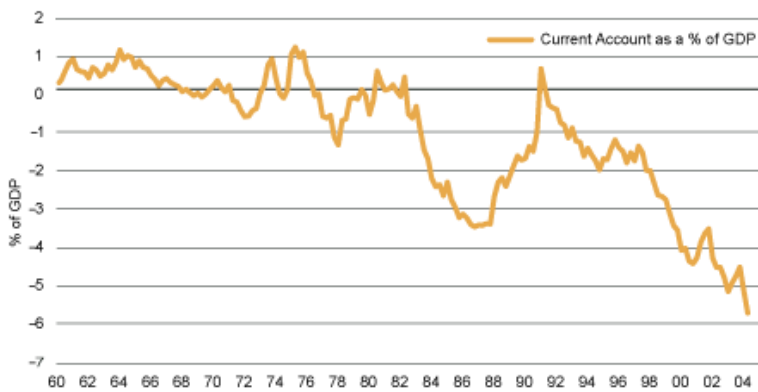
“The current-account deficit is now being financed by foreign central banks and short-term money. In the year to mid-2004, foreign central banks financed as much as three-fifths of America’s deficit. The recent purchase of reserves by central banks is unprecedented. Global foreign-exchange reserves (65%, remember, are denominated in dollars) have risen by \$1 trillion in just 18 months. The previous addition of \$1 trillion to official reserves took a decade. These purchases of dollars have nothing to do with the prospective returns in America, but are aimed at holding down the currencies of the purchasing countries.

Worse, in recent years capital inflows into America have been financing not productive investment (which would boost future income) but a consumer-spending binge and a growing budget deficit. A current-account deficit that reflects a lack of saving is hardly a sign of strength.”

This ties right back to our worries about the American consumer running out of money. Right now the U.S. is borrowing from whoever will lend us money and we are going further and further into debt. That is true of the individuals and government entities alike.

The sheer size of the debt and the amount of capital that is required to fund it make us incredibly nervous. Right now it takes approximately 80 percent of the entire world’s surplus of savings to buy U.S. Treasury Notes and Bonds EVERY SINGLE DAY to continue financing the U.S. deficits. If the debt continues to grow at present pace it will require 100 PERCENT OF THE WORLD’S SURPLUS SAVINGS WITHIN JUST A FEW YEARS! That CAN’T be done! Something has to change.

Too Much!



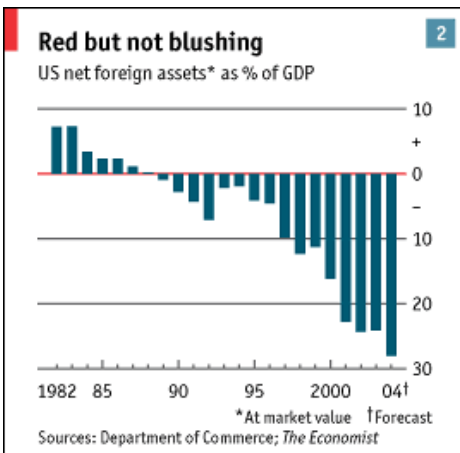
Source: Bureau of Economic Analysis/Haver Analytics
This chart is not indicative of the past or future performance of any PIMCO Advisors product.

The chart to the left shows the trend line of the current account deficit. As Bill Gross pointed out, we are fast approaching levels that have broken “banana republics.”

The Economist also reports, “For almost two decades, economists have worried about America’s current-account deficit and predicted a plunge in the dollar and a hard landing for the

economy. The dollar did indeed fall sharply in the late 1980s, but with few ill effects on the economy. So why worry more now? One good reason is that the current-account deficit, currently running at close to 6% of GDP, is almost twice as big as at its peak in the late 1980s, and on current policies it will keep widening. Second, in the 1980s America was still a net foreign creditor. Today it has net foreign liabilities and these are expected to reach \$3.3 trillion, or 28% of GDP, by the end of 2004 (see chart 2).”

