



ELLUMINATION

December 4, 2007

LEAVING THE BUILDING?

Introduction

This has been the toughest newsletter for me to write in the 9 year history of this K&A newsletter series. I have drafted it at least 8 times and started it well over a week ago. At this point it looks and reads nothing like it did when I started. The paragraphs that I am drafting now are actually being written at the end of my drafting process, even though they are appearing at the beginning of the letter. It has finally dawned on me that I am struggling because I am writing during a time when conditions are probably more uncertain than at any time I can remember in my investment management career.

To put that statement in perspective you have to realize that I put my entry date in this industry at 1981. During 1981 the U.S. was deeply entrenched in a bear market that had been going on since 1964. The Dow Jones Industrial Average reached 776 on January 09, 1964. On August 12, 1982 it was at 776. That is 18 YEARS LATER! Now it didn't just stay at 776 for 18 years. No, it actually bobbed up and down, back and forth over 1000, many times during that period. It was possibly the most frustrating 18 years in U.S. stock market history. By the time I arrived on the scene no one cared about stocks. Real estate was king and it had just gotten another boost from a very generous tax benefit package, compliments of the first Reagan administration.

But in August of 1982 the U.S. stock market started to rise from its 18 year slump and it has never really looked back. Over the past 25 years the market has risen from its nadir of 776 to 13428 today. Later in this newsletter you will see a chart of that entire move and my explanation that we have been in a grand super cycle bull market all the way up.

The question on my mind now, getting back to what is making this newsletter so tough, is that I am starting to wonder if we are now seeing the last gasps of this super cycle bull market. The honest answer is that I really don't know. If we are not seeing the end of the super cycle, we certainly might be seeing the last convulsive phase of the 3rd leg of this 25 year bull market, which kicked off in 2003. I've got some charts and further explanation of these components of the bull market later in the newsletter that will help you understand those statements.

The rub is that I really don't know. Lee and I have exhausted ourselves looking at data, charts, running quantitative screens, talking to other money managers, talking to bankers, talking to analysts and we simply don't know.

It all really comes down to one simple equation. If this credit and housing crunch gets as big as I now think it might the conditions will be in place to tip the economy into a serious recession and tip the markets into bear market territory. If the credit and housing crunch is well contained, and almost over (as a minority now claim) then other global economic conditions should still be sufficient to lead the markets out of this mess and the bull market should remain intact.

Now let me ask you a question. Do you know whether this housing and credit crunch is going to keep getting bigger, more far reaching and more economically destructive, or is it well contained? With that question on the table, which is unanswered in my mind; please read on.

Back to the newsletter that it has taken me 8 days to draft

December is normally one of the strongest months for the U.S. stock market, with an average gain over the past 50 years of 1.7%. November is also normally strong, but it was a dud this year. The danger in relying on seasonal or monthly “averages” is that they aren’t really reliable as predictors of real events. A lot of highs and lows must be combined to come up with an average.

For example, while November is usually strong it has been down 18 times in the post-WW2 period. Sixteen of those 18 down months have been followed in December by a strong rebound. Will we experience a December rebound this year, or are we headed toward rare back to back November and December declines? That has only happened twice; in 1969 and 1974.

S&P 500 Historical November and December Returns

Year	November	December
1950	-0.10%	4.72%
1951	-0.26%	3.89%
1956	-1.10%	3.53%
1963	-1.05%	2.44%
1964	-0.52%	0.39%
1965	-0.88%	0.90%
1969	-3.41%	-1.87%
1971	-0.25%	8.62%
1973	-11.39%	1.66%
1974	-5.32%	-2.02%
1976	-0.78%	5.25%
1984	-1.51%	2.24%
1987	-8.53%	7.29%
1988	-1.89%	1.47%
1991	-4.39%	11.16%
1993	-1.29%	1.01%
1994	-3.95%	1.23%
2000	-8.01%	0.41%
Average	-3.03%	2.91%

It is interesting to note that in both 1970 and 1975 the market finished higher following the back-to-back November and December sell offs in the previous year. 1970 was a gut wrencher though. The market plummeted into the spring and summer before completely rebounding in the second half of the year.

