



ELLUMINATION

August 30, 2007

DON'T FIGHT THE FED, and the BOJ, and the ECB

Get a glass of wine or Calistoga Water, then sit back, and let me tell you a story that will probably seem too strange to be true; but I assure you it is true. I can also assure you that nothing you are about to read is an exaggeration or distortion of fact. This all came from hard research while trying to figure out how bad an ending this story might have. Naturally I am referring to the current 'sub-prime' crisis.

Now here is the irony of it all; if you blink you might miss it. What could easily have been the biggest crisis to hit the financial markets in decades is probably going to get "liquidated" by the FED and other central banks of the world before the end of the year. Central banks around the world have responded to this crisis with almost unprecedented speed, coordination and intervention. They include our FED, the Bank of Japan (BOJ), and the European Central Bank (ECB). It is my very strong opinion that they intend to paper over the problem with new money supply so as to make like it never happened.

Global Money Trends, a research service we subscribe to, indicates that they believe that global financial institutions may experience \$150 billion in losses related to writing down sub-prime loans. Is it a coincidence that the ECB and the FED have already pumped over \$150 billion of new liquidity into the system? Is it simply a coincidence that the FED has lowered their discount rate and invited banks to step up to the window and borrow directly from them NOW if they need to? Of course not. We think these are simply the first steps that central banks are taking to make sure that this crisis simply fizzles out.

Making that happen may be a gargantuan task. Make no mistake about that. There will be plenty of nay-sayers who disagree with me about both the potential magnitude of central bank intervention and their likelihood of success. The nay-sayers will take advantage of every bump in the road to explain why I am wrong. There are plenty of people already saying that we will be rolling over into recession or worse by 2008; but they are wrong.

I am going to jump ahead and tell you the conclusions I have reached about what is going to happen; then I will fill in the blanks as to why these things are the likely outcome of the present crisis.

1) The stock markets will not collapse and it is highly likely that we have seen the worst already. We may see a test of recent lows on U.S. stock markets, but those tests should be successful. That means that the markets should not fall lower than recent panic lows. Over the next couple of months the U.S. stock market should approach 1500 as measured by the S&P 500 and 13700 as measured on the DJIA before running into any real headwinds again. I am very confident the markets will end 2007 higher than they are today.

2) Commodity prices were falling and should have fallen more. That trend has been reversed IMMEDIATELY; and prices are already on the rise again. We told you several weeks ago that copper was headed all the way back to \$1.30 over the next few years. **Cancel that alert.** Copper prices; gold prices; aluminum prices, steel prices; and oil and gas prices are now likely to stay higher for longer than would otherwise have been the case. For example we were setting up for oil prices to retreat to the low \$60's. We now believe the floor is in at \$70 for the foreseeable

future. The commodity bull market has been extended thanks to overwhelming infusion of new cash into the financial system. We don't think that infusion is anywhere near complete.

- 3) Inflation rates will rise, but no matter, short-term interest rates in the U.S. are going down.
- 4) The U.S. Federal Reserve Bank will be cutting the FED Funds rate. We can't predict by how much, but we are confident that the odds exceed 99 to 1 that the first cut will come in September. It may larger than 25 basis points to give a clear signal to the markets and the world that the FED is serious about keeping money available and flowing.
- 5) The consequence of the interest rate cuts will be a greater disparity between interest rates in the U.S. and much of the rest of the world. Therefore the dollar will be falling against the Yen and the Euro. The U.S. Dollar Index will be falling below the long term line in the sand at 80 that we have pointed out in past Ellumination's. We now expect it to get to 75. This is a significant change in our thinking. We came into 2007 thinking that the U.S. Dollar Index would hold at the 80 level. The collapse of the dollar is likely to accelerate thanks to actions the FED will be taking to obliterate the "sub-prime" crisis.
- 6) Money supply for the U.S., formerly measured as M3, will be exploding upward. It already is and that will not change immediately. **Global Money Trends** reported on August 26 that U.S. M3 money supply is currently growing at a 13% annual rate; and may accelerate to 17%. That would be the fastest growth rate of money supply in U.S. history and match recent growth rates in Australia and China.

