



E-illumination Mid Year Report to our Clients and Friends of K&A July 6, 2006

One thing that we have all learned it is that the financial markets are entirely different in the 2000's than they were in the 1990's. There certainly seems to be a surprise every hour. For example in early May there was great excitement about U.S. stock markets breaking out to new multi-year highs—then KABOOM. By the middle of June all the talk had turned to the possibility of a new bear market in U.S. stocks. Today the “sentiment” is evenly split—and it is only two weeks later.

After studying all the markets continuously, day in and day out, we haven't changed our basic opinions on the various financial markets since we published our 2006 Report to Clients and Friends on January 2. So if you want a detailed look at our positions on the various markets you might want to read that report.

You can find it at on our website at <http://www.kaassets.com/illuminations.htm>.

If you have already read it, or don't want to, I will try to give you a quick update and summary. Let's start with our results for the first half. Our four main models finished the first half with “simple annual returns” as follows:

Bonavista Model Account = 4.12%
Hatteras Model Account = 6.67%

Halifax Model Account = 6.38 %
Mendocino Model Account = 7.9%

Your personal accounts results may vary from these reported results, even though our four main models are client portfolios that we manage, and from which we benchmark the trading and performance of many other client's accounts. None of the four models ever went negative during the first half, even during the May-June slide in global markets.

The bottom line is that we were pretty much spot on in reading economic and market events during the first half of 2006. For example inflation is high and the numbers our government and Fed use to measure inflation are a joke. That is a fact; not an opinion. GOLD ruled. Oil stayed above \$70 per barrel. The U.S. stock market went practically nowhere, and so on.

So let's switch our focus to the second half of the year and you can look at it as I do I, i.e., WHAT ARE WE GOING TO DO FOR A FOLLOW UP ACT!

The bottom line is that I am still as nervous as a cat on a greased roof. I don't like the U.S. debt, trade debt, consumer debt, and gross economic imbalances in the domestic economy any more than I did coming into this year. I think the economic rubber band is

getting wound tighter and tighter. But, so what I say; we have been worrying about those same things for years.

Reality is that we just might be in for a good third quarter of 2006 in the investment world. It just might turn out to be a cross over quarter in which the forces that we are worried about for the long term; and which make us bearish are washed over by the forces that are influencing the short term; and that allow us to have a little window of bullishness.

Despite all our misgivings about where the capital is coming from to keep our economy going, it is going.

So let's go through the investments quickly.

GOLD

Our first investment selection for 2006 was gold (GLD). Our premise for holding gold was, "The four year stealth bull market in gold will finally go public. It had to break over \$500 to get the public's and the media's attention. Our minimum target for gold is \$720 and it could approach \$1000 per oz. before this cycle is over. That could take another 2 to 4 years. Gold is not going up as a predictor of 'inflation'; it is going up as a defensive measure against a world flooded with paper money that is falling in value. January 2006 Report



Gold wound up getting to \$720 much faster than we ever anticipated (by May), and we wound up selling out at the equivalent of \$713 per oz., or \$71.30 for the GLD. We would not have anticipated doing that so soon, particularly when we had built up the allocation to gold (GLD) and/or GOLDX and UNWPX to 15 percent of portfolio values in several of our model portfolios.

In retrospect we are delighted that we took the profit when we did, but we are confronted with the age-old dilemma of trying to time our reentry into the gold market. Gold is once again showing surprising strength after such an unequivocal sell off.

Over the LONG TERM it will keep going up as a defensive measure against a world flooded with paper money that is falling in value. As of this writing we have started to build an allocation to gold in all four of our model portfolios. We allocated 2.5 percent of each model to the GLD on June 27, 2006.

We will continue to add to gold positions in the third quarter.

That brings us to the Dollar

We entered 2006 not sure whether the dollar would go up or down, or hold its own in the short term; even though we think the long term path for the dollar is downward. Because of our lack of conviction regarding short-term direction we sort of took the chicken way out in trying to hedge the portfolios in the event that the dollar did resume its slide in 2006.



