



“Illumination”

The Annual Report to Advisory Clients which Sheds light on the Major Trends that can make you money in 2006

Part II

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So how do we make money in 2006?

Start by owning commodities; gold first!

We suspect that the road to success in 2006 will be somewhat similar to 2005. We are finishing 2005 with a heavier than normal allocation to commodity related investments through precious metals; gold and precious metals mutual funds; oil and gas; timber; water and water resources; and other commodities owned through a diversified commodity mutual fund.

Two of our model portfolios are approximately 25-30 percent allocated to the combination of these assets that we describe as “real and scarce”.

What gold has in common with other precious metals, oil and gas, and many other commodities including timber and water resources is really quite simple. They are all in scarce supply and very difficult to replace. Another similarity is that demand for all of them is increasing. By now everyone has heard the stories of the economic growth that is taking place in China, India and other developing nations. Well those stories are true. Simply stated, the world is spawning hundreds of millions of new middle class consumers throughout Asia and other parts of the developing world. They are consumers of all of these “real and scarce” assets. Demand is leading supply and that means one thing—rising prices.

We will qualify that statement with the one qualification we always offer. Prices never go straight up. As we finish drafting this report in January the price of gold, for example, has

spurred upward and way past our expectations for this point in time. Gold could easily retreat from its current price near \$555 per ounce, all the way back to \$515.00 and still remain within its current upward, or bullish, zigzag trend line. We firmly believe that any pull back in gold will be an excellent buying opportunity. We will use that opportunity to add to current allocations.

Our minimum target for gold is \$720 per oz. and we believe it could reach \$1000.00 per oz. Our long term target for oil is at least \$80 per barrel. Our long term target for gas is at least \$18 per mcf. We have no long term price target for water. We only know that it is going to get more and more expensive around the world. The same is true for other natural resources like timber.

As we started drafting this report in early December the talking heads on CNBC and elsewhere are discounting the current rally in gold. It is now late January and they are still skeptical of the rally in commodities and seem to be convinced that the prices of oil and gas have peaked out. They might be right and we might be wrong.

However, we offer the following comments for your consideration:

Regarding GOLD...

At the time this report is being drafted we are long: Streettracks Gold Share Trust (GLD), Gabelli Gold Fund (GOLDX) and U.S. Global Investors World Precious Minerals Fund (UNWPX)

“The rally in gold has been explosive with the metal doubling to over \$500/ounce since bottoming in 2001. The gold market has become extremely overbought and due for a sharp pullback. However, any correction should be used as an opportunity to increase positions. From a long-term point of view, there is potential for gold to double again from its current level, taking prices to \$1000/ounce at some point in the next few years.” Bank Credit Analyst, Global Investment Strategy, December 9, 2005

“Inflation risks and the steady increase in equity risk bolster our case that gold and gold equities will perform over the next 12 months. We observe that the equity risk premium suggests that investors are factoring greater risk into equity markets; this has historically been supportive of gold.” UBS Global Equity Research, December 1, 2005

First, we believe equity markets are less likely to offer as much competition for investment demand as they did in the late 1990s, when double-digit annual rates of return were the norm. While the stock market may have a positive return in 2005, we think financial asset returns in general will be less rewarding than during the 1990s.

We believe erratic financial market returns will boost demand for gold and gold stocks.

Second, we see higher commodity prices in 2005 and 2006, reflecting consolidation in commodity-producing industries and continued global economic growth. The Commodity Research Bureau (CRB) Commodity Price Index rose 23% in 2002, 8.9% in 2003, and 11.2% in 2004. Through October 14, 2005, the CRB Index was up 15.4% year to date.

Third, we believe the gap between production and consumption of gold should widen as output stagnates and physical demand rises. We believe the low level of gold prices in the late 1990s led to sharply reduced exploration, which we think will result in flat to lower production even if the metal price rises dramatically.