The rapid increase in money supply in the U.S is being matched by many countries around the world and that is highly inflationary. That is why we will be seeing higher inflation rates and higher commodity prices at the same time interest rates in the U.S. will be dropping. Money supply growth rates in Europe are now at 28 year highs. Eighteen of the top twenty economies in the world are currently growing their money supplies at rates exceeding 10 percent per year. (See **Global Money Trends**, August 2007)

- 7) Several other countries were at the brink of raising their key interest rates but those rate hikes have been postponed. China is the exception. (See **Global Money Trends**, August 2007)

All of this is predictable because of the enormous coordinated intervention and cooperation between the Bank of Japan (BOJ), the European Central Bank (ECB), the Federal Reserve Bank of the U.S. (FED) and a little help from folks like the Saudis and Dubai.



So as market maven Marty Zweig always used to say—don't fight the FED. I would add that is particularly true when they are part of a gang—otherwise known as the Plunge Protection Team (PPT).

A couple of weeks ago I wasn't so sure of myself and that is why we got caught flat footed in a very defensive posture at the moment the FED made its announcement that it was lowering the Discount Rate and opening the liquidity gates to U.S. banks who needed access to instant money. Check out this chart. See the market collapsing; and see the market rising. That was the inflection point at which we were leaning into the wind just as the FED spit—on us.

Actually the first tick upward was in response to the FED interjecting huge liquidity into the market. It turns out that it wasn't enough to stabilize the situation. We saw the markets continuing to trend down in a big hurry and we got extremely defensive. We told you in our last newsletter about all the stocks we got stopped out of at the time. We were also short the DJIA and the NASDAQ 100 at the time. Profitable trades on the short side turned unprofitable over night when the FED announced the Discount Rate cut ([the blue circle on the chart](#)).

Hey, no one ever said that managing money was easy. But we know one thing for sure, when the FED changes course, then we change course and that is what we did.

The cut in the Discount Rate won't be enough either, but don't despair! The FED's Open Market Committee meets on September 18 and I have no doubt that they will be cutting the FED Funds rate at that meeting. In fact I have no doubt that the FED will do everything necessary to inflate our way out of this crisis and to avoid a long term systemic problem within our banking system; and therefore our financial markets.

By now you must be saying to yourself that Paul's tone is pretty emphatic, and it is. I am not equivocating here—not at this point. But as I often have a tendency to do, I am getting ahead of the story. Let's go back and check out what the FED has already done. They injected a HUGE amount of money into the banking system and made it cheaper for banks to borrow from them. I candidly admit that I thought they would do this, but I wasn't certain, and that is why we got so defensive so quickly when the markets started to unravel. It is one thing to have a theory and believe something will happen. It is another thing to see it actually happening as theorized. Before the FED started to act it was still difficult to know exactly how they would react in a crisis. That is no longer the case. They are behaving just as I thought they would and they will continue to do so.

At this point I am remembering Arnold Schwarzenegger in the movie TWINS when he admonishes his adversary that "You forgot the first rule of a crisis." In our case that rule is DON'T FIGHT THE FED!

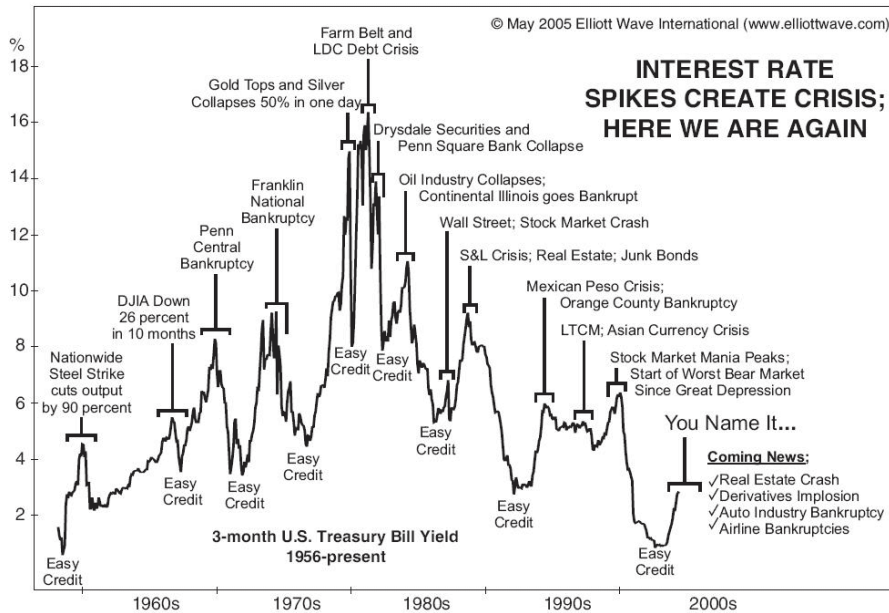
The FED is acting in concert with other central banks to minimize and contain this crisis as quickly and efficiently as they can. That is what we thought they would do when the proverbial "stuff" hit the fan. Let me offer you some history lessons to explain what I mean by these statements.