We owe that money to foreign governments! Get it? We owe them. They don’t owe us! They own that debt in U.S dollars, which they have been buying in droves. The Economist also concludes, and we concur, that if we let the dollar fall another 30 percent—that is in effect the largest foreign debt default in the history of the planet. We are very worried about the possible consequences of that ‘default’.



The foreign governments who are buying this debt are not stupid. They know what is going on and they are already starting to take steps to diversify their holdings away from the U.S. dollar. What happens if their purchases of the dollar slow too much to continue financing our insatiable appetite for their imported capital? Interest rates in this country will have to RISE dramatically to continue attracting their purchases of our government bonds. We are like addicts to their money and we will have NO CHOICE but to pay them what they demand to keep the juice flowing.

Now assume our fears about an economic slowdown in the second half of next year turn out to be correct. Couple that slowdown with rising interest rates and what do you get? STAGFLATION. Welcome back to the 1970’s. We just hope we don’t go back to those fashions! Saturday Night Fever anyone?

We think a lot about how small a world we live in nowadays, and how interdependent we have all become. There is a precarious economic balance in place right now. The continued health of the American economy is a key to that balance. Therefore the policies of the U.S. Federal Reserve Bank and the U.S. government are also keys to that balance. We certainly hope that they know what they are doing with their “de facto” weak dollar policy—but we aren’t exactly betting on it.

They should be focusing on reducing the deficit, not monetizing it. The Fed and the current administration are risking creating long term inflation at much higher rates than are currently desirable. They are also risking a “de facto” default that could end the reign of the U.S. dollar as the world’s reserve currency. That will inevitably lead to higher borrowing costs for the U.S. and contribute to a long, slow DECLINE in the standard of living for many Americans.

Interestingly many American companies have been strengthening their balance sheets during the past several years, and avoiding the debt pitfalls that face many consumers and government entities. Corporate America’s balance sheets have probably not been this healthy in years.

So how did we finish 2004?

The bulk of our equity investments have been in mutual funds that have demonstrated remarkable resilience and positive investment results through the past 7 years. The following table ranks them by the size position they represent in the various K&A managed accounts.

Performance as of 10/31/04	EOY 2003 Rank	EOY 2004 Rank	1998	1999	2000	2001	2002	2003	2004
Dodge & Cox Balanced Fund	1	1	6.69	12.06	15.14	10.05	-2.94	24.44	6.51
Matthews China Fund(1)	na	2	na	47.11	-6.69	20.91	-7.52	65.00	-1.35
Dodge & Cox Stock Fund	11	3	5.40	20.21	16.31	9.33	-10.54	32.34	8.28
Oakmark Equity Income Fun	2	4	12.38	7.90	19.89	18.01	-2.14	23.21	5.90
Excelsior Value & Restructuring	3	5	10.32	41.98	7.21	-4.96	-23.32	47.78	8.84
Tweedy Browne Global Value Fund(2)	na	6	10.99	25.28	12.39	4.67	12.14	24.93	12.48
Aegis Value Fund	6	7	na	9.95	14.67	42.66	1.35	35.75	7.10
Clipper Fund	4	8	19.20	-2.02	37.40	10.26	-5.51	19.35	-1.65
FBR American Gas Index Fund	10	10	na	10.72	50.37	0.32	-6.24	33.36	7.54
American Balance Fund Class F	8	11	11.13	3.47	15.85	8.19	-6.29	22.79	3.89
Fidelity Select Medical Equipment(3)	na	12	na	10.72	50.37	0.32	-6.24	33.36	7.54
Royce Opportunity Fund	12	13	4.91	32.34	19.85	17.32	-17.01	72.87	3.29
Vanguard S&P 500 Index Trust(4)	7	9	28.62	21.07	-9.06	-12.02	-22.15	28.50	2.94

Footnotes to Table: (1) Matthews China Fund was first added to portfolios managed by K&A on October 5, 2004. (2) Tweedy Browne Global Value Fund was first added to portfolios managed by K&A on March 1, 2002. (3) Fidelity Select Medical Equipment Fund was first added to portfolios managed by K&A on February 11, 2004. (4) Vanguard S&P 500 Fund was not selected by K&A. It was an existing position in various accounts when we took over management. Cost basis is unknown.