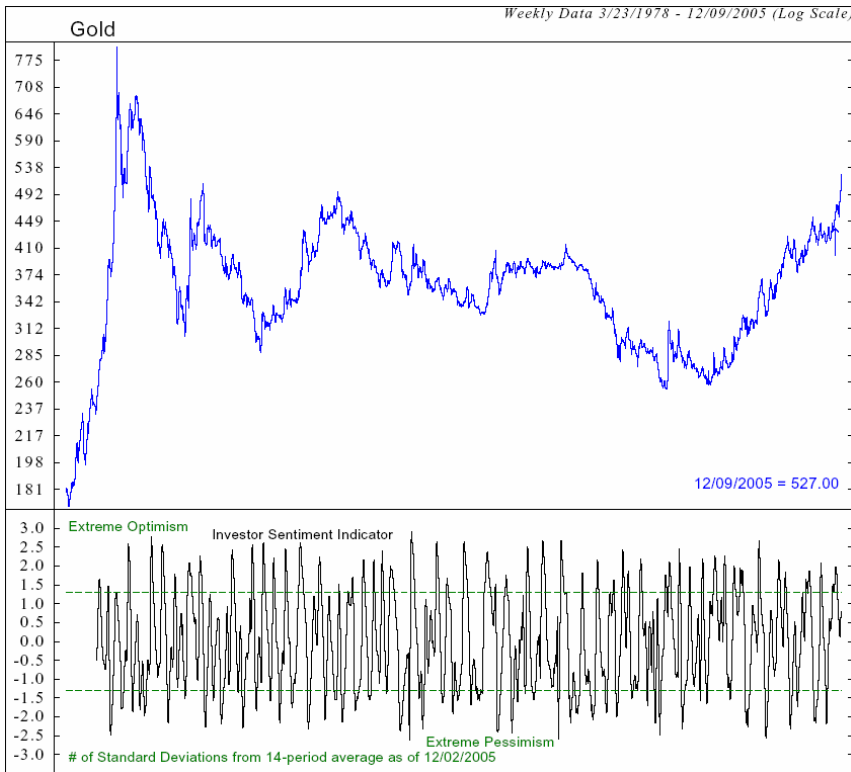
Fourth, we believe that a cyclical decline in the U.S. dollar that began in mid-2001 will resume some time in early 2006. Also, greater volatility of currencies in general will likely increase the demand for gold.

*Finally, the industry has undergone major consolidation, and the trend appears to remain viable in the wake of the Barrick-Placer news. Barrick acquired Homestake Mining in 2001, and Newmont Mining acquired Australia's Normandy Mining in early 2002. Mergers should, in our view, result in larger market capitalizations and more trading liquidity in the stocks. We believe this will make the group more attractive to institutional investors. **Standard and Poor's Industry in Focus, November 2, 2005***

What we like about these comments from three different research reports is that none of these firms would be typically associated with the term “gold bug”. Bank Credit Analyst, UBS, and Standard and Poor’s are not exactly known for being newsletters extolling the virtues of gold.

Why did we use so much space in the context of this report to support our theory of \$1000 gold? Hey, no one believes us—and they won’t until we get there. But we wanted you to know what is going on.

That is one thing we like about the current gold rally. It has been a “stealth rally”. The public has not bought in to it at all. In our experience rallies run until the last fool has bought. We suspect that is a long way off yet in the case of gold.

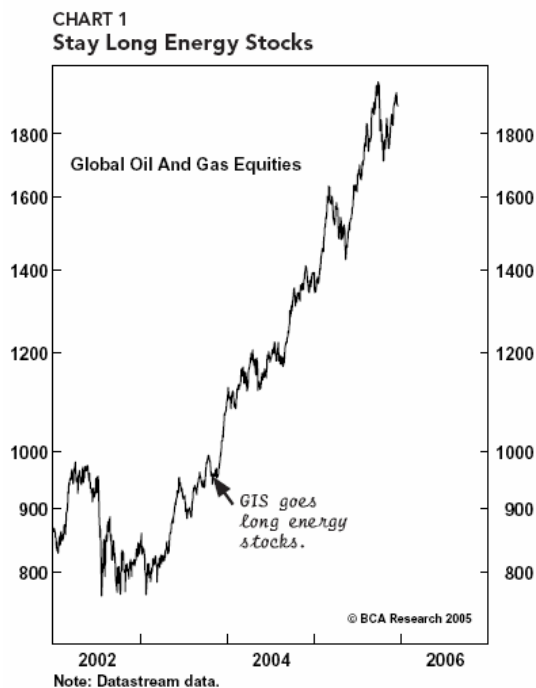


The chart at the left, from Ned Davis Research, is a picture of the path of Gold from 1978 to the present. Note that gold still has a long way to run to reach its old highs (every dog has its day). Also note in the Investor Sentiment Indicator at the bottom that we have not yet reached the “extreme optimism” that normally marks tops of markets. We believe that we have a ways to go!

Regarding Oil and Gas...

At the time we are drafting this report we are long ConocoPhillips (COP), Canadian Oils Sands Trust (COSWF.PK); Kinder Morgan Partners (KMP); and the Energy Select SPDR(XLE), Encana (ECA), and Chesapeake Energy (CHK)

The following report was originally written in June 2005. It still applies today when considering the energy markets.



More than once lately we have commented that if we really knew what was going to happen to the price of oil, we could place all our chips on one bet—oil up or down. There really wouldn't be much need to do much else. But so far it has never been that easy. I have personally been following the goings-on in the oil patch since 1984 and it has never been easy to decipher the truth about oil supplies, and therefore future pricing.

