



ELLUMINATION

February 22, 2008

TODAY'S MARKET ACTION DEMANDS A NEWSLETTER

How often have you heard the expression "If you blink you could miss it?" That sure applied to the U.S. stock market today. A story came across the tape late this afternoon that a bailout of municipal bond insurer AMBAC was in the works and that it would be announced by Monday.



The markets had been down all day but on that rumor they took off and never looked back. Usually I would scoff at a market move of this magnitude based upon a rumor like this one. But I have to admit that I was relieved to see this happen. The markets have been getting uglier and uglier. It would be great to see a truly constructive solution to AMBAC's problems. It would go a long way toward soothing these markets for more than one day.

There has been some debate on Wall Street as to whether or not we even need muni-bond insurers. But that isn't the appropriate debate right now. The fact is that huge segments of the muni-bond market are absolutely locked down right now. You can't even get bids on certain bonds if you try to sell them and auctions for new bonds are failing regularly.

We could devote an entire newsletter to the workings (or failures) of the current muni-bond market, but we

won't. Instead, let me make a statement that you will instinctively find to be truthful. That is, our national economy, public and private, can't thrive without the free flow of credit. We are simply too debt laden as a nation and a society to be able to keep the economy thriving without extreme liquidity and easy access to credit.

Before anyone jumps on me because you mistakenly interpret that comment as political or judgmental—forget it. This is just plain fact. In the U.S. the game is really quite simple; credit must keep revolving. Our appetite for credit is GARGANTUAN. If it suddenly becomes unavailable the whole economy could spiral downward. Cities, counties, states and the U.S. government are BROKE and they all need to issue bonds regularly and frequently to keep the economic music playing.

The market reacted to news, or rumor, this afternoon that one of the biggest muni-bond insurers might find a way to improve its capital base, keep its AAA credit rating and avoid a complete meltdown. Let's hope there is some fact behind this story, because if there isn't the markets will immediately be in trouble again next week.

Reality is that the U.S. stock market was headed toward a very ugly close today and it was saved by CNBC breaking this story. We shall see if 20 minutes of momentum on a Friday afternoon can hold up to the economic news that will break next week.

NOW FOR SOME REALLY GOOD NEWS

A half hour before the close today, with the markets all in the tank, the K&A model portfolios were all UP for the day. After the market close, with rally included, five of the six models closed up on the day. Only The New World closed down slightly.

Year to date five of the six models are UP for the year. Only The New World is down slightly for 2008.



So how could the models be up when the market was down, and yet still be up (save one) when the market was up too? How can five of six models be up for the year when the markets have been trashed? The answer to those questions is simple; good asset selection and good HEDGING! K&A's portfolio managers have been extremely busy since we went to cash in November.

As of tonight all the models are partially allocated to ownership of individual stocks. Those stocks vary model to model but we have been building back positions since January 8th. As of tonight all of the models are short three stock indexes.

Let me interpret that for you. We have been buying individual stocks as prices drop to levels that we think makes them good buys. The overwhelming majority of

those purchases are profitable as I am writing this letter despite the fact that the overall market keeps dropping.

On the other hand, we have very little faith in the overall markets so we are also shorting the DJIA, the S&P 500 and the Russell 2000 indexes. That means the models profit as these indexes fall. The funny thing is that as I write this, most of those trades are profitable too.

The strategy here is simple. We believe that we are pretty good stock pickers and that even within this bear market we can find individual stocks that will be winners. That has turned out to be the case so far. On the other hand, we know of no reason why we shouldn't try to profit from the markets going down too—thus the shorts on the major indexes. This combination of longs and shorts is also acting to dampen volatility in the models. What does that mean? REMEMBER THIS—we were up today when the market was down. That is "dampening volatility."

Now for an important qualifier—not every stock purchase is profitable, but most are, and none are anywhere near being stopped out. I repeat that five of the six models are profitable for the year. Needless to say we intend to get to six of six very soon.

The overwhelming majority of the stocks we are buying are those of U.S. companies. We have purchased shares of two Chinese companies, but that is the only international diversification we have introduced back to the models since going to cash in November.

We have our eyes on Brazil and Russia and we currently anticipate that they will be the first foreign markets that we add back in size.

WHAT ELSE HAVE WE BEEN DOING?

We did an about face on oil this week. We established a short position in the 5 models that can participate in the oil markets. That is a bet that oil prices will be declining. Oil broke above \$100 this week, and then backed down. We believe that oil prices are likely to trade back down to the bottom of their recent range. That is \$88-\$93 per barrel. We also believe that natural gas prices have room to fall in the short run. If these things actually happen we want the models to profit from the fall in prices. The probability is that this will be a very short term trade. The long term trend of oil and gas prices is still UPWARD. But the very short term trend is likely downward. Why not profit from both trends?