The funds we have selected have provided extremely competitive performance. They cushioned the blow of the bear market. Most of them made it through 2000 and 2001 with positive rates of return. While most struggled during 2002, with the exception of Excelsior Value & Restructuring, they all did better than the S&P 500 Index Trust during that terrible year.

The results posted in the table above are the actual performance figures reported by the fund or fund family itself. Our source was Yahoo.finance.com/ It is important for readers of this report to understand that no one portfolio managed by has owned all of the funds for the entire periods shown. The use of this table is not meant to imply that the numbers illustrated represent actual performance numbers for individual portfolios managed by K&A. The funds listed do represent the largest mutual fund positions in K&A portfolios. This table is included in this report to provide readers with an illustration of the type of assets that K&A uses to create core positions in various portfolios.

The funds act as core holdings for us in the area of equities. Most of our allocation to equities will be through the use of these reliable funds.

We use individual stocks to supplement these holdings. Our top holdings at the end of 2003 were as follows.

Stock	First	First	Price	Percent
	Date Acquired	Price Acquired	12/31//2003	Change
Altria	May-00	27	54.42	101.56%
Senetek PLC	Sept-03	0.44	0.44	0.00%
FleetBoston Financial	March-03	24.86	43.65	75.57%
Intel	Apr-93	3.21	32.05	898.44%
Time Warner	Dec-94	0.67	17.99	2585.07
Bristol Myers Squibb	Nov-02	25.55	28.6	11.94%
Suburban Propane	March-02	26.2	31.95	21.95%
Petrochina Co. LTD	August-03	31.03	57.05	83.85%
Nasdaq 100 Trust	May-03	28.84	36.46	26.42%
Microsoft	June-01	18-Jan	27.37	48.59
Bank of America	Dec-03	75.36	80.43	6.73%
AT & T Wireless	Nov-03	6.75	7.99	18.37%

We have since profitably sold all shares of Altria due to our perception of increasing and ongoing litigation risk. We sold all shares of Senetek. Both buying and selling Senetek involved multiple trades. FleetBoston Financial was merged into Bank of America. Many of our shareholders came close to doubling their money on the transactions related to FleetBoston Financial. We still hold Intel and Time Warner in some managed portfolios. We have sold Bristol Myers, for the most part at a small loss. We still hold Suburban Propane. We have sold all Petrochina LTD. Many of our shareholders nearly doubled their money on this transaction. We have since sold all shares of the Nasdaq 100 trust for a profit. We have also since shorted the Nasdaq 100 Trust in certain accounts and profited from that trade as well. We still hold Microsoft and Bank of America. AT&T Wireless was profitably merged into Cingular Wireless.

By illustrating this information about the stocks in the table we are not trying to imply that all portfolios managed by K&A owned all of these stocks. Nor did every portfolio managed by K&A own the various stocks for equal periods of time. Therefore investment results for each portfolio that owned any or all of these stocks may have varied significantly from the results illustrated in the table. K&A tracks all stocks from the first date purchased as a method of monitoring direction, momentum and potential investment results. After any stock is purchased for the first time, for inclusion in the investment portfolios of K&A clients the stock is added to a K&A stock list and tracked using the method illustrated in the tables above and below this paragraph.

Stocks may be added to investment portfolios after the first date of purchase at the discretion of the advisor represents at K&A. These stocks do represent the largest positions held cumulatively by portfolios managed by K&A at the end of 2003. This table is included in this report to provide readers with an illustration of the type of assets that K&A uses to create core positions in various portfolios.