Besides oil has always been the stuff of politics, embargos and wars as well. That

has added all the more intrigue and guess work to solving the puzzle.

Lately oil prices have been going pretty much one way—UP! Given the news lately it is easy to think that they will just keep going up. But that never really happens. If the price of oil is going to continue to rise it will do so in the same zigzag manner that all stock and commodity prices rise or fall. But after more than 21 years of reading; 21 years of oil related politics; 21 years of bluffing by OPEC; 21 years of wars; and 21 years of guesswork; something is finally becoming clear to me. The world has just about squandered away the chance to bring prices back down substantially.

The chart above is from Bank Credit Analyst's forecast for first quarter of 2006, advising their clients to "stay long" energy stocks.

The truth seems to be that we are pumping about all we've got, all around the planet. Believe it or not production in the USA has been declining since 1970. We'd bet you didn't know that.

Even if we aren't pumping all we've got; we certainly are refining about all we can. Anyone recall any new refineries being built lately? You bet you can't. The last one built in the U.S. was back in 1976. The truth is we've actually closed up a bunch since then, and we have approximately 60 percent of the refining capacity in this country that we had 20 years ago.

Don't get me wrong. I am not setting you up to make the case that oil prices are going straight up. There is a lot of speculation, and possibly some fear, built into the current pricing structure of oil. It is still possible that we could see prices back down in the \$40's before we see \$80. But I've got a distinct feeling that we will see \$80, and possibly higher. Earlier this year one lonely analyst at Goldman-Sachs speculated that oil could be priced at \$100 per barrel by the end of the year. Most other Wall Street mavens laughed and ridiculed him. I suspect those smiles are a little tighter on people's faces right now. Let me get down to explaining the problem and why I am more and more concerned that prices will zigzag their way up, and not down.

It seems that we use about 84 million barrels of oil per day throughout the world right now. Approximately 21 to 22 million are used right here in the good ole USA. The good news seems to be that if we continue to use oil at that pace, by everybody's best reckoning, we probably have a 40 year supply of oil left on the planet. The bad news is that is probably a lie! The worse news is that doesn't help to have a 40 year supply of something that you can't deliver today-when it is needed. It isn't a matter of how much we've got left. It is a matter of how much can be delivered to the market place each and every day—refined that is! You remember that little relationship of supply vs. demand don't you—and what happens if one gets out of balance with the other?

Now I want to qualify everything else I am about to say here by disclaiming that figures lie and liars figure; and if I have ever known a good bunch of liars they were oil men.

But here are some figures to ponder. The U.S. Department of Energy has recently reported that by the end of 2005 the total supply of oil available to the U.S. will be 700,000 barrels short of projected demand at that time. If that turns out to be true, that's a problem.

Now, lest you haven't been paying attention, there is another little country which has gotten pretty thirsty for oil. Have you ever heard of China? They are the folks who just came knocking at our door and offered \$18.5 billion to buy Unocal. I gotta hand it to them. That's a pretty gutsy move; and a very wise one too. The fact is that China's three largest oil companies are aggressively buying up reserves all over the world. After all they got all that money selling things to us at Wal-Mart and Nordstrom's for that matter. Have you checked the label in your Tommy Bahama shirts lately?

In case you have not been paying attention, let me update you on a few facts about China. Theirs is the world's fastest growing economy. It grows at a pace of 8 to 9 percent per year every year—for the past 20 years. That is double to triple our rate of growth—and our economy grows faster than anybody else—except China.

Some are forecasting that China's need for oil will grow to match ours in the next 20 years. Without getting into all the gory details, all that "some" are doing to come up with that number is reflecting back on the rising rate of oil consumption in the U.S. and Europe as we industrialized in the first half of the 20th century and applying similar growth rates to the Chinese economy. The only difference is that their economy is growing much faster than the U.S. or Europe ever did back then. So much for accurate forecasting methods!

Now if you haven't linked the two contradictory premises that you just read about, let me do it for you. Six paragraphs above this one (not counting this one) I mentioned that "if we continue to use oil at {the present} pace, by everybody's best reckoning, we probably have a 40 year supply of oil left". In the paragraph above this one I mention that "China's need for oil will grow to match ours in the next 20 years." It is at this point in the story that I feel like I am watching Sesame Street and I have just heard the question "which of these things don't go together?"

But wait, there's more! I forgot to tell you how different the current demand for oil is in China vs. the USA. We currently use about 21 to 22 million barrels per day. They use 5-6 million barrels per day. That is a big disparity, and the forecast is that they will grow to match our demand.

