E-llumination
September 30, 2006
No Runs, No Drips, No Errors

One of my favorite commercials dates back to the 1980's. It featured the legendary Cincinnati Red's catcher Johnny Bench sitting on a freshly painted park bench, promoting Rust-Oleum paints with the tag line, "*no runs, no drips, no errors*." The main message was that no one could expect to paint without runs, drips, and errors—and Rust-Oleum provided a heck of a surprise in that there were none.

I feel like we have just been through an experience like that related to our investment portfolios. Given all the conflicting forces at work in global economics and politics, I certainly was expecting some kind of "error" in the markets during August and September. In fact our August 27^{th} newsletter was called **The Coming Storm**. It featured a litany of bad things that have happened during this season over the past several years, and warned that we might expect a similar season in 2006. Here we are finishing September with the strongest market performance in the past nine years. Hey, we'll take it.

There were no major hurricanes, no major terrorist attacks, no more interest rate increases, oil and gas prices shot downward, bond yields fell and bond prices went up, global emerging markets broke down and then stabilized, the U.S. stock market stabilized-turned around-and went up. Consequently the 3^{rd} quarter of 2006 ends quietly and successfully for us, with *no runs, no drips, and no errors*!

How did the K&A portfolio models do during the 3^{rd} quarter?

All four of the major models that we manage are "balanced" or "multi-asset class". In other words they are a combination of stocks, bonds and cash. That fact alone means that they are never going to perform like "the S&P 500" or any other specific index. The bottom line is that all four were up for the quarter and are up nicely for the year. We feel like all four are accomplishing their stated goal of achieving "*competitive total return with below average portfolio volatility*"; and "*to provide positive investment returns over a 12 month period in almost any investment climate*". We point this out again, because we think we have done a commendable job of managing risk in the portfolios this year. As we end the 3^{rd} quarter with the stock market at multi-year highs, you may forget that in June and July the S&P 500, and other major U.S. stock averages, were underwater for the year and looking like they were about to drop into the abyss. None of our model portfolios ever were ever in negative territory at any time this year.

Simple annual returns (see note 1) for the year to date in 2006 are as follows for the four models:

Hatteras=8.4%	Mendocino=9.89%	Bonavista=5.6%	Halifax=7.95%

At this point it is important, for compliance reasons, to disclose that not all K&A clients are in a model portfolio. But even "the exception" portfolios are managed in similar fashion, attempting to achieve competitive rates of return with low volatility.

Accounts that are managed according to the models may experience rates of return that are different from the models due to various factors, particularly the timing of cash flows in and out of accounts. For example, a client who is taking a monthly withdrawal from their account may have a different return from someone who isn't because of the need to make cash available for distributions by selling assets.

Turning on a dime and giving nine cents change?

The third quarter was not without its challenges. Gold reversed direction in May, and continued its slide into the 3rd quarter. “Oalngaz” prices and “oalngaz” stock prices peaked and seemed to reverse “on a dime”. Many commodity prices collapsed. The real estate market turned downward in much of the country. On the other hand large cap domestic stocks, like those in the DJIA and the S&P 500 were down and out in June and July and approaching all time highs by the end of September.

Navigating the third quarter sometimes meant “turning on a dime”. The themes that worked in the first half of 2006 went south during the 3rd quarter. Themes that weren’t working in the first half emerged as the winners during August and September. The securities held in all four models look substantially different today than they did at the beginning of the year.

Most of the trading moves we made in the 3rd quarter could be considered tactical moves that support the risk adverse strategies that we employ in managing all our client’s accounts. We are not yet entirely convinced that the themes we believed in coming into 2006 have permanently changed. But cyclical or short term change in trends demanded that our tactics change. Our job is not to be dogmatic; it is to make money for our clients. That is what we did.

What do we see for the 4th quarter?