1969 was an extremely tough year for the stock market. Credit was tight, interest rates were high, the fed was fighting inflation and the Vietnam War was being blamed for high inflation as a result of the “guns and butter” policies of the Johnson administration (inherited by Nixon).

In December 1974 the markets were bottoming out after almost 24 months of gut wrenching decline that erased 45% of market value from January 1973 to December 1974. The 1973-1974 periods included one of the worst recessions the U.S. has ever experienced. But looking back it seems that no one saw the recession coming.

Check out this quote from Wikipedia: **“1972 had been a good year for the DJIA, with gains of 15% in the twelve months. 1973 had been expected to be even better, with Time magazine**

reporting, just 3 days before the crash began, that it was 'shaping up as a gilt-edged year'. In the two years from 1972 to 1974, the American economy slowed from 7.2% real GDP growth to -2.1% contraction while inflation (by CPI) jumped from 3.4% in 1972 to 12.3% in 1974.”

That quote might explain just how tough it is to forecast the future. The same was true just before the stock market crash of 1929. Economists around the nation were declaring that 1930 should be a great year for the U.S. economy. Then all hell broke loose.

As we kick-off the last month of 2007 the markets are up for the year, but staggering toward the finish line. Economic forecasts for 2008 keep getting revised downward on all fronts. **Goldman Sachs** just hit the streets with major downgrades on stocks in many sectors and significantly reduced their overall GDP guidance for 2008.

Wells Fargo Housing Trends Report was released on November 16th. It was one of the most depressing documents I have read in a while. Here is an excerpt.

- *We cannot at this point detect any shift in housing market dynamics: inventory levels are high, demand is weak, construction is too high, and prices are falling. The housing market correction will take us through 2008 and into 2009. The disequilibrium is just too severe at this point for the market to clear excess inventory within the year.*
- *Moving into 2008, the impact of housing on the rest of the economy will be in full swing, with the consumer sector taking the brunt of it, as we suggested in this space nearly a year ago.*
- *With much weaker economic growth ahead (after the head-fake from a substantial upward revision of 3Q GDP growth due within two weeks), the risk is that events that otherwise could be absorbed will sink the economy.*

“As a result, we put the risk of recession in the next six to nine months as high as it has been since immediately before the 2001 recession.”

Merrill Lynch released their Market Economics report on November 30th. Here are a few excerpts:

“We took a good top-down and bottom-up look at our 2008 earnings forecast and have made some revisions – to the downside. We now expect 2008 S&P 500 operating EPS to come in at \$83.00 (down 7.3%), a sizable haircut from our earlier view of \$89.00 (-2.4%). We are certain that the consensus view from the bottom-up analyst community of +14% operating EPS growth for 2008 is far too optimistic. So be prepared for a tsunami of earnings downgrades in 2008, which then means that investors should retain a defensive, high-quality portfolio with a focus on stable earnings and reliable dividends.”

“Recession odds are increasing. Its capitulation time for those who believed that there would be a soft landing.”

“The bad debt problem is acute as it stands, and the worst has yet to come.”

“All we can say is that there’s more to come. While it is still open for debate as to whether the overall economy will tip into a contractionary state in the coming year, it became more evident this week that the housing recession is morphing into an outright depression.”

The truth is that no one yet knows if we are headed into recession next year or not. The most reliable research services that K&A uses are terribly conflicted. If we have a recession we certainly can’t yet forecast the total impact on the U.S. or global stock markets.

Yet, the more data K&A collects on the current housing and lending crisis the more worried we are becoming that the U.S. economy is facing a more serious economic downturn than we had previously imagined. Therefore we continue to get more cautious toward the markets, at least for the short term.

We are absolutely convinced that major banks across the U.S. are being less than forthright in their disclosures regarding potential damage to their balance sheets. **Goldman Sachs** issued a report last week that we took as a confirmation of our suspicion. They estimate that U.S. banks are facing at least another \$100+ billion in write downs, above and beyond those already announced. **Goldman’s** analysis is actually one of the more conservative that we have seen.