We said in the January report, “If the dollar does start to move down significantly the holders of shares of OIBAX should benefit.” OIBAX stands for the Oppenheimer International Bond Fund. It is an unhedged international bond fund that should have seen its share price appreciate in the event that the dollar slid downward in value against a basket of foreign currencies. The dollar did slide in the first half of 2006, as you can see in the chart on the left, but the OIBAX did not go up as we had anticipated. Its very clear inverse relationship to the dollar completely broke down. It is simply not worth the time to get

into a lengthy explanation of why the anticipated result did not come about. Suffice it to say that we sold OIBAX out of all portfolios at either a break even or a minor loss.

The next time we want to hedge against the dollars decline we will be more definitive in our opinion and therefore much more direct in our tactics in order to get the desired result. We are bearish on the dollar and expect that the U.S. dollar index will retest its May-June lows near \$84. If it breaks that low we would expect to see \$80 as the next test.

We currently have no positions in currencies.

OIL and GAS (or as we have since written “oalngaz”)

We have acknowledged in previous newsletters that these two commodities are often referred to in one breath as if they are the same thing, as in “oalngaz”. This year their prices have taken distinctly different paths as oil continues to hover over \$70 per barrel while natural gas prices have plummeted from recent highs.

We believe that oil prices will hit \$80 before the end of the summer. Natural gas prices have dropped from \$15 per mcf to less than \$6 in the past year. We think the drop is about over and the longer term direction of gas prices is upward.

It is interesting that oil prices set new highs today (July 5), as I was writing this, and most oil stocks went down. That is a signal that investors do not believe these high oil prices will hold. We would respectfully disagree.

We are overweight oil and gas stocks in our four main model portfolios and intend to remain so.

Water

We are accumulating positions in the stocks of companies that supply water, or that make water drinkable. Long after the oil ‘crises’ has been solved. Long after Iran and Iraq join the community of nations the people on this planet will be looking for a clean glass of water.

We are accumulating water related companies as opportunities present themselves.

Emerging Market Stocks

For us “emerging markets” means China. There is no more “emerging market” than China. We entered 2006 with an overweight position in all four model portfolios through the Matthews China Fund.

We do not see the Chinese economy slowing significantly and we remain overweight China. We anticipate adding to this weighting on any significant pullback.

Developed Market Foreign Stocks

We entered 2006 with allocations in our various models that were established primarily through the use of high quality mutual funds. We remain invested through Tweedy Browne Global Value Fund and Capital World Growth & Income Fund.

Two of our models also contain allocations to ING and Diageo.

We maintain those positions and look to take additional positions in strong, competitive companies that are based in Europe.

U.S. Stocks

“We would be happy if the broad stock markets simply held their ground in 2006. We honestly can’t predict that they will go up. We think it could be another very long year for the U.S. stock markets.” That is another quote from the 2006 Annual Report. The major stock averages have made gains in 2006 although they have been modest. We stand by our original statement for the remainder of the year.

It is quite possible that U.S. stocks could have a good 3rd quarter, but finish the year about where they started the year.

U.S. Bonds

We have been net sellers of bonds during 2005 and 2006. You almost have to be in years when the Fed is raising interest rates. Portfolios managed by K&A, that owned bonds, have seen their durations shortened and the longest maturities are now about six years, with most bond holdings being much shorter than that.

When we say we have been “net-sellers” we were selling off the longer maturity bonds last year and into the early part of this year. There is no point in holding long maturity bonds when yields are rising.

We recently added a very large position in all four model portfolios. We purchased a block of a 7 month Federal Home Loan Bank Note paying 5.46%. This note makes up a 20 percent portfolio allocation in many of our managed accounts now. In other words, in seven months we will collect a risk free 5.46% interest on this note. Frankly we consider that a pretty decent rate of return in today’s environment—particularly risk free.

Foreign Bonds

We currently have no positions and do not anticipate adding any.

Cash

It was not long ago that Fidelity Cash Reserves, our default money market account, was earning less than .7 percent interest. Today its 7 day yield is 4.82 percent. We are content to earn 4.82 percent on a risk free basis on cash that is in reserve for other opportunities.

Those opportunities have to offer a lot more promise when cash is earning 4.82% than they did when it was earning 0.7 percent!

Paul Krsek
For K&A Asset Management, LLC
July 6, 2006

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*Paul Krsek
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