Here is a chart of recent price action of oil. We believe that Q2 of 2008 will be the weakest quarter this year for oil prices and that they will retreat back to the bottom of this trading range. The long term direction is still up and we could easily see \$110 to \$120 per barrel for oil in 2009 and beyond. Natural gas prices will inevitably break out of their trading range too—to the upside.

Despite our short term view that oil and gas prices will decline we are currently holding on to all oil and gas related stocks in the models. We are profitable in all of them and none are likely to be stopped out even if oil and gas make the short term move we are expecting.

SHORT THE EURO

Any American who has traveled to Europe lately knows that the dollar has been crushed and the Euro is at or near all time highs right now. That relationship is not likely to hold. We believe that the top is in for the Euro and that it is likely to trend down relative to the dollar for the next year or two. A move from 150 back down into the 130-140 range would not surprise us. We are short the Euro as of this week in Hatteras and Fresnel. They are the only two models eligible for this trade.

WE ARE STILL LONG GOLD

We really don't think we need to say much more about this trade. When we say to our clients that we (they) are long gold and have been since \$400 per ounce they tend to nod knowingly and smile. When we say that we are long gold to people who are not our clients the response we tend to get is, "Really?" When the folks who are not K&A clients start to say, "Oh yea, me too", then we will finally be sellers and walk away from this trade permanently. Not before.

WHY IS THE NEW WORLD MODEL DOWN (slightly) WHILE THE OTHERS ARE UP?

The New World enjoyed our best return in 2007. It is down slightly so far in 2008 because we have not been strictly enforcing our 9% stop loss policy on a few stocks. They all represent companies that are in early stages of growth and development and we have decided to give them a little more room to run. That has added some downside volatility to the model in the short run. But we anticipate that these companies will be real winners in the long run and we simply don't want to keep getting stopped out of them, only to have to keep buying them back. We have no intention of abandoning them, unless they would disappoint us from an operational point of view. To date, they have not done that.

THOUGHTS FOR OUR "401K" CLIENTS

I have been writing these letters for years with no attention being paid to our clients who are buying shares of select mutual funds through 401k plans at work. I apologize and am rectifying that oversight right now.

You know who you are and you know how good your plans are. KEEP funding them. What you are doing is entirely different from what we are doing in the models but it is paying off for you. How many 401k plans do you know of that beat the S&P 500 every year? You know yours does. Keep it up. Dollar cost averaging every payroll period works magic when it comes to compounding.

FINAL THOUGHTS FOR THE DAY

We see ourselves as good long term strategists, but we may be even better short term tacticians; at least most of the time.

We are in full court tactical press right now, trying to make money for our clients in the craziest markets we can remember. The trades we are making all seem to us to have a low probability of failure and a high probability of success. We make that judgment using quantitative, technical and market sentiment analysis. Those tools do not allow us to produce perfect results. We all know that, right? But so far 2008 is shaping up just great for the models and our strategic and tactical methodology is working absolutely according to plan.

We won't report actual performance again until the end of the quarter. But 5 of 6 models are up (from .01% to 2.75%. The New World is down, a little over 1%. The S&P 500 is down a whopping 7.83%, and the U.S. stock market is off to its worst start in decades. The Lehman Aggregate Bond Index is up .81%.

The year is very young and there is a long way to go so final judgment on our performance and the market's is still out. But so far we are executing well on the promise to make money in almost any market environment. And that takes me to my final thought for the day.

There is a very famous guy on CNBC. Jim Cramer is his name and his nightly show is "*Mad Money*". His claim to fame is that "*there is always a bull market somewhere and I will help you find it.*" Every night on "*Mad Money*" he dispenses wisdom to the masses. He yells. He screams. He makes the choice between "Buy, Buy, Buy" and "Sell, Sell, Sell" for stocks. He touts his service called "Action Alert Plus" which is an actual portfolio of stocks that he owns for his charitable remainder trust. You can subscribe to his "Action Alert Plus" newsletter and get all his trading signals and mimic his trades. I have been a subscriber since the beginning; as I am for a whole host of newsletters; too many in fact.

From January 1st through tonight his "Action Alert Plus" portfolio is down 7.38% for the year. That number is taken directly from his performance table on his website at 9:25 p.m. tonight for anyone who wants to know. Hey what can I say, he is on TV and we are not? But then again, we are making money and he is not. Go figure.

Sleep tight. Have a good weekend. Next week will surely bring some more rock and roll to the markets.

All the best,

Paul Krsek

For K&A Asset Management, LLC

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Effective February 1, 2008 Lee O'Dwyer has started to edit some portions of Ellumination. He also works closely with Krsek in the formation of investment policy so his influence is felt in the content of Ellumination.

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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>.

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. Krsek and O'Dwyer are striving to reach a point in the management of the portfolios where they are likely to share more equal authority over the models. O'Dwyer has proven to be an excellent addition to the management team and is already having significant influence over the models.

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.

Much of the content of Ellumination does not apply to K&A clients who are not invested through the models.

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

Updated: February 3, 2008

