



ILLUMINATION

August 14, 2007

MR. TOAD'S WILD RIDE

Mr. Toad's Wild Ride was removed from Disneyworld in 1998. I didn't realize until just recently that it had been moved to the New York Stock Exchange. But that must be the case given the unprecedented "wild ride" the stock market is taking us through during 2007.

I have been involved with the stock markets in one professional capacity or another all the way back to 1981. I have never seen market gyrations, on a daily basis, like we are currently experiencing. Mr. Toad had nothing on these markets. No one else can remember this kind of daily volatility either. It is all the talk on CNBC. There is very little doubt that much of the extreme daily volatility can be attributed to the excesses of hedge funds. They have become the tail that wags the dog. There is so much money available to hedge funds that they have become a huge factor in the market. They are all leveraged too and the leverage tends to magnify their moves on both the upside and the downside.



For example, Goldman Sachs Global Equity Opportunities Fund has declined 28 percent in value this month alone. Goldman operates two other funds that are also down for the year. They are North American Equity Opportunities and Global Alpha.

I don't know about you, but knowing that makes me feel even better about having my personal accounts invested in K&A's models.

I wouldn't care so much what the hedge funds do except for the fact that they impact what we do. When they take the markets down; or an individual stock down we have to contend with the consequences. There is no question in my mind that part of the reason our trading velocity has increased is the need to be defensive in response to the activity of hedge funds.

DEALING WITH THE HUGE SWINGS

We have long employed a policy of using stop-loss orders for stocks and mutual funds. Our guideline is simple. If we buy a stock or fund and it drops 9 percent in value from our original purchase price we are inclined to sell it. This is not a hard-and-fast policy. There have been times when we have treated a drop in prices as an opportunity to add to an allocation. But for the most part we stick to this guideline. We use stop-loss orders to protect the overall value of our client's accounts.

But from time to time, this is a tough policy to live with. In markets like we are experiencing now we can tend to get 'whip-sawed'. That means that we might sell a stock that has dropped 9 percent, or more, only to find it bouncing back violently the next day. We hate that, but we don't

really get too bent out of shape when it happens. We have learned that over time the 9 percent stop-loss is a good policy and we intend to keep using it

This all raises another issue for me. If the markets are truly “efficient” as some pundits claim, why are there such big swings in prices? The answer is simple. The markets aren’t efficient.

SO MUCH FOR EFFICIENT MARKETS

The fact is that I have never believed in the “efficient market hypothesis” or EMH, for short. According to the EMH stocks always trade at their [fair value](#) on stock exchanges, and thus it is impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices.

There is much more to the theory than this brief explanation. In fact EMH also holds that it is impossible to “beat the market”, but the basic tenet is that all stocks trade “efficiently” at all times, at fair value, based on all known information and therefore pricing is unbiased in the sense that prices reflect the collective beliefs of all investors about future prospects of a stock.

That is crap. How can the market be “efficient” when Hansen Natural (HANS), for example, trades at \$41.78 one day and over 17 percent higher the next? Was the value of HANS really 17 percent less 24 hours ago? Was there really that much new information that came to market today to make the company worth 17 percent more? The answer is no.

How about Perini (PCR)? Check out this one-month chart. PCR has fluctuated between \$75 and \$47.50 in one month. Tuesday it closed at \$50.39. Wednesday morning it opened at \$61.65 and closed the day at \$51.10. On Thursday morning it was at \$48.22. Does that action represent an efficient market; not a chance?



Model	YTD Simple Return	These are just two of hundreds of examples of stocks and major market averages swinging up and down on a wild ride that is being driven by overwhelming liquidity and trading action. BIG investors are moving in and out of stocks on a daily basis and moving prices as much in 24 hours as might otherwise be expected over the course of a year or two.
Fresnel	13.19	If the markets were truly efficient then HANS might be expected to move up 3 to 5 percent on a great earnings announcement. To move up 17 percent in a few minutes is frankly ridiculous. But that is the market that we have to deal with today. We don’t make the markets. We simply have to do the best job we can in the market environment as it exists.
Halifax	9.92	
The New World	9.72	
Bonavista	5.74	
Mendocino	5.61	
Hatteras	3.93	
S&P 500	2.61	

So far we feel we are doing that again in 2007. As of Friday, August 10, 2007 all six of our model accounts were still outperforming the S&P 500 for the year. We can’t say that the volatility in the models has been low. It hasn’t. But we are keeping ahead of the markets, and we are sure as heck keeping ahead of Goldman’s hedge funds.

Lee and I were comparing notes on the markets early this morning and here are the comments that we wrote to each other after doing our independent reading through the weekend. They are not edited.

Me to Lee:

1) I do not know if we will test Dow 12,700 again, but I believe we will.

2) The test will probably come around a hedge-fund shock that is currently unknown-and-to-be-announced.

3) The consensus seems to be that oil prices are 20-25 percent too high than supply-demand would dictate. The rest is hedge fund speculation. I don't know if I agree with that, but it seems plausible to me. All our oil stocks are gone from VE models. That is certainly not a good sign. I suspect oil prices will stay above \$68 until we get an all clear on hurricane season. Then they will start to move back down. Lot's of smart people expect \$50 to \$60 to be the new floor. We shall see. It would probably be wise to lighten up soon. I am thinking of cutting COP from the models. All the others are smaller cap and potentially take over candidates.



4) STLD is the best "value stock" we follow. Based on Mark Thomas's enterprise value formula it is a SCREAMING buy.

5) I want to add more TASR back to Fresnel on any new weakness.

6) GLW should be added to TNW.

7) The guys at stocks under \$10 are pounding the table for XOMA. It is a \$2 bio tech. Maybe for TNW.

8) Fresnel didn't have any money on Friday and is the only model that didn't get into the EMC trade. I am wondering if it is too late.

9) The best "hedging" trade we could probably make right now are adding to our Yen position.

10) Gold seems to be setting up for another move up.

Lee to me:

I'm VERY bullish on the global economy

I'm bullish on the US economy.

I think the market hasn't really corrected – it'll sit here for a while and then go lower in one more move through 13,000

The recent rally is a Fed instigated fraud.

Housing still has a lot further to go as all these reduced prices are going to be met by longer escrows as borrowers find it harder to get approved.

You can't bottom fish at what is essentially a market high!

Our buying must be concentrated in the international companies we like. Being cute and trying to pick off brokers is to risky/early right now. We should look for LARGE tech companies also.

I think oil still holds a wonderful terrorism option value but worry that the liquidity it provides might make it vulnerable to a hedge fund unwind.

Gold looks great. I don't think the "hedgies" are really holding it.

HOW IS THAT FOR CANDOR?

The bottom line is that we are very bullish on the global markets. We are not expecting a recession in the U.S. But we think this correction may have another 3 to 4 percent downside before it is over.

We will keep you posted.

All the best,

Paul Krsek
For K&A Asset Management, LLC

Disclosure and Disclaimer: (Updated August 13, 2007)

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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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