



## Fear is Palpable

There is real fear now. I am hearing it on CNBC, from other money managers, my friends, professionals we do business with, and even from a few of our clients. The fear is very real. It is also very understandable. The global economy is clearly in the midst of the greatest crisis since the Great Depression. Even I was depressed for a while today. I am not afraid, but this constant pounding can get you down.

But I am not down as I write and I don't want any of you to be either, and I don't want you to be afraid. Let me outline for you what we are doing and why we are doing it.

By way of review I want to remind you of some things we wrote in previous newsletters. On October 16<sup>th</sup> we published **How will we get back into the market?**

In that edition we outlined three possible scenarios for moving from cash back into the broad equity markets, plus one sector play.

The basic theme of that letter was that by October 16<sup>th</sup> the markets had moved to lows that were rivaling many previous bear market moves in magnitude. Stocks were extremely over sold, and in many cases DIRT CHEAP. It seemed like the right time to be putting some money back to work. We made it clear in that letter that there was no certain way to do it, without the potential for experiencing some near term pain.

The intraday lows for the market had actually occurred on October 9<sup>th</sup> and 10<sup>th</sup>. Those numbers are 7773 for the DJIA and 839 for the S&P 500. The closing lows for those averages came on October 27<sup>th</sup> at 848.92 and 8175.77. Tonight we are back to 852 and 8282.

As I am writing this the stock market futures are indicating a lower open in the U.S. tomorrow. If that were to happen a "test" of both the closing lows and the intraday lows could be in the cards for tomorrow or Friday. I have highlighted where we are on the chart to the right. You can see that we are now making our second test of the October 9<sup>th</sup> lows. Should this test be successful it is likely that you will be hearing the pundits talking about the "triple bottom" that got put in during October and November of 2008. They will be reporting about it as the market has moved much higher.

We can't tell you for sure, but we think the odds are pretty high that test will come and that it will be successful, for now. We still think that the most likely case for the equity markets is that a rally is in the offing. We are hoping that it is not a 10% one-day-wonder, as those are simply not sustainable. We would rather see a test of the lows, followed by an intraday turnaround and a healthy push back up on some healthy trading volume. A couple of percent move on day one, followed by some sustainable upward action for several more days would be the ideal case.

Now some of you are probably reading this and saying to yourselves that Krsek is CRAZY. What could cause a rally? THINGS ARE SO BAD THE MARKET CAN'T RALLY. KRSEK DON'T YOU KNOW THAT THINGS ARE GETTING WORSE AND WORSE AROUND THE WORLD EVERY FRIGGIN DAY?



Actually, yes I do know that, and a LOT of that bad news is baked into the price of stocks, at least for now.

- INTEL DROPPED TO A 14 YEAR LOW TONIGHT!
- Alcoa (AA) is down 80% from hits 52-week high.
- Goldman Sachs sells for less today than it did during its Initial Public Offering (IPO) in 1999.
- Motorola (MOT) has \$3.18 of cash on its balance sheet for every outstanding share of stock. The stock sells tonight for \$3.86. The price of a share of MOT is almost entirely covered by the cash on the balance sheet. You basically get the business for almost nothing if you buy that stock now.
- Freeport McMoran Copper and Gold (FCX) is down 83% from its 52-week high and selling for approximately ½ of its book value and a ratio of .41 times sales. Unbelievable; and it has a dividend yield of 7.2%.

These are just a few examples of the extremes we are seeing individual stocks. Does this mean that stocks can't get cheaper. No it doesn't—unfortunately. But at these valuations it is time to start nibbling again.

Nibbling has been painful. We are the first to admit that. The models are dropping just as the market is, but the models are dropping a few tenths of a percent a day while the markets are collapsing.

As we get back to the levels of 8000 on the DJIA and 850 on the S&P 500 the current market plunge will have approximated the magnitude of the drop that took place in the 1973-74 recession. We are all but there. That is the second worst drop in U.S. stock market history.

If the DJIA dropped to 7450 and the S&P dropped to 784 that would approximately equal the magnitude of the crash in 1929.

In the October 16<sup>th</sup> newsletter we described our Option #2 for getting back into the market this way:

**“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.”**

As of tonight we are seeing this as the most likely way that things will play out. Therefore as of tonight we are roughly 18-20% long individual equities and short approximately 8% through index shorts in the following models: Hatteras, Mendocino, Halifax.

(long refers to the fact that the the accounts own stocks, a bet that they will go up in value)

(short refers to the fact that we have place an option or and ETF in the account that is a bet that the market will go down)

Today we added approximately a 5.5% allocation to each of those models in individual equities. Most were purchased in the last hour of trading as the market approached its low for the day. We offset every purchase with an index short of equal size that will go up if the stock goes down. The buys today were fully hedged.