YEA, YEA, YEA

Buy now you might easily be saying, "yea, yea, yea Paul; as if you predicted how the FED would act in a crisis. Well I actually did in our 2006 Forecast Report to Investors. You have to read this to understand the rest of what I am going to write about in this paper. So here are some excerpts from that report dated January 3, 2006. If you want to go back and read that paper in its entirety it is on the website at www.kaassets.com in the archives of Ellumination.

For our purposes here I am blatantly taking the liberty of changing the order of sentences and paragraphs and leaving lots of explanation out to make our point concisely for the present crisis.

So here you go:



We opened that 2006 report with this graph and we discussed the possibility that the next financial crisis may already be looming on the horizon. They tend to be precipitated by FED tightening, which was happening at the time. They tend to be resolved, or fixed, when the FED starts to lower rates again. But we also said in that report that the FED

was “fooling” us with their apparent restrictive stance on interest rates and that they were already hard at work flooding the system with new money supply to head off any potential recession.

Well, the crisis is now here and the FED is likely to accelerate their work related to stopping any recession in its tracks before it gets started.

Here is our first quote from that report.

“We believe that during 2006 the FED is going to fool you by making you focus on what they do with interest rates while they flood the globe with an increased supply of U.S. dollars. They can’t afford a recession and will “error” towards favoring inflation. Inflation is likely to go higher than the pundits currently expect, not related to the magnitude of movement of interest rates; but because the globe is being flooded with U.S. dollars.”

That happened in 2006, and money supply growth is accelerating in 2007. At the time we were writing that report our current FED chief, Ben Bernanke, was still an unknown. We wrote this:

“We also know that there will soon be a new FED chief. The truth is that no one knows how he will conduct the business of the FED. We believe his options are somewhat limited by the fact the neither the FED, nor the Administration can afford to let the U.S. slip into recession.”

Before we get too far into this story it may be important to get everyone on the same page as to why money supply growth rates are important. They are because they are the core cause of “inflation”. Here is a little “econ 101” reminder of what inflation is and what money supply has to do with it.

The American Heritage® Dictionary of the English Language, Fourth Edition, Copyright © 2000 Published by Houghton Mifflin Company says:

Inflation:

2) A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of available goods and services.

We believe that the FED actually helped to cause the current crisis by making too much money available for way too long and they are still doing so.

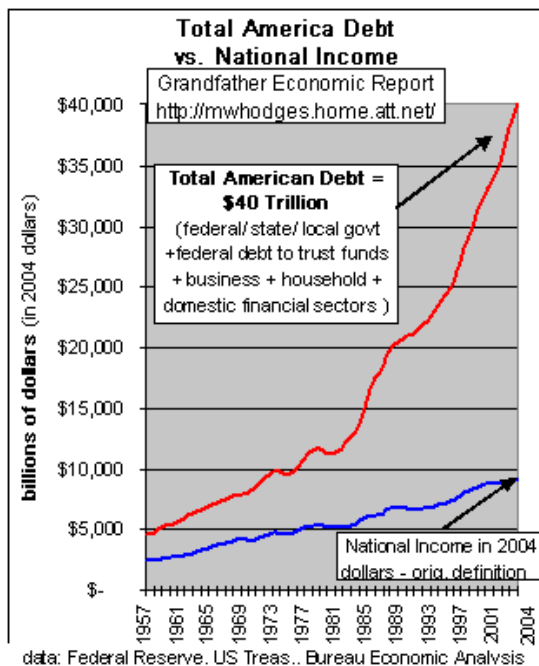
We are now dealing with the first crisis related to this behavior. It always turns out to be the case, doesn't it? Eat too much and you suffer. Drink too much and you suffer. The same is true of anything that is "too much".