Last Friday I had a very interesting conversation with a banker who works for an NYSE listed bank holding company. He had just been in New York and had spoken to some of the **Goldman** guys who had issued the report referenced above. They told him their estimates of \$100 billion +

are very conservative. Yet, it is a number that they were confident would be the minimum additional impact from the current crisis.

Another of our research services is estimating the write downs could go as high as \$500 billion.

We know that it will be several months from now before we know the true story.

Given all the uncertainty, and given the current volatility of the markets we continue to reduce our exposure to equities and to change the nature of that exposure. We used the rally last week to sell out the last of our individual stock positions in all six of our models. We then added back a relatively small allocation to index tracking exchange traded funds (ETF) that track the S&P 500 and the NASDAQ 100. At this point that is the only equity exposure we have in our Hatteras, Mendocino, Halifax and Bonavista models. We consider these ETF's to be "rentals" that give us limited exposure to capture a little more upside for the models, should it occur in the form of a December rally. They are also positions that can be jettisoned in a heart beat if these markets continue to break down.

Here is a snapshot of our model trading account's performance right through November 30. (See note at bottom of this report regarding these performance calculations.)

Model	Sept. 30	Nov. 30	Change
Hatteras	10.86	10.32	-0.54
Mendocino	13.29	11.75	-1.54
Halifax	17.00	12.30	-4.70
Bonavista	12.02	7.24	-4.78
Fresnel	19.06	16.98	-2.08
New World	15.72	23.92	8.20
S&P 500	7.69	4.44	-3.25

All of our models are still outperforming the market by a wide margin for the 2007 calendar year even though the markets have degenerated significantly. On the other hand, if you have been paying close attention you know that we have given back all of the stellar gains from October and then some. Halifax and Bonavista under performed the market in November. Only the New

World model actually made additional gains since our September 30 reporting period.

You can clearly see that the market has given back a lot of the gains it had achieved through September 30th. A little over a week ago the S&P 500 was actually in negative territory for the year. Today it is up 4.44%. We actually see that gigantic volatility as a negative, and not necessarily a positive.

So, as of today Hatteras, Mendocino, Halifax and Bonavista are 10% long U.S. common stocks via indexing and they are 8% long the GLD (gold shares trust). The rest of the assets in all four of these models are temporarily in cash (money market).

In Fresnel we hold a position in GLD and call options on two equity indexes. In the New World we hold only the call options on the same two equity indexes. The index call options in Fresnel and The New World will rise in value during significant stock market rallies like the one that we saw last week. We see the options as a cheap way to capture some upside, as it becomes available, without risking much money if it the upside has no follow through, or a downside move resumes.

We also sold the last of some old stalwart funds held in several smaller accounts that don't fit into the models including Oakmark Equity Income Fund, Dodge and Cox Stock Fund, Dodge and Cox Balanced Fund, Hussman Strategic Growth Fund, Tweedy Browne Global Value Fund and the Matthews China Fund.

Please bear in mind that these sales were done with two things in mind. The first was our caution on the markets. But the second was more a housekeeping task. We still owned shares of several mutual funds that are now closed to new investors. That simply doesn't work for us. Given our model portfolio structure and clustering of similar account types, we need access to funds for all

accounts. As it stands now if we own a fund that is closed to new investors we have to find a fund to substitute for it when we take in a new client. Then we wind up with some clients in the old fund and some in the new one. That simply doesn't work in our management style. So now all the "closed" funds are gone.

We also sold out all shares of Matthews China Fund (MCHFX) except in our employee directed 401k plans. This was not done because we have lost faith with the fund or China's investment potential. It was done because we have long wanted to remove all mutual funds from our model accounts. Mutual funds are the perfect investment vehicle for our 401k clients, but they do not suit our trading style in the models. From here on we will be using individual stocks or Exchange Traded Funds (ETF) in the models, and not mutual funds.