Forecasting can be a dubious art but it may surprise you, after reading the newsletters for the past several years, to know that we are actually optimistic about the 4th quarter. Later on I will list all the reasons that things could go wrong for the portfolios as they are currently constructed, but as we prepare of Q4 of 2006 we are feeling good about the prospects for all four of our major model portfolios.

We expect the following trends in Q4 of 2006:

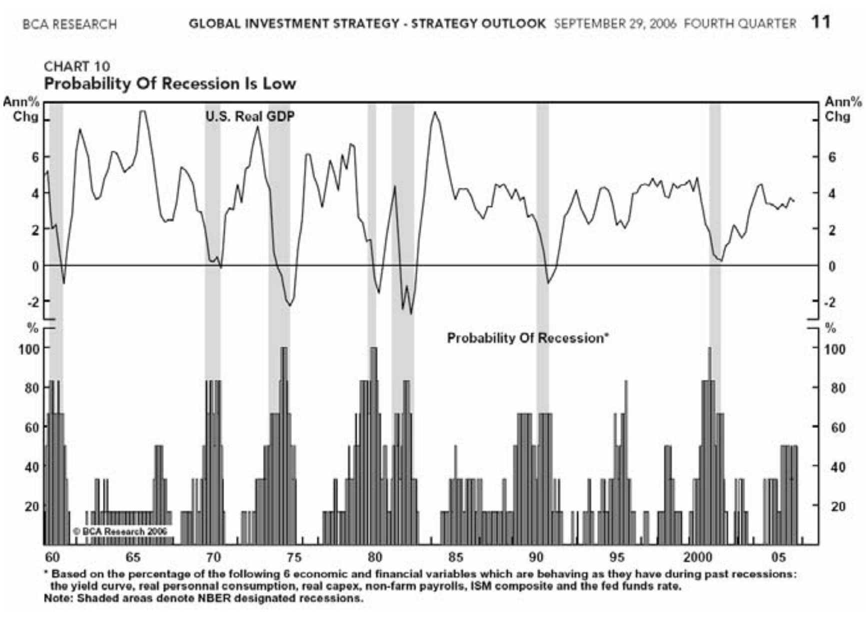
1. The dollar will remain steady, or may even strengthen against most foreign currencies as the global economy decelerates.
2. The Fed is done raising short term interest rates in the U.S. for the rest of 2006.
3. Longer term interest rates will hold steady or decline.
4. Mortgage rates will hold steady or decline. They hit 6-month lows last week.
5. Residential real estate will not collapse. While supply will decline, prices will not experience sharp declines in most markets. The exception is southern Florida which is in the early stages of a major real estate recession caused by dramatic over building.
6. The broad U.S. stock market may experience a correction in October but is likely to finish the year higher than it did on September 30.
7. Our optimism on stocks is based primarily on long term trends related to end of Fed tightening cycles, short term seasonality cycles and that we expect the chance of recession in 2007 will actually diminish during the Q4 of 2006.
8. Oil prices will not fall below the mid-$50’s, if they get that low. The short term trend is difficult to forecast. Longer term prices will rise.
9. Natural gas prices have either bottomed, or will bottom within the next few weeks. They will start to rise again into November and December.
10. Gold is a toss up. It currently sits at a level from which it could rise or breakdown. We are neutral on gold and not invested at the present time.
11. China and Asia will continue to do well, and their stock markets should advance.
12. We are negative on India. Other emerging markets do not play a significant role in our Q4 2006 strategy.
13. We are neutral on Europe.

Based on these assumptions we are likely to be doing several things to improve portfolio performance during Q4 of 2006.