The fact is that our current FED is not the first one to act this way. Arthur Burns tried to do the same thing back in the 1970's.

Here is the core portion of what we wrote about this topic back in early 2006.

"We believe the FED is literally playing a game, but a very crucial and intricate game. While acting modestly restrictive on interest rates, they are flooding the market with dollars. They are going to make sure that despite rising energy prices, and despite the huge personal and government debt loads, there is all the liquidity individuals and institutions need to keep buying all the goods and services they need and want.

The only problem with this policy is that we are not sure how this gaming by the FED



eventually corrects itself. We are not sure what the final chapter in this story will be. We think the FED may be up to the same tricks that the Arthur Burns FED pulled in the early 1970's that led to the staggering inflation of the late 1970's and early 1980's.

This policy of rapidly increasing the supply of money to provide "all the liquidity individuals and institutions need to keep buying all the goods and services they need and want" is exactly what the FED did in response to the oil price shock of 1973-74.

We obviously can't say definitively yet that this is the current FED's policy, but that is what the situation looks like to us."

FYI, when I first circulated the 2006 report people jumped all over me about it. I heard from people that I had never heard from before that I was wrong about money supply growth rates and the course of the FED. I was told that "Bob Brinker says you are wrong." I never heard from Bob Brinker, by the way. That statement came from someone else.

Well I haven't been wrong. The FED is still on the same course they were on then. So now, back to the story....

*“If you are a discerning reader you have to be asking why the FED would risk such a thing. The answer is simple. The U.S. is carrying a staggering debt load and can simply not afford a recession. The chart, above, depicts the growth of total American debt vs. the growth in national income through 2004. You can see the problem. We are essentially a debt financed society. The chart does not even include the unfunded entitlements for Social Security, Medicare, Medicaid, various state government and local government pensions, and unfunded private pensions. **The U.S. simply does not have the economic flexibility to get through a mild recession. The next recession in this country is likely to be a hum dinger in which not only private entities will be declaring bankruptcy, but so might government entities. The FED wants to avoid that scenario if at all possible.**”*

Therefore ‘inflating’ our way out of this dilemma is the more palatable choice. The irony is that this time the FED has allies that the Burns FED didn’t have. Today the oil producing nations are loaded with cash and that cash needs to go somewhere. Much of it is being recycled right back to the United States and is supplying our economy with much of the infusion of cash flow we need to keep the economy growing and to keep interest rates low. The same is true for China and India. They are selling us goods and essentially lending us back the money we need to keep buying from them. If only Arthur Burns had such friends; he would not have looked so bad in comparison to Paul Volker. And maybe Alan Greenspan would not be known as “the best FED chief ever”.

On another note, U.S. consumers are increasingly broke, but they are not telling and they will just keep borrowing—until they can’t any more. That time is drawing much closer. However, the American consumer has proven much more resilient than we could ever have imagined. Debt loads are now staggering in many households. Rising real estate values have been the only thing keeping the American consumers balance sheets intact. If real estate does collapse we are in for a major recession. Real wages are simply not growing fast enough to fuel additional personal and family consumption.

Unfortunately, the U.S. government is also broke and so are all the state and local governments and they will be looking EVERYWHERE to solve their problems.”

The USA is in the same state today that it was during the “Roaring 1920’s” when Will Rogers said, “This country is not prosperous. It’s just got good credit. We live better and owe more money than anybody in the world.”

We were simply trying to sound the alert back in early 2006 that things were way out of whack in the financial structure of the U.S. We thought that Will Roger’s quote was quite appropriate.

So here we are, a year-and-a-half later and we are seeing some of the consequences of the FED’s excesses. But we are now arguing that despite real estate rolling over we will NOT see a recession next year. We admit that we have changed our tune in that regard. We have done so because of very real developments since early 2006.

First, the global economy remains much more robust than we were probably considering at that time. Second, real wages are growing faster than we thought back then. Third, corporate America remains in good health and economic activity outside real estate and American autos remains solid. Fourth, if anything, the FED and other global central banks have accelerated their infusion of liquidity into the system.

