



E-llumination

August 27, 2006

The Coming Storm

Everybody is on storm watch again because it is hurricane season in the Gulf of Mexico.

But I am now watching for a different kind of storm. This one seems to blow in during August or September and knocks the crap out of the U.S. stock market. This storm has appeared each of the past 9 years, and pretty much right on schedule—like now!

So we are battening down the hatches and getting prepared for the possibility that it hits again. To understand what I mean check out the “History of Autumn Declines in the Dow Industrials from 1997 to 2005” provided by Robert McHugh to safehaven.com

1997: A stock market crash that began on August 7th at 8,340.14 and fell for 57 days to a low of 6,936.45 on October 28th, a 1,403.69 drop, or **16.8 percent**.

1998: A stock market crash that began on July 17th at 9,412.64 and fell for 32 trading days to a low of 7,329.70 on September 1st, a 2,032.94 plunge, or **21.6 percent**. It hung around that low through October 8th, hitting a bottom that day at 7,399.78.

1999: A near-crash that began on August 25th at 11,428.94 and lasted through October 15th when it fell to 9,911.42, 36 trading days, a **13.2 percent sell-off**.

2000: Another stock market crash, this one commencing September 6th at 11,401.19 and lasting until October 18th's 9,656.12 bottom, a 30 trading day plunge that saw prices fall 1,745.07 points, or **15.3 percent**.

2001: Again, a stock market crash. It began on August 27th at 10,441.37 and lasted through September 21st, bottoming at 8,062.34, a 2,379.03, **22.7 percent bloodbath that took only 14 trading days**.

2002: Again, the sixth stock market crash in a row if you consider the 13.2 percent 1999 wipeout a crash. It started innocently enough on August 22nd, at 9,077.01, and lasted until October 10th at 7,197.49. When the carnage was over, the losses were 1,879.52 points, or **20.7 percent**.

2003: Even in 2003, when a glorious rally was in full swing, the Dow paused to follow tradition by dropping a measurable **4.7 percent**, or 455.61 points from 9,686.08 on September 19th to 9,230.47 on September 30th.

2004: A significant **6.2 percent** drop followed suit, markets in the tank from September 13th's 10,348.39 high to October 25th's 9,708.40 low, a 639.99 sell-off.

2005: One of the milder declines, we still saw a **5.1 percent** decline that started from September 12th's intraday high of 10,701.81 and lasted through October 13th, 2005's 10,156.46 low, a 545.35 point drop.

That is a pretty steady track record, right? Unfortunately the overwhelming majority of our chart watching and technical market analysis indicates that another storm is forming up. Bear in mind that we are subject to a lot of the same imprecision in forecasting that impacts the National Weather Service, but to us it looks like the markets are headed for another wash out in the next several weeks.

Before getting too gloomy, please remember that late October through December 31 are often the best days for the U.S. stock market—so don't rule out a "Christmas rally". We may have to get through the coming storm first however.

So I wanted to show you how we are set up as we prepare to go into "Storm Season". Our readers know that the bulk of accounts managed at K&A are split up into four model portfolios. You also know that some of the accounts we manage are "customized" to fit very specific needs of individual clients, so the models do not apply to those accounts. But here are the "model" configurations (asset allocations) as of the close of the markets on Friday afternoon.

Model	Hatteras	Mendocino	Halifax	Bonavista
Cash (money market)	12.34%	16.64%	11.00%	15.17%
Bonds	29.04%	19.70%	18.45%	18.70%
International Stocks (outside U.S.)	15.36%	12.34%	22.24%	22.27%
International Real Estate (outside U.S.)	0.00%	0.00%	6.67%	6.31%
Long U.S. Stocks	17.86%	19.17%	5.54%	5.62%
Hedged U.S. Stock Funds	12.59%	18.41%	24.71%	24.71%
Short U.S. Stocks	-4.63%	0.00%	0.00%	0.00%
Oil, Gas, Energy Related Stocks (global focus)	10.89%	11.71%	9.73%	9.80%
Gold	1.90%	2.03%	2.05%	2.03%
Total (over 100% because of use of leverage)	104.61%	100.00%	100.00%	100.00%

You can see that a minority portion of assets is allocated to U.S. stocks in each of the four models.

"Long U.S. stocks" simply means that portion is invested in U.S. stocks or U.S. stock mutual funds with no hedging attempted.

"Hedged U.S. Stock Funds" means that portion is invested in one or two funds that are "market neutral" or fully hedged to manage downside risk within the fund. These funds tend to outperform the market when stock prices are going down, and often actually produce a positive rate of return, despite the decline.

"Hedged U.S. Stock Funds" may also apply to one fund that we use that employs a long/short strategy within the fund. While this particular fund as a long-side bias, it tends to do well in preserving value even has stock prices decline.

“Short U.S. Stocks” means that portion is invested in individual stocks that we have “sold short” betting that we will make money if they go down in price. Only the Hatteras model can do this.

So as you can see, we are headed into “storm season” with a pretty good set up, in that a rather small portion of assets are “long U.S. stocks”.

We have to point out that the “oil, gas & energy related stocks” section may also include some U.S. based stocks. But, we manage that category based on what is happening with oil and gas pricing, supply and demand information, as well as technical analysis of this unique sector; and not based on what is happening in the overall U.S. stock market.

This season is no fun for me; and probably not for you either. It has become the habit at K&A to “batten down the hatches” as we get to mid-to-late August and September. By mid-October we are usually ready for the storms to pass and “Christmas” to arrive. Frankly I’d rather skip this season particularly since I simply have no way of knowing if the market storm is going to be like a “Katrina” or a minor blow.

Remember that the model allocations might change as early as Monday morning. I’ll keep you posted and we’ll get you through this season—and ready for Christmas! All hands are on deck!

All the best, PK
For K&A Asset Management, LLC

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K&A manages accounts with various histories and investment objectives. Various accounts may be managed differently from time to time.

During 2005 Paul Krsek was appointed Chief Investment Officer of K&A, and as such is responsible to make all trading and management decisions for all client accounts which are being managed according to a specific portfolio model. A description of each of our models can be found on our website at <http://www.kaassets.com/choices.htm>.

Some accounts managed by K&A are managed individually and not subject to the discipline of a particular model portfolio. Individual advisor representatives, including Krsek or Andreae, may be assigned to an account and have the authority to make decisions related to accounts that are not subject to a model's discipline. K&A Asset Management, LLC, as an entity, does not manage investment accounts.

Paul Krsek, Rob Andreae and Nancy Widener currently act as the investment policy committee for K&A, and as such do review general and specific investment policies of K&A. But when it comes to the implementation of those policies Krsek is primarily responsible to manage the accounts that fit into each model portfolio description. He makes all final investment and trading decisions relative to those accounts that are "modeled."

From time to time K&A receives requests from clients to purchase securities that are not included in the model portfolio to which they are assigned. Effective May 24, 2006 K&A will accommodate such requests by opening a separate account for the client in which to hold such securities. Because K&A is a "fee only" registered investment advisor" it will charge its normal management fee for monitoring such securities in the separate accounts in which they are held.

No securities that are 'requested by the client' will be held in modeled portfolio accounts.

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If you are not satisfied with the investment results in your account it is your responsibility to inform Krsek or Andreae and to discuss possible changes that can be made to the account to accommodate and satisfy your needs.

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Sincerely,

Paul Krsek
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