As 2004 draws to a close our top individual equity positions are as follows. (see table on pages 16-17)

Company	First	First	Price	Percent	Annual	Yield as	Yield as
	Date	Price	12/06/2004	Change	Dividend	of	of First
	Acquired	Acquired				12/66/04	Price
						Price	
Capitol Bancorp (1)	Jun-01	17.59	33.74	91.81%	0.68	2.02%	3.87%
Nokia ADR	Apr-04	14.62	16.31	11.56%	0.36	2.21%	2.46%
Thornburg Mortgage	Nov-04	28.64	28.99	1.22%	2.68	9.24%	9.36%

Diageo PLC	Oct-04	51.45	57.27	11.31%	2.49	4.35%	4.84%
Canadian Oil Sands	Mar-04	68.73	86.6	26.00%	1.67	1.93%	2.43%
Annaly Mortgage Inc	Oct-04	17.18	19.97	16.24%	2.00	10.02%	11.64%
Washington Mutual	Mar-04	43.27	40.67	-6.01%	1.80	4.43%	4.16%
General Electric	Oct-02	23.42	35.67	52.31%	0.80	2.24%	3.42%
Sanmina Corp	Aug-04	6.96	9.04	29.89%	0.00	0.00%	0.00%
Bank of America	Dec-03	37.68	46.5	23.41%	1.80	3.87%	4.78%
Plum Creek Timber	Apr-02	30.21	38.62	27.84%	1.44	3.73%	4.77%
Microsoft	Jun-01	18.42	27.33	48.37%	0.32	1.17%	1.74%

You will note that with the exception of Sanmina and Microsoft they all have above average dividend yields. Although Microsoft's current annual dividend is below that of the S&P 500, they have just completed payout of a one time dividend of \$3.00 per share.

We believe that the solid dividend yields offered by most of these stocks provide them with a performance cushion in the market place. Investors are often slower to sell stocks that provide a high current yield. Therefore their prices often tend to fluctuate much less. At a time when we continue to be cautious about the equity markets we prefer the sizable dividends offered by this group of companies.

A Few Words about Foreign Stocks and China in Particular

Two of our largest mutual fund holdings are Matthews China Fund and Tweedy Browne Global Value Fund. Three of our largest individual equity holdings are foreign companies, Nokia ADR, Diageo PLC, and Canadian Oil Sands Trust.

We have been adding I Shares MSCI Japan Index (EWJ) to various accounts that we manage. We will be adding shares of First Eagle Global Fund (SGENX) to various accounts as well. It is our intent to enter 2005 with approximately 10 percent of total portfolio value allocated to foreign stocks.

Matthews China Fund is now our second largest mutual fund holding. You may also notice that the fund has been in existence since 1999 and has been moving up in a stair step pattern, alternating years with positive total returns with subsequent years of negative total returns. We added the fund this year, during a down year. We hope that next year will be a positive year for the fund. Whether it is or not, we will be adding to our holdings in this fund during 2005, and dollar cost averaging well into the future.



We took these pictures from Mathews Funds website. It shows Shanghai 10 years ago and now. These pictures certainly are worth a 1000 words.

Goldman Sachs recently wrote a wonderfully thoughtful report on the future of China. The bottom line is that they expect that a day will come when China's GDP is as large as ours. We believe that such an event is very likely. China's growth will not be linear. It will get interrupted by recessions just like ours does. But the future is clear. They will be a world economic power of the first magnitude.

Focus on Other Asset Classes

Bonds

We entered 2004 owning as many as five different taxable bond funds in many accounts we manage. We leave 2004 owning none. We sold them early this year in preparation to the shift to the higher rates that were being forecasted at the time.

We do own individual bonds in suitable portfolios, most of which are short term or intermediate term maturities. Most bonds held in portfolio's are California tax-free municipal bonds.

We will be adding TIPS to various portfolios. Many of our clients also own TIPS through the Pimco Commodity Real Return Strategy Fund. (Also mentioned below in the **Commodities** section)

Gold

We finish 2004 owning shares of two gold funds in various portfolios.

