



ELLUMINATION

APRIL 24, 2008

Trading With Conviction or Throwing Darts?

It is clear that we are struggling with these markets, just as the markets are struggling with themselves. As of this writing only Fresnel and Pt. Reyes have anything near the kind of performance we are happy with. Bonavista and The New World have really taken in on the chin and the rest of the models are toughing it out in negative territory. We can easily second guess ourselves on every trade and we have been doing so. We can easily say that it would have been better to stay in cash rather than working our way back into the markets. We can easily do a "shoulda, woulda, coulda" replay every afternoon and we have been doing so!

The past two days have been particularly rough on us and on the models because "fast money" is flowing out of commodity related investments. Oil and gas related stocks were crushed yesterday and again today. We are overweight oil and gas. Gold has been in a significant downtrend for the past several days. We have a 4-5% weighting in gold. The steel, aluminum, materials and agricultural related stocks have been taken out and shot. We are overweight all of them. We have been answering a lot of questions, particularly from newer clients who aren't really used to us and are nervous about what they see.

Our problems in some of the models have been compounded by the fact that we took positions in several tech stocks too early. We bought the likes of AMAT, DELL, MSFT, ORCL and others and got stopped out, only to see all of them recover. The fact is that we like "tech" a lot in here and it is very unfortunate that we were early and stopped out. It is turning out that we were right about the trend, just wrong (at least the first time) in our timing. For the record we bought back MSFT yesterday and we also added AAPL back to the models. One day doesn't make a trend, but those trades are already quite profitable.

We love Apple (AAPL) and we were only waiting to get some confirmation on business trends there before wading back in. Their earnings report confirmed our suspicions that business is actually very good. Microsoft reports tonight.

Aaron Task, reporting for RealMoney.com said today, *"A funny thing is happening amid all the recession talk: Most big tech companies are reporting spectacular earnings and revenue growth, especially those with significant overseas business."*

"There's no economic slowdown that's affecting most tech companies," says David Kirkpatrick, senior editor of Internet and technology at Fortune. *"Tech stocks are down because the conventional wisdom is 'we're in a recession or heading into one' -- but that's clearly wrong for most tech companies [which] are powering ahead."*

There have been other trades in 2008 that haven't worked either, but several that have. The sum of it all is that we are down with the markets, just not so much as the markets, except in The New World. We reiterate that Pt. Reyes is up for the year, and Fresnel is off "a touch".

We have several very clear and very specific messages to our clients about all of this.

The portfolio of assets that we currently hold for Fresnel, Hatteras, Halifax, Bonavista and Mendocino are all overweight stocks and ETF's that are weighted toward energy (oil and gas), agricultural commodities, steel, aluminum and materials related stocks. **We intend for them to stay that way. We are not panicking in the face of this temporary dislocation and sell off.** We are delighted that the "fast money" has temporarily exited the scene. For now we are left with the field for ourselves and others who believe like we do that all of these markets are in long term bullish trends and that prices will be rising, not falling, for years to come. We also know that the "fast money" will be back, and when it does these stocks will shoot back up as fast as they have shot down in the past few days. The way things go in these markets that could easily happen on MONDAY!

CIBC World Markets strategist Jeff Rubin came out today with a report that projects targets for oil prices to be \$150 per barrel by 2010 and \$225 by 2012. We have no problems with those targets. It would not surprise us to see natural gas prices up another 10-20% by the end of 2008, from present levels. THERE IS NO BEAR MARKET IN OIL AND GAS.

Marketwatch.com reported today that, *"CIBC based its prediction on an analysis of crude-production estimates by the International Energy Agency, which the investment bank says has overstated supplies because the agency counts natural-gas liquids as part of the output. Stripping out natural-gas liquids, the global oil market is much tighter, and oil production will hardly grow, they added.*

"While natural-gas liquids only account for 10% of total supply, they account for virtually all of the increase in petroleum-liquids production since 2005," according to Rubin.

"Stripping out natural-gas liquids, oil production has not grown for over two years, which certainly goes a long way to explaining why oil prices have doubled over that period," he said in the statement.

At the same time, there is little evidence to suggest that there will be any reduction in oil demand, CIBC predicted, as demand growth outside the Organization of Economic Cooperation and Development offsets slowing demand in OECD countries.

Countries such as Brazil, China and Russia have seen surging demand for automobiles, while car sales in the United States and Europe have been declining or flat. Gasoline, diesel and other transportation fuels account for about half of the world's oil consumption.

The portion of natural-gas liquids in total oil production is increasing, from about 4% in the 1970s to an estimated 10% by 2012, CIBC said. Natural-gas liquids are not a viable substitute for oil and cannot be economically used as a basis for gasoline, diesel or jet fuel."