But wait, there's still more! Do you think that demand in the USA will be static for the next 20 years? Umm, let me count some fingers here. It is estimated that our economy will grow 2 to 3 percent per annum (give or take a recession or two), and our population will grow by 100,000,000, mostly through immigration. So even by counting my fingers I can surmise that the USA could be consuming much more oil 20 years from now than we are today—actually about 38 million barrels per day at present growth rates.

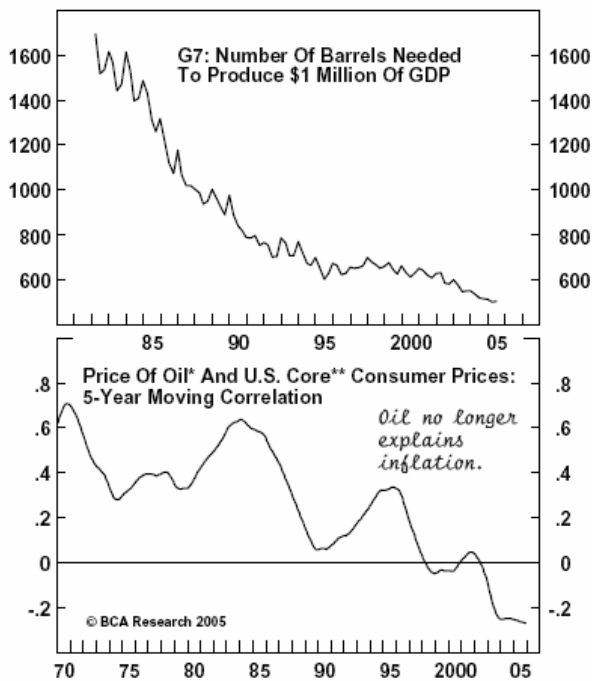
But wait, if you act now—by continuing to read—we will deliver the punch line. China’s demand is not expected to grow to match our demand figures today. Their needs are expected to match ours 20 years from now, inflated by our own growth rates—because they are simply growing so much faster than we are. So it is possible that both countries will be consuming approximately 38 million barrels per day in 20 years. Where is all that oil going to come from? I don’t know about you but I am almost exhausted just thinking about it. Whoops, did I forget to mention India and Brazil? Got a few minutes? We can forecast their growing demand too. No, just kidding. I think you get the point. Maybe I am a little slow. After all it has only taken me 21 years to think that I have spotted a trend, but let’s make this guess together. You finish the next sentence. The price of oil is going _____ from here!

Epilogue:

Yea, yea I know we are still exploring for more oil! Anyone seen a major new discovery since 1986? (The answer is no!) That is not a trick question. Anyone seen a new refinery lately?

Yea, yea I know there are plenty of sources of alternative fuel. Seen any nuclear power plants built in the USA lately? Natural gas—well its price has only quintupled in the past 20 years. Coal—burns a little dirty don’t you think? Sure they are cleaning it up, and the price is going up, as it gets cleaner. Love to own some, it will probably be a good investment, right along with oil. Besides, I think I read somewhere that between us and the Chinese we have a 400 year supply. That is more than I am going to need. There is too much coal, but it can make a solid diversification investment as the prices of oil and gas keep rising.

CHART 7
Declining Impact Of Oil



* West Texas Intermediate.
** Excluding food and energy.
Note: moving correlation is shown smoothed.

Sure there are fuel cells; but has anybody got one that is efficient enough to replace fossil fuels right now or next year? Hydrogen? Oops, it takes fossil fuels, and lots of them, to make the Hydrogen. Imagine that. Solar power—sorry it accounts for less than 2 percent of our supply of energy. Wind, even less. Probably one to two percent of our energy supply.

The truth is folks that we have squandered years during which we could have been developing alternative energy supplies. But it has never seemed necessary because we have always allowed ourselves to believe that we’d have plenty of cheap oil.

I've got a feeling that is really about to change. It just might be time to actually buy some wind turbines.

The good news is that expensive oil doesn't impact GDP growth or inflation in this country as much as it used to. Check out the chart above from Bank Credit Analyst.

Regarding Water and Water Resources...

At the time we are drafting this report we are long Suez, Inc. (SZE), Aqua America (WTR) and Power Shares Water Resource ETF (PHO), and General Electric (GE)

Go ahead and "Google" "global water crisis"; or "the coming water crisis"; or "will we have enough water". The hair on the back of your neck will stand up when you see the number of search responses that appear. Start reading them. It only gets worse.

Here is one paragraph that is one example of what you will find: "More than one billion people lack access to a safe supply of drink water. Water related diseases are the leading cause of death in the world. This killer takes the lives of more than 14,000 people each day and is responsible for 80% of all sickness in the world. Compounding the problem is the fact that more than 50 percent of the water supply projects in the developing world fail."