	Year to date performance
Gabelli Gold Fund (GOLDX)	-4.24%
US Global Investors World Precious Minerals Fund (UNWPX)	5.20%

Commodities

We finish 2004 owning one commodities fund in various portfolios.

	2003 Performance	2004 YTD Performance
PIMCO Commodity Real Return Strategy Fund (PCRDY)	29.12%	20.49%

Real Estate

Our only real estate related holding is currently Cohen & Steers Realty Shares.

	2002 Performance	2003 Performance	2004 Performance
Cohen & Steers Realty Rund (CSRSX)	2.79%	38.09%	31.12%

Currencies

As 2004 draws to a close we are marking the end of two years of trading for Predictive Growth and Income, LP, (PGI), the first currency fund that we pioneered through a company called Predictive Financial Technologies, LLC. Paul Krsek was a co-founder of that company. PGI is currently available only to a limited number of investors.

But, it is our intention to make currency investments available to more investors in 2005. PGI's total return to investors, net of fees, has been 16.10 percent during the approximately 23 months that it has been trading; as of 12/14/04.

We are in the process of forming a new partnership called Predictive Growth and Income 3 (PGI3). Predictive Financial Technologies, LLC is withdrawing as general partner of PGI and a second partnership that was formed called PGI2. K&A will be the general partner of PGI3, which is modeled after PGI and PGI2.

PGI and PGI2 will be closing and investors in those partnerships will be offered the opportunity to purchase units of the new PGI3. PGI3 will also be open to new investors.

What major trends will we be following in 2005?

- Holiday sales and the status of the American consumer!
- Big deals are on the rise like KMART and SEARS; ORACLE and PEOPLESOFT; ATT WIRELESS and CINGULAR; SPRINT and NEXTEL. The pace may accelerate in 2005.
- Can the U.S. keep up the Productivity Miracle? According to the UCLA Anderson Forecast productivity grew in the U.S. at an annual rate of 1.7 percent from 1970 to 1998. Since 1998 it has been growing at 3.8 percent. But this incredible rate appears to be slowing. Can it reaccelerate?
- Maybe even more important is the number of hours worked by U.S. workers. Hours worked have dipped enormously since the recession of 2001 and have not reaccelerated. GDP growth is the sum of growth in hours worked plus growth in productivity. We need productivity growth and an increase in hours worked to keep the GDP growing. It's not just JOBS! Its how long are people working on those jobs, and what are they accomplishing.
- Rate of change in wage increases!
- Can corporate earnings growth keep pace with consensus forecasts?
- What new innovations are going to change the investment landscape? What is the next IPOD?
- Will real estate keep going up, level out, or will the bubble burst?
- Will China and Japan keep buying our bonds, and at what price?
- How far will the dollar fall?
- How high will the price of gold go?
- The next big accounting scandal!
- Will oil get back to \$50, before it retreats below \$40?
- The war on terror!
- The terrorist's war on us!
- Debt, private and public! TOO MUCH!
- Could we get the ultimate contrarians surprise from the stock market and actually see growth stocks outperform "value" stocks for the first time in many years? Check out this table. See large growth stocks near the bottom during the past four years. Could they lead the market in the first quarter or half of 2005?