It is interesting to note that even after the huge rally last week the cumulative value of all the stocks we have sold in the past month is still LOWER than it was when we sold them. In other words our models have benefited significantly by SELLING and cumulatively we haven't missed a thing, so far.

That brings me to the key point of all of this. Right now we are trying to preserve as much of our gains for 2007 as possible and our commanding lead on the market. I would consider it tragic to let it all disappear after 11 months of what is sometimes excruciatingly hard work accompanied by loads of tension.

One also has to keep these actions in the proper context. Our models are designed to be absolute return models. That simply means that we don't want the model portfolio values to dip into negative returns if we can avoid it. Therefore we always become net sellers as technical market conditions deteriorate, in order to prevent going into the red. Prior to late last week our short-term technical indicators were all flashing red.

One may ask why we didn't short the market, rather than raising cash. The answer to that question is simple. We did that in August and the Fed surprised us with an early rate cut. We got blown out of our short positions in the rally that followed the Fed announcement. Last week's rally was supposedly all about the prospects of a Fed rate cut after everyone interpreted two of the Fed's governors (including Bernanke) to have made very accommodative comments. So did the next "Fed rate cut" get priced in already? If so, what happens if they don't cut? I don't even want to think about it. Frankly, if they don't cut we believe the markets will take a big tumble downward.

The fact is that we have always believed they will cut. We have been very emphatic in all our newsletters over the past several weeks and months that they have no friggin' choice. They are trapped. We have not changed our opinion on that fact in the least.

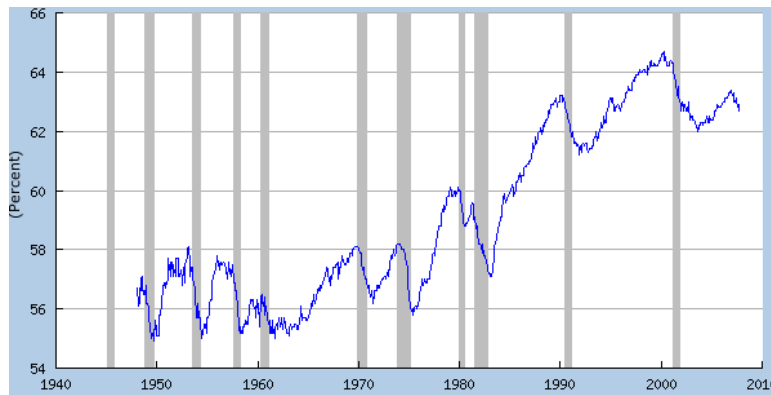
So what now; given that we are mostly in cash just as the markets are starting to rally?

It is still quite possible that the markets might experience a significant rally as we head toward the end of the year. If we start to get clear technical signals that indicate a short term floor has been laid in, we might be buying equities or options on equities to participate in the rally. In other words, we are leaving our options open.

After all, we have certainly proven ourselves to be nimble traders over the past three years. Our models have consistently beaten the markets during all market conditions in 2005, 2006 and 2007. Cumulatively all our models have beaten the markets since the end of 2001; when four of them were created.

But despite our willingness to be nimble and quick in attempts to gain performance our bullish conviction has certainly waned; at least for now. We have become much more concerned that the depth of the real estate recession and its impact on the total economy is not yet priced into the markets. We freely admit that we have "changed our minds" about the magnitude of the impact

this real estate downturn. But we have done so constructively. We simply have more data now than we did in the past.



We are well aware that the debate over whether we are headed into recession or not is inconclusive so far. We are also aware that more and more data is indicating that if we are not headed toward recession that we are certainly approaching something that looks a lot like one. This chart looks at the EM ratio as provided by the St. Louis Fed. We found it on

RealMoney.com, within an article contributed by Adam Oliensis.

Mr. Oliensis explains this chart for us: *“The gray highlights show us that every time the EM ratio has dropped by more than about 0.5 percentage points; the National Bureau of Economic Research has declared a recession. That’s every time (all 10 times) since World War II.*

The EM ratio is at 62.7%, down from a high of 63.4% in December '06. That's a drop of 0.7 percentage points, which is greater than the 0.5-percentage-point declines that have been associated with all the postwar recessions.