Do you think gold is precious? Do you think "light crude oil" is in short supply? Think again. They are readily available when compared to simple clean drinking water. More than 14,000 people die each and every day on this planet because they don't have clean water to drink. That is 5,110,000 per year. We didn't make that up. On a planet of 6.8 billion people that is a rounding error, except its not. You could fight the Vietnam War for 91 years to kill that many people. You could play bumper cars on American highways for years to cause that many deaths. People die because they can't get a clean glass of water.

We could write a 20 page report on this single theme alone. But we won't. Instead we are investing in the private companies that are bringing hope to this situation and the water utilities that control huge amounts of water. The demand for technology to make clean water is growing exponentially. Those who own clean water will be commanding higher and higher prices for it.

Presently, 1.1 billion people lack access to improved water supply and 2.4 billion to improved sanitation. Unless action is stepped up, the number of people who lack access to improved water supply could increase to 2.3 billion by 2025.

Of all water on earth, 97.5% is salt water, and of the remaining 2.5% fresh water, some 70% is frozen in the polar icecaps. The other 30% is mostly present as soil moisture or lies in underground aquifers. In the end, less than 1% of the world's fresh water (or about

0.007% of all water on earth) is readily accessible for direct human uses. It is found in lakes, rivers, reservoirs and in underground sources shallow enough to be tapped at affordable cost.

If all the earth's water fit in a gallon jug, available fresh water would equal just over a tablespoon.

A person can live about a month without food, but only about a week without water.

A person needs 4 to 5 gallons of water per day to survive.

The average American individual uses 100 to 176 gallons of water at home each day.

The average African family uses about 5 gallons of water each day.

More than 200 million hours are spent each day by women and female children to collect water from distant, often polluted sources.

Approximately 60 to 70% of the rural population in the developing world has neither access to a safe and convenient source of water or a satisfactory means of waste disposal.

Water systems fail at a rate of 50% or higher.

According to the UN, 20% of the world's population in 30 countries faces water shortages.

This number is expected to rise to 30% of the world's population in 50 countries in 2025.

Some of the world's largest cities, including Beijing, Buenos Aires, Dhaka, Lima, and Mexico City, depend heavily on groundwater for their water supply. It is unlikely that dependence on aquifers, which take many years to recharge, will be sustainable.

Poor people in the developing world pay on average 12 times more per liter of water than fellow citizens connected to municipal systems; these poverty-stricken people use less water, much of which is dirty and contaminated.

Every \$1 invested in children, including money to improve access to clean water and sanitation, saved \$7 in the cost of long-term public services.

Today the headlines are about oil and gas. One day soon they will be about water, and our clients will be owners of the water supply and the technologies to increase that supply.

A real cynic might be asking so what? An investor might be asking what the catalysts to change all this are; and how to make money from these circumstances. Let me tell you the answer. When people who have money don't have water to drink things start to

change. Think China, India, and the Middle East. Hey, think America for that matter. If you think we are immune to the problem—think again.

And what of trees and other “commodities”?

At the time we draft this report we are long Rayonier Timber (RYN) and Plum Creek Timber (PCL) and the Pimco Commodity Real Return Fund (PCRDY)

We like owning trees. It is not that we are “tree huggers”. I don’t suppose we are. But there is nothing more comforting in an investment portfolio than owning shares of Plum Creek Timber (PCL) which owns 7.8 million acres of trees; and Rayonier Timber (RYN) which owns another 2.2 million acres. Much of the rest of the world is cutting down their forests. In the U.S. and Canada we are trying to do a decent job of managing the resource—and therefore selling timber and paper products to the rest of the world. Not a bad way to go. Besides we get dividends equal to 4.00 percent from PCL and 4.5 percent from RYN; and we have enjoyed significant appreciation in the stocks over the years. We have enjoyed an average annual appreciation of 5.46 percent in PCL since 2002. Couple 5.46 appreciation with a 4.000 dividend and a 9.46 annualized total return isn’t bad from a bunch of very quite trees. We didn’t buy Rayonier until this year, but we are up over 25 percent on our first purchase.

Finally we own Pimco’s Commodity Real Return Fund (PCRDY in all eligible accounts managed by K&A. The truth is that we can figure out gold, oil and gas, water and even trees, but we are not about to take on the cash and futures contracts of all 19 commodities traded in the Dow Jones AIG Commodity Index. We leave that to Pimco.

Going into each year we usually seem to have a favorite theme. This year it has to be the continuing demand for scarce commodities and therefore the probability that all their prices will keep rising.