It is now August 29 as my drafting of this newsletter continues. We had one of those 'tests' of the market yesterday—whew. This morning I came into the office and immediately got into a discussion about some of the themes of this newsletter with one of our bankers at **Napa Community Bank**. That discussion made me realize that I need to go back to the 2006 report and dig out some more background information for you so that you can completely understand the themes I am writing about and get comfortable with the conclusions I am coming to.

One piece of the story that I have left out so far is that measuring inflation in this country has become pure gamesmanship. The Consumer Price Index (CPI) measures official inflation. But official inflation has almost no correlation to the real inflation that you and I experience in our daily lives. CPI is simply a tool that the government uses to foist some "double-think" (a term from George Orwell's 1984) on the public. The amazing thing is that they actually get away with it.

Here is some more history from our January 2006 report:

"We believe that real rates of inflation are much higher than official CPI and PPI numbers indicate. We believe that these indexes have been sufficiently modified over the past several years that they no longer come anywhere close to measuring real rates of inflation. Both the CPI and the PPI have gone through revisions in their methods of calculation over the past decade, for the purpose of reducing the rate at which they measure inflation. The significant revisions started during the Clinton administration as a method of reducing cost of living increases in entitlement payments such as social security, which are tied to the rate of increase in the CPI. The lower the CPI increase the lower the benefit payment increase. It is just that simple—and therefore less Federal spending.

The CPI can be manipulated easily by adding, subtracting or otherwise changing which factors get measured and also by how those factors are weighted in calculating the index. Change the components or change the weighting and you get a different CPI. That is exactly what the U.S. government has been doing over the past decade. They have changed the way we measure inflation to decrease the stated rate. Everyone seems to be happily ignoring that fact that today's CPI significantly understates the real rate of inflation.

So what you might ask? Well we have a good answer. Any darned fool can read that inflation is increasing at 3 percent per year. That same fool can find his or her home heating bill increasing at 25 percent per year, his car gas bill going up by 20 percent, and the price of his house appreciating 12 percent, and know that the 'official' statistics are wrong. It isn't a matter of what the statistics report. It is a matter of whether or not people can afford to pay for the goods and services they need. We think fewer and fewer people can do that.

In other words, there is currently a huge difference between the world as the keepers of statistics would like it to be and the world as it really is. The world as it really is happens

to be getting more and more unaffordable for more and more people, and that will eventually become a serious problem. It is also becoming more and more unaffordable for government entities at every level including local, county, state and Federal.

Inflation is rampant and the official measures of inflation like CPI and PPI have been so manipulated over the past several years that no one seems to realize how much real inflation is in the economy. If the CPI were still calculated today using the same methods in the 1970's through the early 1990's the stated inflation rate would exceed 7 percent and we would all be panicking.” (That was as of January 2006.)

So we continue to march forward in a “double-think” world in which our government tells us that inflation is only 2-3 percent, while we all know it is higher than that. We hear every day on the news that the FED is diligent about fighting inflation and yet our money supply growth rate is currently approaching all time highs. It has hit 28 year highs in Europe. It is at double digit rates in 18 of the top 20 economies in the world—and MONEY SUPPLY GROWTH CAUSES INFLATION!

So do you get it yet? Global central banks are inflating the heck out of the global economy; including our own FED. It is just that simple. Case closed. There is no “diligent” inflation fighting going on. These guys simply can't let the economic music stop and they know it. The whole world is simply too interdependent on excessive growth rates at this point and NO ONE can afford a recession; particularly in the U.S.

So the next time you see and hear all those talking heads on CNBC pontificating about Ben Bernanke as an inflation fighter remember you read it here. It simply isn't so. Neither is it true of the BOJ or the ECB.

So here are the bottom line(s).

- 1) The sub-prime crisis is not going to sink the U.S. or global economy. The central banks of the world and the current strength of the global economy will see to that.
- 2) That doesn't mean there won't be some pain. It is reported that 1.5 million residential foreclosures are already under way. There will likely be many more.
- 3) It is too early to bottom fish by trying to buy the beaten down bank stocks. No one yet knows just how much pain banks will endure. For example, it is estimated that Citigroup is holding \$35 billion of sub-prime paper. Is it worth 90 cents on the dollar? Is it worth 10 cents on the dollar? I don't think anyone knows the correct answer quite yet.

