



How will we get back into the market?

Lee and I have taken the models out of the market a few times over the past twelve months, only to get back in too soon and live to regret it. We last exited the market in mid-September, which feels like eons ago at this point. That decision has turned out to be the best defensive move we have ever made. We all know that the markets cascaded downward right after we got out. While we have not made any money in any of the models year-to-date, our “relative” performance now looks stellar. Our losses are minor enough for those who have been in the models for the entire year that we are still hopeful we can finish the year profitably for the period starting January 1 through December 31, 2008. That is the objective.

It all begs the obvious questions. When do we go back in? Do we reenter on the short side, or do we buy and go long? How will we know it is safe this time? Let me state the obvious first, there is no assurance that it will be safe. But we think we have identified four optional strategies, all of which significantly reduce risk, and provide solid opportunities to profit from any year end rallies.

We also believe it is too late to short this market. Talking heads and research services galore have made calling a bottom the parlor game of the year. We don't know if we have seen the bottom yet, but it is way too late to try to make money shorting the market in what remains of 2008. It is also very wrong seasonally. Frankly we were quite unsuccessful shorting the market this year anyway. It is astounding given what has happened, but we are clearly not alone. We know of lots of managers who are in the same boat, having spent a very frustrating spring and/or summer trying to trade around the constant interference of the PPT. We have written extensively about this in past newsletters.

So let me offer you the four strategies that we see as our options at this point and let me rank them in the order that we think is most likely to happen.

UNCHARTED WATERS (ALMOST)

During the past century, there was only one other time when stocks lost 6.5% or more three times within one month - November 1929.



Option #1 (most probable and least problematic and least risky)

We continue to wait in cash for a bottom that is several percent below current market levels. There is not much history to guide us right now as to where the bottom is. We are in pretty uncharted waters. But there are two historical precedents that offer some clues as to what might happen next.

SentimenTrader.com reports that there has been only ONE other time in history that stocks lost 6.5% or more three times, in daily moves, within one month. That was in November of 1929. Yesterday was the third time this happened during THIS month in 2008. Back in 1929 the market rallied 2.6% the day after the last big drop. **That would be the**

equivalent of today. The market rallied hard today and we anticipated that. We entered today thinking that it would, if for no other reason than conditions relating to options expiration today. So the set up is perfect. We had the repeat of the one day rally, just like back in 1929. What will tomorrow bring? After the one day rally back in 1929, the market proceeded to drop another frightening 17% over the next four days.

If the market were to act exactly the same way this time we would close today above 8800 on the DJIA and 932 on the S&P 500. Then we would cascade down to roughly 7450 on the DJIA and 784 on the S&P 500. Those numbers look frightening, but this is how things would look if "history repeats itself".

Given that there is only one historic precedent for today's market condition we have an extremely limited sample as our guide. Therefore we are also looking at the 1972-1974 bear market as a possible guide. It was the only other bear market that we have had, other than our 1929 example that is similar in scope to what we are experiencing now.



This is a chart of the S&P 500 back in the 1970's (white line), with the current S&P 500 (yellow line) laid over. This chart begins at the end of 1971 and you can see the market rising right to the end of 1972. It rolls over into 1973 and continues to cascade down right through September of 1974 where it finally finds a bottom (white line). Our current S&P 500 (yellow line) was moving up in 2007 (equivalent of 1972 on this chart). It peaked in November of 2007, retreated into the end of last year, bounced again in early 2008 and has cascade down right through 2008. The magnitude of the rise in 2007 matched almost precisely the market rise in 1972 and the tumble in 2008 has almost matched the fall in 1973, except that we have collapsed faster this year than in 1974.

You can see the white line (1970s) continuing to move down from March 1974 through September of 1974 and finally making a bottom. Our current market has dropped almost as much in the past two weeks as it took the 1970s market to move over 6 months in 1974. If history was to repeat itself the current market has to fall to a close of 8000 on the DJIA and 850 on the S&P 500 to match the magnitude of the 1973-74 collapse.

	<i>Collapse projected by 1929 comparison</i>	<i>Collapse projected by 1973-74 comparison</i>
<i>DJIA</i>	<i>7450</i>	<i>8000</i>
<i>S&P 500</i>	<i>785</i>	<i>850</i>

We are therefore enticingly close to a bottom that would compare to the 1973-74 bear market. We have quite a way to go to get to a bottom comparable to the 1929 crash.

We see both of these potential downside targets as chances to “back up the truck” and buy equities. We could start buying at 8000 on the DJIA, for example, and continue to buy down to the 7450 area. Scaling in would allow us to prevent the stopping out of any positions due to our 9% stop loss policy. Buy the time we got down to the 7450 area we would most likely be buying aggressively. We would anticipate that a good solid bottom was in from which we could rally nicely.

If nothing else we could be confident that the “bottoms” we are calling for here match the worst case scenarios that history has to offer.