Ranking of Investment Categories from Best to Worst Over the Last 20 Years

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	
Best	Bond	Int'l	Int'l	Gold	Small Value	Gold	Bond	Small Growth	Small Value	Gold	Int'l	Large Value	Large Growth	Large Value	Large Growth	Small Value	Small Value	Small Value	Gold	Small Growth	Best
	Large Value	Gold	Gold	Int'l	Int'l	Large Growth	Large Growth	Mid Cap	Large Value	Int'l	Large Growth	Large Growth	Large Value	Mid Cap	Int'l	Large Growth	Bond	Gold	Bond	Small Value	
	Int'l	Mid Cap	Bond	Large Growth	Large Value	Mid Cap	Mid Cap	Small Value	Mid Cap	Small Value	Small Value	Small Value	Small Value	Small Value	Mid Cap	Int'l	Mid Cap	Bond	Small Value	Gold	
	Small Value	Large Growth	Large Value	Large Value	Mid Cap	Large Value	Large Value	Large Growth	Bond	Large Value	Large Value	Mid Cap	Mid Cap	Large Growth	Large Value	Mid Cap	Large Value	Mid Cap	Mid Cap	Int'l	
	Mid Cap	Bond	Mid Cap	Mid Cap	Small Growth	Small Growth	Small Growth	Large Value	Small Growth	Bond	Small Growth	Bond	Small Growth	Bond	Bond	Large Value	Gold	Large Value	Large Value	Mid Cap	
	Large Growth	Large Value	Large Growth	Bond	Large Growth	Bond	Gold	Bond	Large Growth	Mid Cap	Mid Cap	Small Value	Gold	Small Growth	Small Growth	Small Value	Int'l	Small Growth	Int'l	Large Value	
	Small Growth	Small Value	Small Value	Small Value	Bond	Small Value	Small Value	Int'l	Gold	Small Growth	Bond	Gold	Int'l	Int'l	Small Value	Bond	Large Growth	Large Growth	Large Growth	Large Growth	
Worst	Gold	Small Growth	Small Growth	Small Growth	Gold	Int'l	Int'l	Gold	Int'l	Large Growth	Gold	Int'l	Bond	Gold	Gold	Gold	Small Growth	Int'l	Small Growth	Bond	Worst

Source: Steele Systems, Inc., TSE Stock Exchange, and Bloomberg.

Diversification does not protect an investor from market risks and does not assure a profit.

Summary, Conclusion and Action Steps

Last year we concluded that “2004 is unlikely to be as easy or as forgiving as 2003”. That has certainly turned out to be true. Even so, it has been a very profitable year. We must now say that we suspect that 2005 may not be as easy or forgiving as 2004. By that we mean that investors will have to stay sharp in order to make money in 2005. We enter the year with guarded optimism. It is always easier to feel confident about the short term, so it is easy to say that the first half of the year might be better for equity and real estate investors than the second half. The truth is that we don’t really know that.

We enter the year with a model portfolio that is intended to take advantage of any continued movement upward in value in the equity markets. That is the reason for the allocation of approximately 45 percent to various equities. We have limited equity exposure to the segments of the market that we think might provide the best performance, including a rather heavy weighting to foreign stocks.

We have focused the equity investments in mutual funds that are proven performers in both up and down markets. Our bias in equities is clearly toward “value” over “growth”. We believe this provides us a certain margin for error during times of soft market conditions.

We are also focusing on the “short side” of the market as well, and therefore the 5 percent allocation to “shorts”. This may actually be the safest way to make money in the stock market during 2005. If equity market conditions deteriorate significantly at any time during 2005 we are prepared to significantly increase this allocation.

The rest of the portfolio is designed to perform in a weak dollar, strong commodity environment. We are also positioning the model portfolio to take advantage of any rise in interest rates that may come from market forces reacting to the U.S. bloated deficits.

We are keenly aware that the U.S. economy is walking a tightrope. While the most likely case is for modest economic growth next year, the next most likely case is recession, and even “stagflation”. We will be keeping a very watchful eye out for changing conditions.

We believe that our model portfolio represents an extremely thoughtful selection of asset classes that should provide competitive investment returns while reducing portfolio volatility for our clients during 2005. The outline of that model, as presented in this report, is backed up by very high quality asset selection.

We will be constantly rebalancing portfolios throughout 2005 with a goal of maximizing investment performance while reducing portfolio volatility.

We are looking forward to the New Year and the many opportunities and challenges that it will bring. We look forward to working with our clientele and our friends and peers in the industry.

Respectfully submitted,

Paul Krsek & Robert Andreae

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