



Relative Calm

We used to get pretty excited around here on a day that the market moved up 2.89%. Now it seems like nothing. How jaded have we become?

We made a few trades in the models today, but all in all it was a quiet day around here. We removed the index hedges that we had on for Hatteras, Halifax, Mendocino and Fresnel. That means those four models have less protection if the market goes down next week. Before anyone gets uneasy about that please remember that the allocation to equities in these models is still pretty small. We did so because we want to capture some upside in here, if we are right about the seasonality and sentiment relative to the market. Translation: we think the path of the equity market should be upward over the next four to six weeks.

We bought some Wells Fargo (WFC) stock today, timing our purchase around their offering of \$11 billion of new stock that came to market this week. Over the past week or so we have also made small purchases of JP Morgan (JPM), and US Bank (USB). All three positions are very small and we intend to scale into larger positions on pull backs in price.

We also bought a very small position in Merrill Lynch (MER) for the Fresnel model. Bank of America (BAC) is set to buy Merrill Lynch in December. In today's uncertain world there is no guarantee that the merger will actually take place, and due to that uncertainty Merrill Lynch's stock currently trades at 5.6% discount to the proposed exchange ratio. We expect the deal to close and for each share of MER to be exchanged for .86 share of BAC. If the transaction were to close today, for example, we would make an instant 5.6% return on the MER buy. Needless to say that gap may disappear before closing, but it seems a reasonable arbitrage to us and we are happy to own BAC after the transaction closes.

We see WFC, JPM, USB and BAC as the eventual big winners in the post 'credit crunch' world. At the present time we do not foresee adding any other banking or financial common stocks to the models. These four are the cream of the crop as far as we are concerned.

On the other hand we feel that a major recovery for the U.S. banking industry is YEARS away and it is more likely than not that one year from now most bank stocks will be worth LESS than they are today. Therefore we have also started a position in UltraShort Financials ProShares (SKF), which goes up in value as the bank stocks it holds go down. We first mentioned it yesterday. This is likely to be a "trading position" in the models as we attempt to take advantage of days like the Wednesday and Thursday when the SKF rocketed up as the entire market, including financial stocks, fell. But we will also be trying to establish this as a core position based upon our dim view of banking and financial stocks. The plan is simple. We want to own the winners while we profit from the pack withering.

That brings me to a main point of this newsletter

Most of the time we try to keep the various models fairly differentiated from one another. That is easy for the ETF model, Pt. Reyes and The New World because they have very different and very specific mandates. But you may find Hatteras, Halifax, Mendocino and Fresnel looking more homogenized particularly related to the equity (stock) investments. Why? Let me explain it this way. In a bull market like we experienced from 2003-2007, there was never a shortage of great ideas. It might be that each model owned 10 stocks all of which were different from model to model. So we needed 40 GREAT ideas to round out those four models. In that environment we could always find them. In fact in those years it was more like being a kid in a candy store. It was often the case that there were so many good ideas to choose from that narrowing down to 40 wasn't easy. THAT IS NOT TRUE IN THIS ENVIRONMENT.

Good ideas are few and far between right now. We want to offer all our clients ALL our best ideas, whether we have five or ten or two or whatever the number may be. Therefore we have decided that

diversification in the models is not the goal right now. GREAT IDEAS that work is the goal. As we venture back into the markets don't be surprised if you see the same ideas spread across these four models—at least for now.

Our goals are simple, to preserve your capital and make you money. We will use our best efforts and best ideas to do so. So forgive us for “homogenizing” the models for a little while. If and when we get back to the “kid in a candy store” environment we will diversify them more again.

In the mean time the models do maintain some differentiation through their bond allocations. Hatteras owns only tax-free bonds. Mendocino and Halifax own only high grade corporate and government agency bonds. Fresnel owns slightly riskier corporates that throw off higher yields and have a little more volatility.

Now a few words about “wash sales”

The “wash sale rule” is about tax treatment related to stocks sold at a loss. Fairmark.com explains the rule this way:

“When the value of your stock goes down you get that sinking feeling — you've lost money. But the tax law doesn't allow that loss until you sell the stock. In a way that's good, because it means you can control the timing of your deduction, taking it when the benefit is the greatest.

The problem is, you may have a conflict. You want to deduct the loss, but you also want to keep the stock because you think it's going to bounce back. It's tempting to think you can sell the stock and claim the loss, then buy it back right away. And that's where the wash sale rule comes in. If you buy replacement stock shortly after the sale — or shortly before the sale — you can't deduct your loss.”

The rule simply says that if you sell a stock at a loss and buy it back within 30 calendar days after you sold, you can't deduct the loss you experienced on the sale.

Because of this rule we have often avoided buying back stocks that we have recently sold. Avoiding wash sales has been one small way we have simply been trying to do the “housekeeping” in your accounts. By the way, “wash sales” don't impact retirement accounts at all. They impact only taxable accounts.

But we are changing our policy. We are going to stop worrying about “wash sales”. We are more worried about making you money and sometimes it can really pay to buy back a stock that we recently sold.

Let me give you a specific example. There is a tech stock that we recently bought for one of the models. After we bought it we got caught in one of these awful downdrafts that have been occurring and we got stopped out of the stock at a loss. The stock dropped so fast that we got out at about a 10% loss. After we sold the stock it continued downward and finally stopped falling about 12% below our sale price.

We love the stock, love the company but didn't feel we could buy it back for the model in which it was sold because we were trying to avoid the wash sale rule. We bought it, at the now much lower price, for a different model, that hadn't previously owned it and sold it. Guess what? That trade is now very profitable. So we missed out on a profit for the first holders of the stock, trying to wait out the wash sale rule. That doesn't make sense to us. As previously stated, we are out to protect your capital and to make you money. Therefore going forward we intend to ignore the wash sale rule and trade based on “offering our best ideas to all our models” regardless of tax consequences.

Besides everyone we know has plenty of losses for the year. If we negate one for you with a profitable trade would you care?!!

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 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
Updated: August 13, 2007