



ELLUMINATION

September 30, 2007

RECESSION, DEPRESSION, OR GLOBAL BOOM AHEAD

On any given day I can find maddeningly different opinions about where the markets and the economy are heading. One author might be emphatically predicting a recession to be right around the corner. Another is declaring that we should hunker down and get ready for the next great depression. A third is just as confident that we are about to embark on the next leg up of the great global economic boom.

One strategist can be telling me to buy gold while another is telling me to sell it. Even our two quantitative research services often don't agree. One says that the price of Apple stock should be \$169 per share one year from now. The second one predicts \$128. One says that Google stock should be \$605 in a year. The other forecasts \$528.

I just shake my head as I see and hear all this conflicting opinion. I laugh to myself and move on, because at K&A we have become very good at sorting through lots of "noise" to find our way to successful investments. That is what we are all about.

I learned a long time ago that we can't influence where the economy is headed, therefore I don't spend a lot of time fretting about potential economic consequences of higher inflation, a falling dollar, or the prospects for recession for that matter. I do spend a lot of time understanding the probability of those things actually happening and how to make money if they do happen. I spend even more time studying how to make money NOW, given whatever is happening. Making money NOW cures a lot of portfolio ills when you can't be making money.

When I can't figure out how to make money, I start thinking about how to protect it, until opportunities emerge to make money again.

The bottom line is that we have become very agnostic at K&A. We are not being paid to predict prosperity, doom or gloom. We are being paid to figure out how to make money in as many economic environments as we can, and to protect investor assets when we can't.

CLOSING OUT A CRAZY 3RD QUARTER

During the quarter just finished we were confronted with predictions of all of the above—recession, depression, and global boom. We were confronted with huge market volatility and the near melt down of the markets in mid-August. We watched the Fed ride to the rescue of the markets twice.

Through it all we tried to stay calm, focused and true to the investment disciplines we have employed successfully in the past. We employed trading tactics that we know work extremely well to protect capital when we needed to be defensive. We switched our tactics when the Fed intervened and went back on the offensive. The bottom line is that it all worked just as scripted and we are delighted with the quarterly returns in all six of our investment models.

Before I show you the numbers I will comment that it was a crazy quarter, during which Meghan and I took a trip to Peru, Ecuador, and the Galapagos Islands. We left on July 13th. During the few days prior to the trip Lee, Rob and I had several talks about my gut feeling that we should just sell

everything and go to cash in the models. Well, we didn't do that. Guess what; the market collapsed while we were gone and if the Fed hadn't ridden to the rescue, and if Lee hadn't been a very astute trader it could have gotten much worse.

Well a funny thing happened on the way to the end of this quarter. It took us until two days ago to get five of the six model portfolios back to the same values they were on July 13th. The great news is that we did it. Sorry about the 6th. The New World model is still a little lower in value than it was in July. Let's just say that it has been a lot of work taking the same ground all over again. But we did it very successfully and we outperformed the market—across the board. Six for six is how we see it—The New World included. We are very pleased.

Model or Index	Jan1-Sept30 Return
Hatteras	10.86%
Mendocino	13.29%
Halifax	17.00%
Bonavista	12.02%
Fresnel	19.06%
The New World	15.72%
S&P 500	7.69%
Lehman	
Aggregate Bond	3.90%

Here are the Simple Annual Returns for the six accounts that we manage as “the models”. We are still in the process of preparing the Time Weighted Returns for the entire population of investment accounts that we manage. Performance reports will be emailed or mailed to clients who qualify to receive them during the month of October.

ON TO THE 4TH QUARTER

We head into the 4th quarter with several facts and opinions based on those facts guiding us:

1) The U.S. economy is clearly weakening, but we still don't believe that we will see a recession in the U.S. during 2008. Right now we believe that growth in the U.S. could slow to between 1 and 2 percent next year.



Clients; remember one very important thing about this “opinion based on fact”—if the economy continues to weaken, we will continue to adjust based on what actually happens.

2) The downturn in residential real estate is OBVIOUSLY a real drag on the economy and the current real estate recession is likely to take years to work through.

3) We told you in “**Don't Fight the Fed**”, on August 30th, that real estate can recede and stocks can still advance. That is what happened during the last big down turn in real estate from 1989-1995.

Here is a chart that we featured in that newsletter, dated August 30, 2007, that shows the S&P 500 more than doubling in value from 1989-1995 while real estate was in the DUMPS.

We honestly don't know if that will happen again, but we point this out for what might be the obvious reason. It drives me CRAZY when I hear people saying, “We have never had a real estate downturn without a recession.” That is NOT TRUE.

We had a major real estate downturn in the 60's without a corresponding economic recession. The "recession" of the early 90's was so short in duration it barely existed as technically defined. The real estate market stunk for almost 6 years and the rest of the world, economy, and investment community went on just fine.

So don't get too caught up in the doom and gloom predictions that couple "real estate downturns" with "recessions" and "collapses" in the stock market. The relationship simply isn't necessarily that direct.

4) If you think that the Fed won't cut interest rates again this year, you aren't paying attention. **They will.** They are likely to cut another 50 basis points before the year ends. If we are wrong about that it will be because they cut more, not less.

5) The trend of the dollar is down. We have been telling you that for years.

6) The trend of gold and other commodities is up. We own gold and commodity related stocks in 5 of the 6 models.

7) The trend of oil prices is up. Don't get confused the next time prices dip. It will be temporary. The trend hasn't changed. We own oil related stocks in 5 of the 6 models.

8) The only thing that could change the trend of oil prices is that economies around the world get much more serious about alternative energy, much faster. Don't count on alternative energy taking the pressure off oil prices for years to come. Alternative energy and "going green" are the "next big things" but it will take years, if not decades to make these transitions meaningful. Our New World model is benefiting from this ongoing process.

9) China will continue to grow faster than the U.S. and much of the rest of the world for years to come. We own "China" in 6 of 6 models.

10) The global growth theme is intact and has years to run. We are bullish for the long term.

11) If we are worried about anything, and we always are, it would be "stagflation". Inflation is loose in the economy. We have made it very clear that you can't trust government statistics related to inflation. REAL inflation is currently in excess of 6 percent per annum. Real economic growth rates are slowing. That is a formula for "stagflation".

12) We are obviously looking to own stocks of companies that can thrive while conditions that are described above prevail.

13) It will not be a dull quarter, without surprises or challenges!

14) We are headed into the 4th quarter of 2007 believing that the investments currently held in our various models will be worth more at the end of 2007 than they are today.

All the best,

Paul Krsek
For K&A Asset Management, LLC

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

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

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-llumination 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 Andrae 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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