1. We are preparing to sell the James Market Neutral Fund in the 2rd week of October, as soon as we come out of the “short term redemption fee” period.
2. We are likely to replace it with Capital World Growth and Income Fund or individual foreign stocks, as the case may be, thereby increasing exposure to foreign stocks.
3. We are likely to increase exposure to U.S. stocks and reduce cash (money market). We will favor large cap growth stocks, and select small cap stocks that we consider to be undervalued.
4. We will be closely monitoring ‘oalngaz’ looking to add back to oil and gas stock allocations once we are convinced that prices have actually bottomed out.
5. We are not likely to add to bond positions in existing accounts. We are likely to be a seller of bonds as we expect bond prices to peak in Q4 of 2006.
6. We will continue to monitor the price movement of the U.S. dollar index. At some point we do expect another leg down, but not this year.
7. We will continue to monitor the price of gold and other commodities. We are particularly looking to see if gold “decouples” from other commodities. In other words will gold rise again as other commodities continue their downward trend? If that does occur we will be a buyer of gold.

We will work tactically to try to build on the returns that we have generated so far this year in all the model portfolios and client accounts.

What is in store for 2007?



It is too early to start forecasting for 2007. But we did want to tell you that we currently rate the probability of recession to be less than 50/50. We expect that chances of recession to actually recede as we work our way through a corrective process in the U.S. economy during Q4 of 2006.

Certainly U.S. GDP growth is slowing down. We have already seen that fact manifest itself in the downward revision of last’s quarters GDP data. We think the most likely case is that the rate of growth may decelerate a little more, but we are not currently in the camp that recession is “likely”. We are monitoring the situation closely from various data points. Check out this chart from our key independent macroeconomic research service. While the title of the chart is “**Probability of Recession is Low**” you can see for yourself, in the lower half of the chart that the current odds appear to be approximately 50/50. Please bear in mind that this isn’t a random chart. It is based on numerous statistical indicators that are time tested by BCA.

We have something new coming in 2007

We did want to alert you to the fact that we have been “incubating” another portfolio model during the first three quarters of 2006. It will become available to existing clients in the first quarter of 2007. It will be available to existing clients who have account values in excess of $100,000. For new clients the minimum account size will be $250,000. There is no top size limit. The model can scale up to any dollar amount.

It has significant differences in style from the four main models that we currently offer including Hatteras, Mendocino, Bonavista and Halifax.

All four of these models are quite defensive in nature and reflect our continuing caution about the great imbalances that we continue to monitor and worry about in the domestic and global economic and geopolitical environment. Our models and cautious style grew out of the many excesses that have dominated the first decade of the 21st century.

For example, we have not lost our concern about the massive debt load both the public and private sector bear in the USA. We have not stopped worrying about the U.S. current account and trade deficits. We have not stopped worrying about lost jobs and overseas competition and the dramatic decline of the American middle class.

We have not stopped worrying about the long term decline of the purchasing power of the U.S. dollar. We have not stopped worrying about $100 per barrel oil. We have not stopped worrying about overvalued sectors of financial markets. We have not stopped worrying about another 9/11. All of these things have kept our management style defensive in nature; and we are happy with the results we have produced for our clients, given our defensive nature. We are particularly pleased with the competitive rates of return we have produced that are coupled with low volatility.

But we remind ourselves that not everyone shares our point of view. Therefore, it might be appropriate to offer a portfolio style that is not so defensive in nature. The new model, to become available on January 1, 2007 is named the “Fresnel Model”, after the “Fresnel” lens in most lighthouses. The Fresnel is the lens that concentrates and focuses the light and sends it out in that brilliant straight and bright beam that emanates from all lighthouses.

The new model is focused as well. So far that focus has paid off. The simple annual return that we have generated from January 1, 2006 through September 30, 2006 is 18.71%. (Refer to note 1 at the end of this newsletter) That is approaching twice the return of Mendocino year to date.

The Fresnel model has taken fewer positions that are more concentrated than those that are in Hatteras or Mendocino. It features individual stocks in addition to the ETF’s and mutual funds that are in Bonavista and Halifax.

Fewer positions that are more concentrated usually tend to mean one of two things. When you are right about the positions, you make much more money. When you are wrong, you risk losing much more money, or certainly losing it faster. To mitigate the latter risk we are using a pretty tight stop loss policy. We are tolerating no more than 9 percent downside on individual positions.