We could see ourselves moving into a 100% invested position in this scenario.

We will know quickly whether or not this option can really materialize. If the market tumbles tomorrow this option is in play. Friday's have been scary days for the markets lately. No one wants to go into the weekend holding stocks. We shall see.

Option # 2 (next most probable)

We are putting in a bottom right here and now and the INTRADAY lows from last Friday hold. The markets remain volatile, with swings that could average 3 to 5%DAILY for the next two to four weeks while the market forms at least a small base. Those lows are 7773 on the DJIA and 839 on the S&P 500. We can start building positions as the market retreats toward those lows. Note that they are both below the 1973-1974 projections, and therefore probably relatively safe entry points. The 1929 comparables are roughly 6 to 7% below Friday's closing lows. So if we start buying at the equivalent of those points we would not be stopped out of the market, given K&A stop loss policies, even if we tumble all the way to the 1929 equivalents.

We would build positions slowly each time we approach the bottom of the range, 8000-7773 on the DJIA and 850-839 on the S&P 500.

We could see ourselves moving into a 50% invested position in this scenario.

Option #3 (least likely and potentially most tricky)

Frankly we would love to see option #1 happen. We would take option #2, but we may be faced with option #3. That is, that THE BOTTOM IS IN. It happened on Friday and we are moving up from here. This one is the most tricky for us because this trend will not be instantly recognizable. We will be agonizing as the market moves up that WE MISSED THE BOTTOM. So how will we do it?



First we will have to start to see a pattern in the market called, “higher highs and higher lows”

It looks like this.

We will have to find stocks that meet our technical criteria in an advancing market. WE HAVE MADE OUR LIST.

We will have to average into each position very carefully counting on the normal seasonal trend for November and December, which is up.

It is likely that we would not exceed 40% exposure to equities in this scenario and we would most likely do a lot of hedging as we go.

The options markets are still forecasting very high volatility over the next several weeks. So daily swings in the markets are likely to remain wide.

We will not be disclosing in advance which stocks are on our shopping list, but the list is made up and would be the same for any one of the three options.

Option #4 (a sector bet)

In our July 15th newsletter called “It’s A Big Bear” we told you that we had a “friend” who was telling us that oil prices would be dropping into the \$70-\$90 a barrel range. This “friend” is in a business which works very closely with the oil refining industry, so he may have been a guy “in the know”. On the other hand, Goldman Sachs was still forecasting that oil prices would stay above \$140 per barrel throughout 2008. Many other “experts” were forecasting that oil would retreat to \$120 by the end of the year. So our “friend” was the odd man out. But we listened to him and fortunately we sold all our oil and gas related stocks for big profits before this downturn started. Yet we were somewhat skeptical, so we didn’t outright short the oil market even though we mentioned that as a possibility in that newsletter. For reference, oil was over \$140 at the time.

Well our “friend” has turned out to be spot on, and he has continued to advise us that oil prices will continue to drop. His latest guidance is that we should expect mid \$60 pricing, say \$65. Well, we are close and it is getting to be time to buy back oil stocks.

Natural gas prices have dropped from the mid-teens to approximately \$6.60 in the same period of time. Natural gas stocks are starting to look like a buy to us as we are now passing the seasonal trough in pricing and natural gas prices are unlikely to fall further, and may even start to rise. Here is a table that

Stock	Average Sale Price	Price Now
Anadarko	73.93	31.52
Chesapeake	57.46	18.32
Precision Drilling Trust	19.86	9.80
XTO Energy	59.17	29.60

shows the average sale prices for the four energy stocks we held in the Hatteras Model last summer. The first column shows our average sale price. The second column shows the price of the stock now. Those are some drops. We think it is time to reenter some of these positions, or other energy related stocks. Oil and gas prices overshot to the upside this summer and they are seemingly overshooting to the downside now. It didn’t escape us that OPEC changed the date of their next meeting today from Nov 18 to Oct 24. That is three weeks earlier and should at the very least be taken as an attempt to engineer a soft landing to the recent drop in oil prices.

A great coincidence of timing just happened in that our “friend” just called me from Texas where he is calling on a client in the oil business. His latest guidance confirms his call of a couple of weeks ago that oil prices should retreat to \$60-\$65 per barrel, and then start to RISE, slowly working their way back to \$90 per barrel in 2009.

So there you have our 4 options for reentering the market. We shall see how things play out over the next couple of days.

All the best, PK

Paul Krsek

MANAGING MEMBER & CHIEF INVESTMENT OFFICER

K&A Asset Management, LLC

702 Trancas Street, Suite 200

Napa, California 94558

(707) 603-2672 Office

(707) 486-7333 Cell

(707) 224-2521 Fax

paul@kaassets.com

www.kaassets.com

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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-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.

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Sincerely,

Paul Krsek
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