But more than once we have gotten to the middle of a year and found that things have changed. So while we currently feel very strongly about this concentration of investments we are not betting the farm on it.

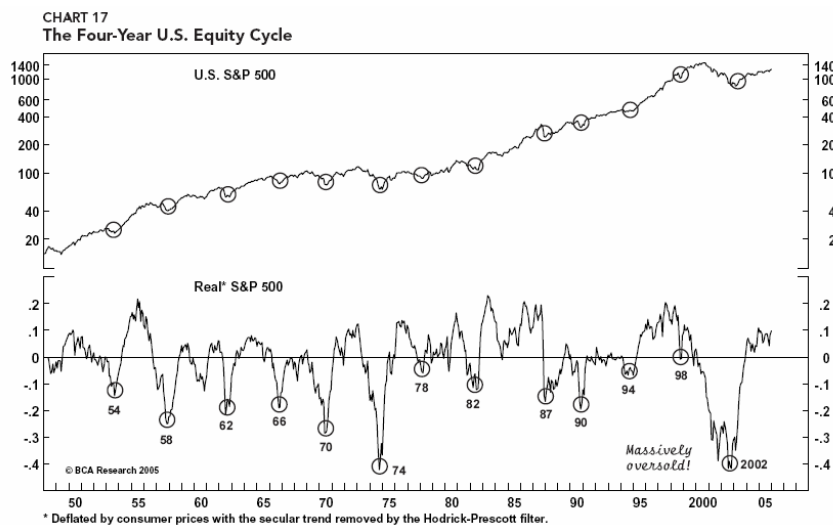
How else will we make money in 2006?

K&A invests in the broader equity markets through the use of individual stocks, exchange traded funds (ETF) and mutual funds. In suitable portfolios we will purchase equities (go long) or short equities (sell short). As we close out 2005 we are not currently short any individual equity or ETF positions.

We are “skeptically” and mildly bullish on U.S. equities for at least the first half of the year. Our skepticism puts us in the minority camp again, just as we were in 2005.

This year **Business Week** published its annual survey of “investment gurus”. Their conclusion, “*stocks are likely to deliver greater gains in 2006 than they did this year, according to the 76 strategists we polled. The gurus foresee a 7.2% gain for the Dow Jones industrial average in 2006, with the S&P 500 rising 7%, and the NASDAQ Composite gaining 7.6%. The technology sector is our prognosticators' overwhelming favorite for 2006.*”

The U.S. economy does seem to have good momentum despite all the excesses that are pulling at it. Stocks seem well positioned for at least modest advances from here. However, the Bank Credit Analyst chart below depicts the “four year U.S. equity cycle”. While this cycle has never worked perfectly, it has been a reasonably reliable pattern. If it repeats itself, stocks will be taking a breather in late 2006 or early 2007.



Our participation in domestic and foreign stock markets has evolved over the years. We now tend to make the majority of these investments through the use of mutual funds. That is for a very simple reason. We find that there are a few select mutual fund

managers who manage in the style we like; so why try to “best” them at their own game. Most of the funds we buy tend to provide market beating returns with lower volatility than the market, or their peer funds. **Competitive returns with lower than normal volatility is among our stated investment goals.**

Here is a performance table that includes all the equity and balanced funds we are currently using to represent broad market participation; and that are currently open to new investors.

Fund Name	1999	2000	2001	2002	2003	2004	2005(1)	Cumulative
Scwhab Hedged Equity Fund	na	na	na	na	22.87	17.44	7.68	47.99
Balanced Fund of America	3.47	15.86	8.19	-6.29	22.79	8.88	2.81	55.71
Hussman Strategic Growth Fund	na	na	14.67	14.02	21.08	5.16	4.95	59.88
FBR Gas Utility Index Fund	-3.71	55.86	-14.78	-23.93	23.49	23.01	11.19	71.13
Artisan Midcap Value Fund	na	na	na	-3.87	36.83	26.20	14.23	73.39
Tweedy Browne Global Value Fund	25.28	12.39	-4.67	-12.14	24.93	20.01	12.20	78.00
Capital World Growth & Income	27.30	1.38	-4.96	-7.27	39.05	19.32	10.67	85.49

ICON Healthcare Fund	3.80	43.03	-3.17	-9.22	31.14	17.93	12.73	96.24
Excelsior Value and Restructuring Fund	41.98	7.21	-4.96	-23.32	47.78	19.36	8.47	96.52
Fidelity Select Medical Equipment Fund	10.72	50.37	0.32	-6.24	33.36	17.48	7.01	113.02
Matthews China Fund	47.11	-6.69	20.91	-7.52	65.00	3.88	4.28	126.97
Royce Opportunity Fund	32.34	19.85	17.32	-17.01	72.87	17.51	3.76	146.64