The positions that are taking in Fresnel come right from the same list as those we buy for the other four models. There is nothing in Fresnel that you can’t find in the others, with one exception that will be explained in a minute. Positions are simply more concentrated and therefore there are fewer positions. That means that not all the positions we buy for the others will ever appear in Fresnel. But Fresnel can’t buy something that isn’t in the others.

When we started Fresnel we were not sure that we were going to enforce the discipline of “buying from the same menu” as the other models. There was one purchase in Fresnel that is a microcap stock that is not in the other portfolios. That position is currently being closed out at a loss. There will be no more deviations from the menu of securities that are available for the other models. That is the policy. In fact, if that position had not been taken, and the money left in money market, the performance for the model would be 20.11% year to date.

Bear in mind, the issue is not whether there was a loss or a gain on the position. The real point is the Fresnel is permanently confined to the same buying universe as the other four models. For a security to be in Fresnel is must first be in at least one of the other four models.

We intend to make the Fresnel model available to clients effective January 1, 2007. We will position it as our 5th main model and one that we hope may produce higher returns over long periods of time than the other four are likely to do. But it is also likely to experience **much** higher volatility than the others. That is important to keep in mind. It will be run as an absolute return model, like the others, which given its highly concentrated positions may mean that trading could be very brisk at times when we are being defensive.

For those who have the point of view that the world is a much safer place than we believe it is, or who are willing to take more risk with their money, Fresnel is a viable option.

We must also disclose that Fresnel was "incubated" by using a personal account of Paul Krsek. Remember that part of our mission statement says that "*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".* That doesn't mean that we experiment with YOUR money. We experiment with OUR money, if we experiment at all. Call it the Dive Master in me, but we don't take anyone into waters we aren't familiar with ourselves, and we never let anyone dive (invest) above their skill and risk level. Being nervous or afraid is not good in diving or investing!

Many Thanks

We have said it before and we will say it again many times. Thank you for being a client of K&A. We are looking forward to working with you in the fourth and final quarter of 2006.

Paul Krsek
For K&A Asset Management, LLC
September 30, 2006

Note 1: We use simple annual return in this report because it is easily calculated by hand and can be done in a timely fashion to get out the report. Clients should rely on the Time Weighted Return (TWR) calculation in your personal performance report. TWR is a complex mathematical calculation that strips out the influence of any cash flows caused by the client and therefore accurately reports the results of management's efforts. The model accounts that we use to calculate the simple annual returns reported here have experienced no inflows or outflows of cash during 2006.

Disclosure and Disclaimer (updated 05/24/2006):

E-llumination is the proprietary newsletter written for clients, friends, and affiliates of K&A Asset Management, LLC (K&A). Until January 6, 2006 K&A published a second newsletter called Illumination. That format has been discontinued. Henceforth K&A will publish all newsletters under the name E-llumination.

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The investment portfolio models or management services mentioned in E-llumination may or may not be available in some states, and they may not be suitable for all types of investors.

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 polices 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.

The investment objectives of various accounts and models may be substantially different from one another. Therefore topics or investments mentioned in E-llumination may or may not apply to specific managed accounts and/or models.

Trades or adjustments to accounts mentioned in E-llumination may or may not happen in every account managed by portfolio managers at K&A.

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.

The assets held in managed accounts at K&A Asset Management, LLC may include stocks, bonds, cash, commodities, foreign exchange or mutual funds, money market accounts or limited partnerships that represent the same. They are subject to market fluctuation and the potential for losses. The assets are not insured. The value and income produced by these investment products may fluctuate, so that an investor may get back less than they initially invested.

The portfolio managers at K&A Asset Management, LLC do not guarantee results.

Past performance should not be considered an indicator of potential future performance. If you do not consider yourself suitable, either emotionally or financially, to experience volatility and/or losses in financial markets, you should not invest.

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Sincerely,

Paul Krsek
Updated: May 24, 2006