Gold is getting crushed today. It has dropped from \$1000 to \$883 over the past several weeks. The public and much of the investing community have avoided gold all the way up from around \$400 when we started buying it. Corrections in gold are violent. That hasn't changed. We are getting closer to a point at which we will be buying more gold than we are to a point at which we will stop out and exit the

gold market. Newmont Mining (NEM) reported earnings today and knocked the cover off the ball. I just listened to a report by their CEO in which he is calling for prices in excess of \$1100 per ounce in 2009. For the record, CEO'S of gold companies are NOTORIOUSLY conservative in forecasting gold prices. Mining production has declined around the world for three years in a row and demand has done nothing but increase.

The broad U.S. and global stock markets have been trading in a range for months now, following their big swoon in the fall of 2007. The range is broad. As measured by the DJIA the range has been approximately 1000 points. See the chart to the left. The bottom of the range is about 11750 and the top of the range has been about 12750. If we used the S&P 500 the range has been about 100-110 points. We have simply not known which way the range would break. Could it be to the downside? If so that would be very ugly because there is very little support below 11750 on the DJIA and 1275 on the S&P 500. We believe the markets would continue to drop another 8 to 15% should that happen. That is why we have been very defensive and have shorted the indexes several times as we approach the bottom of this range. We have seen this shorting activity as "insurance" against a total debacle in the markets.



But, we are now more than half way through the current earnings reporting season and the debacle has not happened. Frankly we don't expect it to now. Our view of the markets has really changed in the past two weeks. Why? Because overall earnings have been very good! So far earnings for the S&P 500 companies are down 24% year over year from this same period last year. That sounds awful. But if you strip out the earnings related to financial stocks, the rest of the companies are actually UP 7.5% from last year. Folks, that is not what happens in big recessions. The point is that most of the earnings destruction really has been contained in the financial sector. OK, not exclusively. WE KNOW THAT. (Think Starbucks) But containment of the bad news to the financial sector has been the overwhelming trend. We couldn't have told you that six months ago, or three months ago. It is only being revealed right now.



We showed you a chart of the DJIA to show you the recent trends, and we most often use charts of the S&P 500. We used the DJIA today only because we believe it is now leading the market to the upside, along with the Dow Jones Transportation Average. Both have broken to the upside—not the downside. So has the NASDAQ COMPOSITE, as of today. Our "target" number, for an upside breakout on the S&P 500 is 1395 and it is at 1394 as I am drafting this letter. We now believe that will happen. If it does we will have "confirmation" by four of the major U.S. stock average that an upward trend has been reestablished. That is happening for "fundamental" reasons. Earnings are simply not bad!

We have made the point several times in previous newsletters that we are giving the FED a 10 for their

performance during this crisis. We have explained that they have had lots of help from central banks around the world.

There has been much complaining and moaning about the decline of the U.S. dollar—never from us. The declining dollar has been an earnings tonic for big multinational U.S. based companies. Earnings are proving that out.

The dollar is rallying today and the folks at CNBC are declaring the dollar bear market to be over. How many times have we told you—it isn't over!

The bottom line is that all the models, with the possible exception of The New World are set up to benefit from the dominant trends impacting the financial markets. We intend to continue to position them to be in better shape before any real breakout in equity prices takes place.

We have warned before that once we were out of the markets it would not be easy to get back in. We have said to many people, verbally and in writing, that the markets would inflict maximum pain upon reentry. Frankly we feel we have done an excellent job of avoiding maximum pain for all our clients. But if you have been with us for only 7-9 weeks it may not seem that way to you.

At this point we would refer everyone to the movie 9 ½ weeks. Nothing that “lasts” can be judged by 7 weeks, or 9 ½ weeks for that matter.

The next paragraph was the original opening paragraph of this newsletter. I will now use it to wind this newsletter to a close.

“Did I tell you that these are the toughest markets I can ever remember? Yes, I am sure that I did. In fact I have told you several times. Did I also mention that these are the most extraordinarily and sometimes surprising markets I can ever remember? If I didn't, I am telling you now. I am sure I have told you that the current credit crisis is of sufficient magnitude that if left to take its own course could cause another Great Depression. That is no exaggeration.”

That is the truth of it. There is no question in my mind about that statement. The good news is that this crisis has not been left to take its own course and it is being brought to a successful resolution long before any of us had any right to expect. That is the real surprise here. Thanks, FED. Thanks, Treasury Department. Thanks, European Central Bank. Thanks, Bank of Japan. Thanks sovereign funds around the world. Thanks emerging economies.

The odds seemed to be stacked against the resolution we are getting. The short trades that we put on that have not worked, should have. They were protection against a calamity. I am absolutely delighted they didn't work.

We reiterate what we told you in our SPECIAL REPORT dated April 2, 2008:

“We see all of these things as being good. Volatility will not disappear from the markets, but we believe there is a very strong chance that the worst volatility is behind us, at least related to the credit crisis. As of this writing we have no short positions in the portfolios. We are noticing stocks and indices starting to show some positive characteristics. We reiterate that we strongly believe that the Fed and the Treasury have averted a major market meltdown.”

My best advice to our clients and friends at this point is to sit back and relax. At K&A we are turning our focus back to longer term trends and less to feeling like every day is an emergency. We believe that we can see the trends that are emerging and intend to take advantage of them.

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 ELLUMINATION 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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