(1) through November 30, 2005

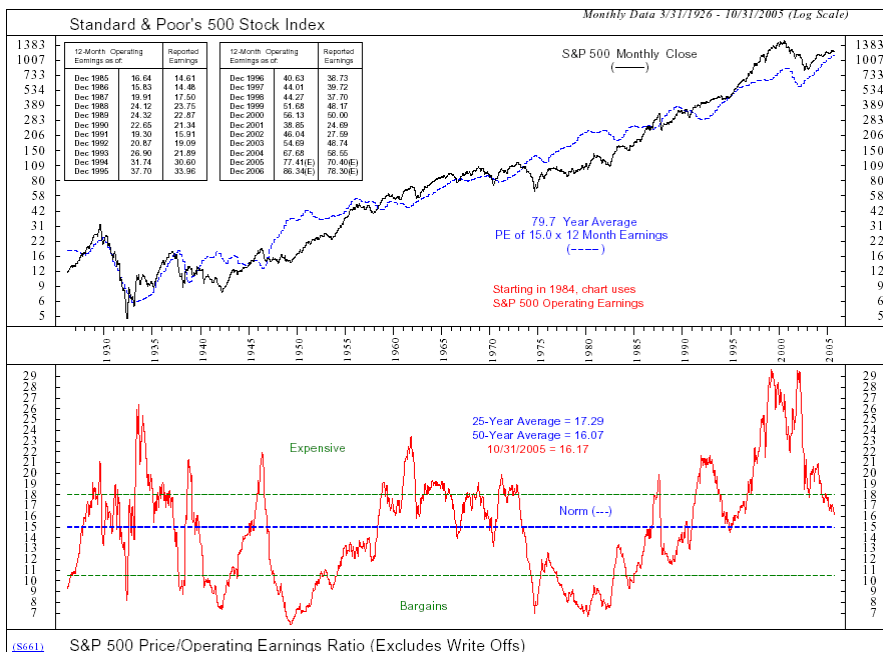
We also use several funds in portfolios that are currently closed to new investors. These funds would not currently be available to new clients of K&A. That performance table follows.

Fund Name	1999	2000	2001	2002	2003	2004	2005(1)	Cumulative
Dodge & Cox Balanced Fund	12.06	15.14	10.05	-2.94	24.44	13.30	5.27	77.32
FPA Crescent Fund	-6.28	3.59	36.14	3.71	26.15	10.21	9.73	83.25
Oakmark Equity Income Fund	7.90	19.89	18.01	-2.14	23.21	10.33	6.60	83.80
Dodge & Cox Stock Fund	20.21	16.31	9.33	-10.54	32.34	19.74	7.53	94.92
First Eagle Global Fund	19.56	9.72	10.21	10.23	37.64	18.37	11.47	117.20

(1) through November 30, 2005

We differ from many of Wall Street's big brand name firms in that we keep hearing them telling the public that stocks are cheap today. One of the reasons that we remain somewhat skeptical about the magnitude of any advance in 2006 is that by historical standards U.S. stocks are priced fairly, but they are hardly cheap.

Check out the bottom half of this chart. U.S. stocks are currently selling near the 50 year average price to earnings ratio of 16 times earnings.



K&A also buys or shorts 'sector' related exchange traded funds (ETF) to represent total sectors of the market that we hope will outperform during our specific holding period. If we have shorted, we naturally hope it will underperform.

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From a purely technical point of view it is very difficult to say where stocks are headed next. We are finishing the drafting of this section on December 29, 2005. The Santa Claus rally has not appeared, and stocks seem to be “topping out”—at least on the charts.

Check out this chart and tell us where you think the Dow Jones Industrial Average (DJIA) is headed next. By the way, this is the DJIA back to 1999. It would be reasonable to forecast the next significant move is back down to 10000. It would also be reasonable to forecast the next move is up to the 11500 range. Finally, it would also be reasonable to forecast another move back to 10000, followed by a move back up to 11500.



The bottom line is that 2006 might turn out to be just as frustrating as 2005 was for U.S. stock holders. K&A will be making significant adjustments in client portfolios during the first week of January in an attempt to concentrate assets in

the sectors that we believe will perform the best during the first half of 2006. This will hopefully gain us some tactical advantage going into the year. Those sectors again are industrials, energy, technology, health care and select consumer staples should lead the markets. We also believe the consumer discretionary stocks have fallen out of favor and we will be looking for values in that sector. The same is true for telecommunications stocks—or as they used to be called—telephone. Everyone hates these stocks and that might just make them a good group for some bargain hunting.