Sub-prime debt is being held by banks in the U.S., Canada, England, Germany and China, just to name a few. No one knows the magnitude of the balance sheet adjustments that will be taking place soon.

3) Residential real estate prices are clearly adjusting downward almost everywhere in the U.S., but the pain won't be equal. Prices have been cut in half in some areas of Florida. They have dropped 20-25 percent in some areas of Hawaii. They are down 5 to 10 percent right here in the Napa Valley. This could be the buying opportunity of a life time if you are looking for a new home, second home or vacation condominium.

4) There is clearly too much supply of residential real estate in many sections of the U.S. It may take places in Florida and Arizona two years or more to sell off that excess supply. Remember that we had a significant real estate downturn that lasted from 1989 to 1995 in some areas of the country. This is not unprecedented.

5) While a downturn in real estate was working its way through the system from 1989-1995 the stock market more than doubled. There is no way to jump to the conclusion that because real estate is turning down that the stock market will turn down too; especially with the global Plunge Protection Team at work.

Check out this chart which shows the progress of the S&P 500 from 1989 through 1995.

6) In the short-term there may be some more real pain in the U.S. stock market. The short-term technical picture is not good. We probably have more scary days ahead of us. If any big U.S. banks announce that they have bigger problems than the markets currently perceive we could see some short term damage to that bank's stock and to the markets in general.

7) All of the stocks that we are currently invested in are as far removed from sub-prime and problems related to real estate than you would hope would be the case.



Our portfolios and the markets should both get through this "crisis" just fine.

I imagine that there is a day of reckoning coming for the U.S. markets and the global economy for that matter. But I truly don't believe that the "sub-prime" crisis will be the cause of that day. Neither do I believe that day is imminent; even though I have been on watch for it for seven or eight years now. What I didn't understand back then, and neither did you, was the huge influence that coordinated global economic growth was going to have on all of us.

Neither did I understand how influential central banks would become in managing financial markets. They have been much more active in managing the markets following the major stock market downturn from 2000-2002 and the events of 9/11/2001.

We certainly didn't have the "Yen carry trade" as part of our everyday vocabulary back then. It has been a huge influence on financial markets over the past few years, and is likely to remain key to the markets in the foreseeable future.

Are you asking, "What is the yen carry trade?" Let me offer a simple explanation.

Imagine that a trader borrows 1,000 yen from a Japanese bank, converts the funds into U.S. dollars and buys a bond for the equivalent amount. Assuming the bond pays 4.5% and the Japanese interest rate is set at .5% the trader stands to make a profit of 4.0% (i.e. 4.5% - .5%), as long as the exchange rate between the countries does not change.

Leverage can make this type of trade very profitable. If the trader uses a leverage factor of 10:1, then he/she can stand to make a profit of 40% (i.e. 4% * 10). However, if the U.S. dollar were to fall in value relative to the Japanese yen, then the trader would run the risk of losing money. Furthermore, because of the leverage, small movements in exchange rates can magnify these

losses immensely unless hedged appropriately. One of the reasons that the market sold off so dramatically in the past few weeks is that traders thought that the Yen carry trade might be coming to an end. Billions of dollars worth of stocks, commodities and bonds were liquidated indiscriminately to raise cash to retire loans in Japan or to otherwise lower the leverage at work in hedge funds around the world.

The funny thing is that within a few days the markets seemed to calm down and the Yen carry trade seems to be part of the lexicon again.

As of early 2007, it is estimated that as much as US\$1 to \$2 trillion may be staked on the yen carry trade. Actually no one seems to know how much money is involved.

I don't think back in 2000 that anyone would have predicted interest rate disparities between Japan and the rest of the world would continue to be as large as they are even to this day; and that a trade like this could last as long as it has.

The Yen carry trade alone has fueled enormous global liquidity. If the broad estimates above are at all accurate there is an extra one or two TRILLION dollars floating around the system that wouldn't be there otherwise. That is a lot of purchasing power.

Consider the following conditions as well:

Who knew in 2000 that China's annual growth rate would exceed 10 percent per year for all these years in a row?

Who knew then that Wal-Mart would become a big outlet store for China?