Of course it's always possible that this indicator, which has been 10-for-10, could be wrong this time and could end up 10-for-11 ... but that's the low-odds bet. The high-odds bet is that we either have a recession on the way or that we're already in the midst of one, and that the NBER will retroactively (long after the fact) declare it to have been one.

Now, why do I look at the EM ratio and not at the monthly payrolls numbers or the unemployment report? Those numbers are so full of adjustments, revisions and compensatory provisional assumptions that they are very poor measurements on which to base prognoses. But, on a related note, and more important, they don't express the kind of accuracy that the EM ratio does in correlating to important economic conditions.”

With more and more data points like this one appearing in our studies we are acting on the side of caution. Remember that we consider ourselves to be sitting in “the catbird seat”. All our models have good performance this year and in each case the absolute return we have generated would be considered good performance for any year. We have the luxury of performance to back up our caution at this point.

So here is the bottom line. We are sitting on tons of cash (your cash). If you are our client and invested in one of our models for the entire period of January 1, 2007 to November 28, 2007 your account is outperforming the market by a **BIG** margin. The same is true since inception of each of the models. So we encourage you to sit back, relax and stay tuned. We are going to see how things play out here a little bit before we take further action one way or another. We are not ready to throw in the towel entirely on the markets or the economy. But we are taking advantage of our ability to watch developments from the sidelines rather than be a potential victim of developments.

It is always interesting at times like this to step back and look at the very long term picture of the market. In fact it is extremely important when you are making decisions like we are right now.



The chart to the left shows the S&P 500 going all the way back to August 1982, the start date of the long term bull market we are still in to this day; at least by my reckoning. For the record, there are many money managers who would disagree with that interpretation. They would point out that this chart represents three bull markets, interrupted by two bear markets. They are right when considering the total time period cyclically. But I still consider this to be all one grand secular bull market move that has now lasted for 25 years.

When you look at the chart you can see that one prospect for the market is that we are putting in what is known as a "double top". We won't actually know that for a while, but if that is happening then we could eventually fall all the way back to about 1250 on the S&P 500 and still be within the long-term bullish super cycle that started in 1982. So not all is lost!

The only problem is that 1250 is a long way down from here. A break below that would end the super cycle bull. On the other hand, a break above the old high would clearly give an all clear for a new big leg upward.

We are still actually closer to the top of this cycle, at 1567, than the break down point of approximately 1250.



To the left is a shorter term view. This is the last leg of the bull market that kicked off in 2003. The trend is clearly not yet broken, but on an intraday basis it has been challenged a couple of times recently.

Finally I offer you the short term view of the S&P 500 pictured on the next page. The movements of the two indexes mirror one another. We are in the NO MAN'S LAND right now, or as some would call it, "a trading range". We clearly need a break below the bottom support line or above the top resistance line to give us a definitive clue to the markets next big trend. I can tell you two things for sure at this point. We are hoping for a break above resistance (the old high). But if the break comes on the downside we are LEAVING THE BUILDING. That means we will go to all cash and then begin initiating short positions.



All the best,

Paul Krsek
For K&A Asset Management, LLC

Note regarding performance calculations: The returns shown in this newsletter are simple annual returns for the 6 accounts used by the portfolio managers in their daily modeling and trading. All accounts within a model group are traded in blocks so as to keep each account as perfectly aligned with the model account for their group as possible. However, it is not always possible to have all accounts within a model group perfectly replicate the model accounts. The biggest potential for disparity arises when account owners add cash or withdraw cash from

their account. The returns shown in this newsletter are tracked daily by the portfolio managers, but they are not reconciled through the Centerpiece software system that generates our quarterly performance reports. Account holders should rely on their individual quarterly performance reports for an accurate representation of their Time Weighted Return. Returns shown in this newsletter and in individual quarterly performance reports are net of all management fees and trading costs.

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K&A manages accounts with various histories and investment objectives. Various accounts may be managed differently from time to time.

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.

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Sincerely,

Paul Krsek

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