At the time this report is being drafted we are long I Shares MSCI Taiwan Index (EWT); I Shares Goldman Sachs Networking (IGN); and I Shares Dow Jones U.S. Technology (IYW)

We also purchase or short specific individual stocks, that we think represent unique opportunities apart from their sector, or the broad equity markets. At the present time we are not short any individual equity positions.

At the time this report is being drafted we are long Capitol Bancorp (CBC); Diageo (DEO); Dynegy (DYN); Electronic Arts (EA); Google (GOOG), Intel (INTC); Microsoft (MSFT); Starbucks (SBUX); Suburban Propane (SPH)

The actual mix of stocks, ETF's and Funds in individual portfolio's will differ depending on which model portfolio a client of K&A is invested in. For a complete list of models please refer to our website <http://www.kaassets.com/choices.htm>

We will try to "beat the market" by using these various combinations of assets. Over all we have little confidence that the U.S. stock markets, at least, will finish higher in 2006 than they did in 2005.

What about bonds?

At the time we are drafting this report we are long various individual CA municipal bonds that are AAA rated and with maturity ranges from 2 to 7 years. We are also long Pimco Real Return Fund (PRRD) and Oppenheimer International Bond Fund (OIBAX).

If we had to buy bonds today we would stick with maturities of 3 years or less. We will keep that bias until we see how our concerns relative to interest rates and inflation pan out.

Holding any domestic bond mutual fund during a time that the Fed is raising rates is a scary proposition. But the PRRDX focuses on inflation indexed bonds. So we feel we have some protection during a rising rate environment. Besides the fund has a stellar track record of providing reasonable rates of return with modest volatility.

OIBAX actually provides our clients with two potential benefits in one. It has provided solid total returns over the years and may prove to be a handy diversification tool if the U.S. dollar starts to swoon again against other major currencies. OIBAX is an unhedged bond fund and its performance should be enhanced in a weak dollar environment.

Fund Name	1999	2000	2001	2002	2003	2004	2005(1)	Cumulative
Pimco Real Return Fund	5.29	13.02	8.24	16.54	8.02	8.71	0.87	60.69
Oppenheimer International Bond Fund	10.98	6.87	2.15	20.81	25.88	15.56	2.75	85.00

(1) Represents 2005 performance through November 30, 2005

What about the dollar?

We were dead wrong about the dollar in 2005. We thought it would continue downward. It went up. Lot's of smart people think it should go down, and go down a lot.

A chart of the U.S. dollar index for most of 2005 follows (through December 28). As you can see the trend has been up. In fact during the months of July through October it formed an almost perfect "reverse head and shoulders" pattern. We have tried to highlight that for you. This is normally an extremely bullish pattern and it could easily have been expected that the dollars gains would continue for quite some time after the completion of the pattern.



They have been short-lived and the index has now moved back down into the top of the channel that formed the left and right shoulders. It is much too early to tell if this is conclusive in any way.

If the dollar does start to move down significantly the holders of shares of OIBAX should benefit.

So what does all this mean to our clients?

It depends! Now how is that for an answer? Well it is an accurate answer, so far as it goes. It depends on which model portfolio style, if any, your individual portfolio is being managed to approximate.

As 2005 closes K&A is offering clients 6 model portfolio styles. We are also managing some of the smallest accounts individually with no model style at the present time.

Each model has a different asset mix. It is just that almost all, if not all, of the assets in all the models will be found somewhere in the descriptions above.

Detailed descriptions of the models can be found on our website <http://www.kaassets.com/choices.htm>

We also provide our clients with performance reporting on a quarterly basis so that they can tell how their model portfolio style is performing. We currently use Centerpiece Software, developed by Schwab Performance Technologies. This service of our company was created to provide accurate and timely investment performance measurement for the portfolio managers at K&A; as well as timely performance reporting to clients of K&A.

Centerpiece allows K&A to provide “Time Weighted Return” (TWR) calculations to our clients. TWR is the standard of accounting and performance measurement adopted by the CFA Institute to provide consistent and reliable performance measurement.

K&A is striving to meet the CFA Institute's **Global Investment Performance Standards (GIPS®)** for performance reporting. The **GIPS®** standards are ethical standards to be used by investment managers for creating performance presentations that ensure fair representation and full disclosure. Global standardization of investment performance reporting will allow investors to compare investment managers and will allow managers to compete for new business in foreign markets.

K&A can not claim to meet the **GIPS®** standards until it has been using the accounting methods and reporting performance on a TWR basis for a period of at least five years. K&A will finish it's forth year of using Centerpiece and TWR reporting at December 31, 2005. We will cross the five year mark at December 31, 2006.

We wish you a successful and prosperous year. We will be working hard to contribute to your financial success in 2006.

Paul Krsek
For K&A Asset Management, LLC