



E-llumination May 21, 2006

Breathe in and breathe out, breathe in and breathe out

Don't you love it? Only when the markets fall do they call it volatility. When they are going up it is called upward momentum! Volatility works both ways you know. I like upside volatility when we are set up for it, and hate downside volatility when we aren't set up for it. This week we weren't set up for downside volatility—except in gold.

Rob, Nancy, Sharon, and Meghan know just how hard weeks like the last one are on me. When you are running models that are basically reliant on “upward momentum” you learn to hate “downside volatility”.

It is not a pretty sight to watch me during a week when almost half your gains for the year are wiped out in 5 trading days. Not only do the gains disappear but so can your confidence in our strategy. I am the first to admit that last week was rough for portfolio results, my tension level and my confidence level. But Friday ended in a way that makes me feel better; and our portfolio results so far this year are stellar when compared to the major stock and bond averages.

So, as Meghan has been trying to tell me, I shouldn't take weeks like this so hard. And, after sweating it all week long I remain comfortable that our basic investment thesis for 2006 is still intact. Nothing happened last week to change it. That is not true of our day to day tactics however. They have changed. Less than a month ago we had the lowest allocation to cash we have had in years. Today we have one of the highest. As the markets have been dropping we have been scaling out of positions in order to protect gains.

You have to remember that the stated goal of four of our most widely used models is to “provide positive investment returns over a 12 month period in almost any investment climate.” We also state that we hope to achieve “competitive total return with below average portfolio volatility”. Those goals are not consistent with sitting around and watching portfolio values erode, and hoping that they will come back up some day. They are more consistent with being active traders in volatile markets in order to try to hang onto gains. This alone is a topic that we could devote an entire newsletter to, and maybe we should.

We finished Friday with our four main models up as follows for 2006: PPGI=6.53%; PPGHI=6.24%; Halifax=6.7%; Peggy's Cove=4.6%. *These numbers are simple annual returns that are the actual performance of the four real accounts that we use as “model portfolios” for all other accounts managed in these styles.* We have probably never given that sufficient explanation to the models so I am going to try to explain so that you can

understand. I am also going to alert you to the fact that we are changing the names of three of the four models.

PPGI is the trading model for all suitable accounts that are tax deferred (IRA's, SEP-IRA's, etc.) and other accounts that do not accept the risk of short selling and that are in excess of \$240,000 in value. It's name is being changed to **Mendocino**.

PPHGI is the trading model for all suitable accounts that are taxable and that accept the risk of short selling and that are in excess of \$500,000 in value. Its name is being changed to **Hatteras**.

Halifax is the trading model for all suitable accounts that are tax deferred (IRA's, SEP-IRA's, etc.) and range in size from \$50,000-\$240,000. There is no short selling in **Halifax**.

Peggy's Cove is the trading model for all suitable accounts that are taxable and range in size from \$50-\$240,000. It's name is being changed to **Bonavista**.

K&A manages several accounts that fit into no models due to specific requirements of the accounts.

Accounts under \$50,000 are not "modeled". They are provided a solid asset allocation strategy through the use of several good mutual funds.

So, that is enough explanation of the models for now. Let's get down to the brass tacks of what the heck is going on in these markets so that we can anticipate what may be coming next and what we can do to make money. Let's take it one asset class at a time.

Gold and Precious Metals

Rarely does a money manager make a call as timely and accurate as our call on selling gold on the day of the top! Spot gold has now fallen from \$732.60 to \$655.80 in a week. The break below \$670.00 on Friday accelerated the decline and sets up the spot gold market for a higher probability that the current decline will continue for a while, maybe back to that 50 day MA we wrote about last week. But remember, we said that even as gold declines, and as the press shouts louder and louder that the commodity bull market is over—that is not likely to be the case. We think that we are seeing a severe correction in an ongoing bull market that remains intact. Frankly, the gold futures markets are telling a very different story from the spot or "cash" market.

May 2006 gold futures closed down \$22.00 today at \$656.00, which very closely tracks the spot or "cash" price for gold. But the June 2010 gold futures contract closed UP \$42.70 on Friday at \$858.50! In a nutshell that means that the futures market is betting that gold will hit \$858.50 by June 2010. So at least the overwhelmingly professional and sophisticated traders that are in that market have not given up on the long term prospects of gold—and neither have we. In fact Richard Russell, who writes the Dow Theory

Letters, said Friday night that the move from the low of approximately \$280 in gold to \$722 marks the end of the FIRST LEG UP in this new bull market in gold. We expect a lot of the speculative dollars that found their way into gold to be shaken out in this correction and we fully expect to be buying gold back after the correction is more complete.

This begs one simple question. Why did we sell? We answered that question already in our previous newsletter called, "The gold bug has landed" Gold got into fools territory. It went too far, too fast and we took some profit. Don't fire us for that!

Oil and Gas

They are two separate commodities but they are almost always referred to in one breath, as in "oalngaz". Well "oal" went down this week and "gaz" did too. In fact "gaz" has tanked for the last couple of months; falling from a high of over \$17 per mcf back to \$5.86 per mcf. All this caused us to get "stopped out" of several "oalngaz" related positions along the way. They include Devon Energy, Chesapeake Energy, and part of the XLE position. The truth is that I hate "stop/loss" orders. But they enforce discipline and take away a decision at a time when emotions are running high. They are predetermined points at which a stock will be automatically sold, therefore the name "stop/loss". They stop the losses. I hate them because they often execute and later the stock bounces right back up. I like them because they enforce the discipline and limit losses for our clients. They tend to dampen volatility and that is what they are supposed to do. You should like them!

