



E-llumination June 15, 2006

This report is an important update on the markets and our management style in relation to portfolio changes that have been taking place; including answers to questions regarding why we are doing so much trading.

One month ago most of the major U.S. stock averages were hovering at either all time highs, or 5-6 year highs. Gold was at a 21 year high. Precious and industrial metals were soaring. Gas and oil stocks were soaring. Foreign stocks were flying. How much has changed in one short month? The answer is A LOT!

As of today all of the following stock averages are DOWN for the year: the S&P Midcap 400, the S&P 500, the NASDAQ Composite, the Russell 2000 and the Philadelphia Gold and Silver, and the Dow Jones Utility Index. The Dow Jones Industrial Index is up nominally. Many emerging markets have absolutely collapsed. Dubai's stock market is down over 50 percent. "Mad Money" Jim Cramer's portfolio is DOWN 8.69% for the year. (June 15, 2006)

One month ago most of the portfolios we manage were up 6 to 10 percent for the year. Now they are up more like 2 to 4 percent. That is a lot better than being down. But we are not happy.

We have also been getting some very pointed questions about the amount of trading we are doing in the accounts and the costs related to those trades. We are grateful that people are asking. We also suspect that a lot of people are raising the same questions, but not asking and we have decided that it is important to provide all our clients with answers to these important questions.

The answer to why we have been doing so much trading is simple. We are trying to keep all four model portfolios in positive territory for the year, despite the big global sell off in almost all asset classes. All our clients are smart enough and sophisticated enough to know that we can't guarantee results, but our stated investment goal for the models is **"to provide positive investment returns over a 12 month period in almost any investment climate. We also state that our objective is "competitive total return with below average portfolio volatility"**.

If you have been following our newsletters and website, you know that our style of management has evolved significantly over the past 6 years. So have our stated goals. In years past we were targeting "relative performance". We used to characterize our goals this way, "if the market declines, we want our portfolios to decline less than the market". In other words if the S&P 500 was down 22 percent for the year and we were down 12 we were happy. That is no longer the case. We are managing to get you a positive rate of

return, regardless of what happens to the overall markets. I reiterate that we can't guarantee success, but we are doing everything we can to make that happen—including increasing the frequency of trading, using tighter stop/loss parameters, etc. For the past 5 years, so far, so good.

Our management style is also influenced by several themes that we have reiterated several times. But those of us at K&A and our clients need to be reminded of these themes periodically to provide context for the decisions that we are making. Some of those themes are as follows:

1. There is a commodity bull market, and we believe that it remains intact. However, global commodity markets are very small. They can be moved a lot by the big institutions, and hedge funds, and can become “unsafe” very quickly. Many commodities have risen in price too far and too fast, relative to actual supply-demand data. We are trying to maneuver around the “hot money” to keep our investors safe.
2. Energy prices, including gas and oil, are likely to remain high. The “oil patch” remains a viable long term investment arena. However, individual stocks, and sectors related to the energy arena can easily become distorted by the “hot money” and geopolitical tensions that have nothing to do with the actual supply and demand equations for oil and gas. Therefore we are the first to admit that there are probably distortions in the pricing of these commodities, and therefore distortions in the price of stocks related to oil and gas.
3. U.S. stocks are not cheap, and have never been cheap during the past 6 to 8 years. We have said many times, that despite all the big sell offs over the past decade, that domestic stock prices have never retreated to the valuations that normally mark the bottom of a bear market. If you believe that, and we do emphatically, then you anticipate that the “final” sell off is still ahead of us. That influences our behavior a lot.

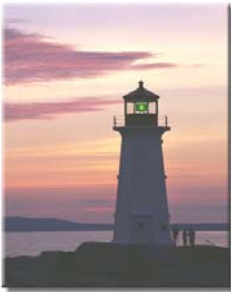
I want to make an important point about this issue. Given the behavior of the markets over the past several years, we have clearly been wrong in our opinion regarding U.S. stock market valuations. They have persistently remained higher than we have expected, particularly given all the imbalances in the U.S. and global economies.

That simply means that, after a couple of hundred years of market history, “things are different this time”; or it means that the rules of the market place still apply and will reassert themselves at a time that most people least expect. We are inclined to believe the latter. You, like us, need to make a decision on which you think is the more likely case.

We have also been asked if we earn any portion of the trading costs you have been experiencing. The answer is emphatically no. Those are costs of doing business with Fidelity and the trading costs are the only way that they make money in their relationship with us, and therefore you. There are no other “hidden costs”. Fidelity has no influence on us whatsoever in our choices to trade. Therefore they can't influence how much or little money they make from the relationship.

Remember that so far this year, all four model portfolios are in the PLUS column-after taking into account all trading costs and management fees. Most market indexes are not.

We can't tell you exactly where any of the markets are headed in the short term, but we can tell you that all our experience and analysis tells us that this correction is probably not totally played out. We are anticipating a "tradable bounce" across the board in domestic stocks, foreign stocks, commodities, etc. Then it is likely that we will experience at least one test the lows set two days ago. Should such a test occur it will give us a clearer picture of how each asset class and sector will behave over the intermediate term (the next several months). But whether or not it does, the markets will sort themselves out either by capitulation or consolidation over the next several days, or weeks.



We hope that this paper clarifies some issues and questions that have been raised. We value our relationship with you. We know you have many other choices of money managers. We know of people who have better results than us, and we know of many more with much worse results. But, we do not believe that any of them have the mission statement that we do; nor do we believe that many have the commitment to you that we do.

Mission Statement

To be the trusted primary investment manager for individuals, families and institutions who are seeking to use their financial resources to make their lives more meaningful and productive for themselves and their community.

K&A should be well known and highly regarded for its superior investment results and high level of commitment to its clients. Our clients should understand that we manage their money like it was our own and that we care for them like they were part of our family.

Vision Statement

We strive to exceed the expectations of our clients, enhance the value of assets they trust us to manage and be a valuable resource to the clients and communities we serve through contributions of our time and resources.

We are diligent about innovation and continuously strive to improve our investment performance and our level of service to our clients.

We are continuously striving to enhance our skills, the predictability of our investment choices, and investment options offered to our clients.

We are seeking to become an important money manager in the Bay Area through the proper allocation of time and resources to develop a significantly larger practice.

We want to continuously expand our profitability for the benefit of all of our shareholders.

Our Values

Our client's interests always come first. If we serve them well our own success will follow.

Our assets include our client relationships, our people, our capital and our reputations. The loss of any one of these may be difficult to replace-particularly our reputation.

Each of us is simply a custodian of a client relationship. Someone before us may have established the relationship, and someone after us may carry it on. Therefore we treat client relationships as if we are preserving them for generations to come.

We work best for our clients and ourselves when we work together. We value collegiality and teamwork.

Each of us has unique talents and can make unique contributions within the framework of overall teamwork.

Paul Krsek

For K&A Asset Management, LLC

June 15, 2006