E-llumination
January 17, 2006

One of the most interesting things I do is re-read the old newsletters that I have written to you. That may sound a little crazy, but if you are a K&A client, you should be glad that I review them over and over again. When doing so I sometimes feel like a genius and, as you might imagine, sometimes I feel a bit stupid-or at least humbled. The good news is that most of the time I feel quite good when looking back at the things we wrote and consequently ratifying the decisions we were making at the time.

It has been particularly intriguing for me to re-read the newsletters from 2005. Frankly 2005 was the hardest year to manage money that I can ever remember. It nearly wore me out. As far as I am concerned it was tougher than the year after 9/11/2001—and that was tough. Our investment performance was better in 2005 than 2002. I think that has a lot to do with the hard lessons we learned in the aftermath of the worst attack on U.S. soil in two generations.

Frankly, we are much more defensive in our management style now than we were at that time. We are much more focused on preserving our investors' capital in any market climate; including the most extraordinary, like after a major terrorist attack.

2005 was tough because for most of the year nothing went anywhere and all the economic and financial signals were so mixed. It was almost like an old Seinfeld show, which was a show about "nothing". For most of the year nothing happened.

In the end it turned out to be a year in which we booked respectable performance for our clients, and in our various model portfolios.

I just finished reviewing our comments on the markets in early 2005 to see how things actually turned out compared to what we thought would happen. Here is my own scorecard for K&A for 2005 based on comparing real results with our forecasts or opinions.

1. February 2005 quote="gold will rally".

Hey, we got that right, and we believe the rally has a long way to go. We have staked out a major position in gold. **Score=A+**

2. February 2005 quote="The dollar will continue to fall".

We got that wrong, at least for 2005. It is now early 2006 and it is falling now for all the reasons we suspected back then. We have staked out a major position in unhedged foreign bonds that should benefit significantly from the falling dollar. **Score=B- (right result, bad timing)**

3. February 2005 quote="...we see higher prices in oil and gas. $60.00 per barrel is not out of the question by 2006. America has no friends in OPEC."

We got over $60 per barrel in 2005 and remain there in 2006. We staked out a major position in oil and gas. We made money. We took profits and trimmed back and now we are adding back to that position. **Score=A**

4. February 2005 quote="The recovery is in the very early stages and we believe this is a good time for investors to be "buying" Japan."

Hey, this was the big "whiff" of 2005. We made exactly the right call, took the swing and "bought" Japan, and then sold too early. We missed a 40 percent rally after we sold. **Score=F**

5. February 2005 quote="We mentioned that there might be a "real estate bubble" but that we didn't see home prices collapsing. They haven't and aren't likely too in the immediate future."

Local residential real estate has softened, but it hasn't collapsed, and won't any time soon. Bay area commercial real estate has actually heated up. As for the "bubble"—it does exist in Miami and Las Vegas. Ask anyone from Cleveland if they have seen a real estate bubble and they will laugh. We currently have no positions in real estate in the portfolios. We have made the decision that almost all of our clients have significant real estate holdings outside their financial portfolios. They don't currently need us to diversify them into real estate. **Score=B**

6. February 2005 quote= We really equivocated on the U.S. stock market in 2005. We didn't say whether we thought it would go up or down in 2005. We simply said, "We have gone from overvalued to significantly overvalued, to not exactly cheap over the course of 7 years."

When we talk about the U.S. stock market in quotes like this we are always talking about the Dow Jones Industrial Average (DJIA), the S&P 500 (SPX), and the NASDAQ Composite Index (NAZ). Those are the three indexes we always benchmark and quote. We'll they didn't go anywhere for 11 months. The SPX and the NAZ sweated out gains in the end. The DJIA finished the year slightly down. We made money in the stock markets, but we wouldn't say it seemed easy. It drove us nuts all year. **Score=B (because we were equivocal, but in the end our perception proved to be quite accurate)**

7. February 2005 quote="we still love China as a long term investment theme. We are buyers of China. Ignore China at your own risk."

We also speculated as to whether the Chinese economy might slow its rapid pace of growth in 2005. It didn't. The Chinese government has recently announced that they do expect a slow down in 2006. We will still be buyers in 2006. We also said in 2005 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." We expanded holdings recently to include Taiwan. We are calling Taiwan and China together "greater China". We will continue to build the position over the next several years. **Score=A+**

8. February 2005 quote="Interest rates should rise in the U.S. but not enough to cut off economic and market growth".

We were right on in this statement, but this is one case in which the statement does not really indicate the full meaning of the thinking behind the statement. We actually thought that economic growth would slow to just below 3 percent in the second half of this year. It didn't. Because we thought growth would slow to below 3 percent we were more defensive in our investment style in 2005 than we probably should have been. **Score=B-**

So there you have it. These were our eight major positions on the markets for 2005. I think we did pretty well. My own scores are **A+, B-,A,F,B,B,A+,B-.** If I were a teacher I would throw out the high and the low, average the rest and give us a **B+** for the year.

The interesting thing is that for most of our clients I would say that our investment performance merited a **B+** to an **A**. However, if your account was modeled after our **Prudent Person Hedged Growth & Income Model** that is not true. We were simply too defensive in those portfolios and they did not achieve the same level of investment performance as others did.

On the other hand, had there been a major terrorist incident or other economic calamity in the world, they would have significantly out performed any other portfolio we managed. That begs the ultimate question, doesn't it? How do you prepare for the worst? Believe me when I tell you that the answer isn't "hope for the best".

We hope that you have read Part 1 of our latest report for 2006. If you have done so, then you know our major themes for the coming year. Part II will be available shortly.

All the best,

Paul Krsek
For K&A Asset Management, LLC
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