Who really understood when the Berlin Wall fell that the seeds were being sown for years of economic growth in Europe?

Who knew that the Euro would help to hold Europe together?

Who knew that on the other side of the collapse of the Soviet Empire that Russia would be poised to truly become a global economic power? It actually has a chance you know.

Who knew that India would become an economic powerhouse and that every time you talked to a "tech support" person, he or she would actually be in India?

Who knew that Amazon, Research in Motion, Google and Apple would become the new "4 horseman" of tech?

Who really understood the power of the Internet?

It is truly a different world in which we live during the 21st century, but business cycles have definitely not been repealed. Greed and avarice have not gone away. Stupidity is still rampant and unfortunately that remains especially true on Wall Street. What passes for brilliance there would look more like idiocy in other venues.

Much of Wall Street still can't figure out who they serve. They keep saying it is their clients, but somehow, more often than not, it turns out to be themselves.

Let's take Countrywide Financial (CFC) as an example just to illustrate a point. It wasn't too long ago that its shares traded for \$45 apiece. The float is approximately 526 million shares. That means that the market value of CFC was \$23.670 billion at that time. If I recall correctly the folks at CFC, including CEO Angelo Mozilo, were saying then that all is well at CFC. In the past seven months the stock price has fallen to \$19.79. Actually it got as low as \$15. That means that Angelo

Mozilo and his team have ripped up approximately \$13 Billion in shareholder equity in seven months. We now know that CFC had to literally be saved by the cooperation of the FED and the intervention of Bank of America.

Ripping up \$13 Billion in shareholder equity is not bad work for Mr. Mozilo's \$68.95 million in total annual compensation.

(See Forbes annual survey of CEO compensation. Compensation is based on total compensation for latest fiscal year. Total compensation for each chief executive includes the following: salary and bonuses; other compensation, such as vested restricted stock grants, LTIP payouts and perks; and stock gains, the value realized by exercising stock options)

But I digress as usual. Sorry. He is only the latest in a long line. Let's move on.

There will be more recessions; just not yet.

Someday I will write the paper on my theory regarding the coming of the next great depression. I have such a theory and that shouldn't surprise you. But don't worry. It should be many years away.

On the other hand, if you want to hear the theory just meet me at the office late one afternoon after the market closes or call me and invite me to Don Giovanni's after 3:30 for a little snack and a glass of Sauvignon Blanc. It is a good story, a good theory, and it the odds are overwhelming that it will happen—some day—a long time from now!

Have a great Labor Day holiday. I am going to try not to labor. I have been doing too much of that again.

All the best,

Paul Krsek
For K&A Asset Management, LLC
August 29, 2007

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Krsek makes frequent reference to the model portfolios called Hatteras, Mendocino, Halifax, Bonavista, Fresnel and The New World. 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>.

Not all accounts managed by K&A are "modeled" accounts. We strongly urge our clients to understand which model, if any, are being used to manage their accounts.

As of July 3, 2007 Lee O'Dwyer joined K&A as a portfolio manager. Paul Krsek and Lee O'Dwyer frequently discuss investment ideas, model portfolio strategies and the investment policies of K&A. But when it comes to the implementation of those policies Krsek is primarily responsible to manage the accounts that fit into each model portfolio description. He generally makes all final investment and trading decisions relative to those accounts that are considered to be "modeled." However, in Krsek's absence O'Dwyer does have the authority to trade all client accounts. He has been actively trading accounts in the various models since joining K&A.

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 has encouraged clients to hold such securities in a separate account for the client. Because K&A is a "fee only" registered investment advisor" it charges its normal management fee for monitoring such securities in the separate accounts in which they are held.

K&A makes every effort to exclude securities that are 'requested by the client' from the 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-Illumination may or may not apply to specific managed accounts and/or models.

Trades or adjustments to accounts mentioned in ELLUMINATION 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 or exchange traded funds (ETF's), 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.

From time to time Krsek lists the simple annual returns of the six model accounts in this newsletter. These accounts are "models" and do not represent the actual results accruing to individual accounts. Simple annual return does not represent "time weighted return" as reported individually to clients in their quarterly reports prepared using Centerpiece.

This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy any securities or other instruments mentioned in it.

Sincerely,

Paul Krsek
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