So if "oalngaz" are going down now, what does the future hold? If you have crossed over to the "dark side" as I have, and are a believer in "peak oil theory" you are confident that the inevitable path of oil prices is upward. Others who breathe in and breathe out with much less effort and volume than I do are more sanguine about prices. So what do the master Jedi's of the futures market say? The futures market is discounting \$68 to \$72 oil for the remainder of this year; peak oil prices of \$75 by November 2007 and then back down to \$68 by November 2011. How accurate will that be? Who knows? But the same guys who are betting on \$858.50 gold by 2010 are betting on the price of oil being the same in 2011 as it is today. That is an interesting bet, in that while they aren't betting on oil hitting \$100 per barrel any time soon, they also aren't betting on it going down in price any time soon! I'd venture a guess here—get used to \$3.00 gas at the pump.

"Gaz" futures tell another interesting story. If the Jedi in the futures pits are correct we are currently seeing the lowest 'gaz' prices that we will see for the next five years. Prices are currently projected to rise back up to over \$9.95 per mcf by the end of this year, and to peak at almost \$12 per mcf in Jan 2008. So don't be surprised if we buy back Chesapeake in the very near future. It was frustrating to get stopped out of that one in the first place.

Industrial Metals and Uranium

You are only interested in this if you have accounts in the PPGI (**Mendocino**) or PPHGI (**Hatteras**) models. The bottom line is that we got stopped out of our two positions today. They are BHP Billiton (BHP) and Cameco (CCJ). We will probably say goodbye to BHP at this point and accept a small profit. We will buy CCJ back again at any appropriate opportunity. They mine uranium and the price of uranium should keep going up. It was frustrating to stop out of that one too.

On to Foreign Bond Funds and the U.S. Dollar

This one is of interest to everyone, as we had MFS Emerging Markets Bond Fund and Oppenheimer International Bond Fund in all four models. They have been liquidated and we will not be buying them back. They are good foreign bond funds, and offer a way to achieve steady, but modest total return. That is part of the reason we bought them in the first place. But our contacts at MFS and Oppenheimer expected them both to perform better in a falling dollar climate than they have during the past six months. That is the compelling reason we bought them back in 2005. Since November the U.S. dollar index has fallen from approximately 94 to approximately 84 last night. That is a 10.6 percent correction. We would have expected the bond funds to appreciate much more than they did during this 6 month period. We are extremely disappointed that they didn't.

The dollar has actually bounced a little in the past few days and we chose this time to exit the funds. The dollar is now approximately one-third of the way through a correction that we think will take it to new lows. We will be taking a more direct approach to capture that remaining two thirds of that move.

Finally on to the U.S. stock market

This next sentence is extremely important for you to understand, so here goes.

If we had any real faith in the U.S. stock markets we wouldn't have spent the time to write the previous three pages about everything else other than stocks.

We also wouldn't be spending the time focusing on all the other investments that we do. We would simply put all your money into U.S. stocks. There are two big problems with doing that though. The first and foremost reason is that we do not see ourselves as stock pickers. Don't get me wrong, we have made some pretty good picks in our time. But we see our jobs as trying to achieve the stated goals of our model styles. That involves more asset class selection than "stock picking".

The second big reason that we don't focus exclusively on U.S. stocks is that for the most part they have been in a bear market for seven years now. The DJIA was at 11,100 in

August of 1999. It is at 11,144 today. The S&P 500 was at 1275 in January of 1999. It is at 1267 today.

The Wilshire 5000 was at 12,842 in November of 1999. It is at 12,811 today. The NASDAQ composite index was at 2163 in December of 1998. It stands at 2193 today.

We have been through seven years of sector rotation in an ongoing bear market. Sorry folks; that is the way it is. And God bless Alan Greenspan. If the man hadn't had the guts to cut the Fed Funds rate to 1 percent this bear market in stocks would look much more convincing to a lot more people. He sheltered us from a much worse fate. But he may also have delayed the inevitable wash out that usually ends classic bear markets.

We know that some readers may think we are a little nuts in that we keep coming back to this theme. Particularly, after the fact that the last three years have looked and felt like a BULL market. (Just remember that we are no higher than we were seven years ago, and maybe you can appreciate our perspective.)

But I digress. Sure there have been plenty of ways to make money in the general stock market during the past 7 years, and we have found quite a few. But it is a hard job. It is just that simple. And for all the good he did, Mr. Greenspan has ably masked the truth about the U.S. stock market for five of those seven years.

In any event we maintain large positions in some very good mutual funds who have worked their way through this crazy market. We intend to continue doing so for the foreseeable future. They include the Hussman Strategic Growth Fund, Schwab Hedged Equity Fund, Excelsior Value and Restructuring Fund, and a few others in smaller accounts.

It would also be remiss not to acknowledge that small cap stocks have represented a "bull market" in the U.S. Today the average small cap index is up over 60 percent more than the major large cap U.S. indexes cited a few paragraphs before. However many signs are starting to point toward an end of that relative out-performance. For example the Russell 2000 index is already 8 percent below its high for the year, and looks poised to drop at least another 8-9 percent.

We have sold our last small cap fund holding, i.e., the Royce Opportunity Fund. It has been a very profitable holding for our clients. We are hoping that selling it now turns out like selling the gold last week.

A lot of technical damage has taken place in the past five trading days in commodities and stocks as well. It will take the markets a few days, or more, to sort things out and to confirm their near term directions. We will be watching and waiting to confirm the directions of the various market trends. OK. That is enough for today. There is more to tell, but no more time to tell it. Have a great weekend.

Paul Krsek
For K&A Asset Management, LLC

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Paul Krsek

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