Why did we hedge? If this “test” of the lows is going to play out successfully over the next few days, there will likely be a little more downward pressure on the markets. We simply want to reduce the short term impact on those models if that happens.

Fresnel is now approximately 16.5% long individual stocks and is partially hedged with about a 6% short/currency hedge. We are very likely to add more hedging to Fresnel tomorrow.

The ETF model is now about about 19% long and is also partially hedged with about a 5% short index position. Remember that the ETF model is also getting over 8% average dividend yield from the three ETF positions it owns.

Pt. Reyes now owns an equity ETF for about a 4% position. It is the ISHARES DOW SELEECT DIVIDEND (DVY), which yields 5.3%. It is completely hedged with an offsetting short.

The New World is 15% long individual stocks with a 5% offsetting index short.

The Mutual Fund accounts are still in all cash.

### **So why are we buying ANY stocks if we are still uncertain of the outcome for the market?**

Let me put it to you this way. We are much more comfortable buying a few stocks down here, at these prices, than we could ever have been at much higher prices. We are buying stocks of companies that we believe have intrinsic value, we are getting paid solid dividend yields on most of them as we approach lows in the markets not seen since 1973-74, or 1929.

We are in turn controlling losses on trades that don't work buy stopping them out.

I don't write these words to convince anyone. I am reporting to you what we are doing and we think it makes tons of sense. I have heard from some of our clients who have told me they hope we are buying at these levels. I have heard from some who have made specific suggestions on what to buy. Those emails usually come with the question, “Do you see how CHEAP so-and-so is? Do you believe it? Wouldn't you want to own that in here? I have also heard from a few clients who are scared to death and frankly don't want us to be buying anything. At this juncture both types of calls and emails are understandable, and they truly reflect the dilemma that we are in.

We are buying a market that is going down. That is called “trying to catch a falling knife” and it has been painful. But we are also averaging into relatively small positions at GREAT PRICES, and we are hedging as we go.

We show you again this statement from Warren Buffett on October 17<sup>th</sup>:

**“THE financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary.**

**So ... I've been buying American stocks. This is my personal account I'm talking about, in which I previously owned nothing but United States government bonds. (This description leaves aside my Berkshire Hathaway holdings, which are all committed to philanthropy.) If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities.**

**Why?**

**A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now.**

**Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over. A little history here: During the Depression, the Dow hit its low, 41, on July 8, 1932. Economic conditions, though, kept deteriorating until Franklin D. Roosevelt took office in March 1933. By that time, the market had already advanced 30 percent. Or think back to the early days of World War II, when things were going badly for the United States in Europe and the Pacific. The market hit bottom in April 1942, well before Allied fortunes turned. Again, in the early 1980s, the time to buy stocks was when inflation raged and the economy was in the tank. In short, bad news is an investor's best friend. It lets you buy a slice of America's future at a marked-down price."**

### **Let me summarize our position on equities for the remainder of 2008**

We believe that the U.S. markets, which we are staying focused on right now, are testing the October lows and the most likely outcome is that test will be successful. A rally that could carry the S&P 500 back to 1000-1075 is the most likely "next step" for the market. That would be a rally of approximately 17 to 26% from today's close.

We believe that TONS of bad news is reflected in U.S. equity prices at this time. In fact there is MUCH MORE bad news priced into the markets today than there was on October 9<sup>th</sup> or October 27<sup>th</sup> when the markets were at this spot before. The amount of EXTRA BAD NEWS since October 9<sup>th</sup> has been staggering.

We are focused on stocks that pay high dividend yields.

We are focused BUYING THE DIPS, not THE RIPS. As scary as it is to buy on a day when the market is down 400 points that is just the time to do it.

Are we saying the lows are in for the market—period? We doubt it. But we are saying that the most likely case is that they are in for 2008. We believe a tradable sustainable rally should form up. We will probably know in a couple of days.

For those clients with a longer point of view you may enjoy this quote from John Maudlin's newsletter:

**"Investors are going to get their hearts broken by their favorite companies time and time again. The economic news will not be good for another year at a minimum. This is not the stuff that wild bull markets are made of. That time will come, but it is not yet.**

**That being said, I am a believer in American business. They will figure out how to maneuver and prosper in this new environment. In 12 years, earnings will have doubled from the trend of last year, which suggests earnings could be \$140 in 2020. Put a multiple of 20 on that and we have an S&P 500 at 2,800, up over 3 times from today. That is the long view".**

(For the record Mr. Maudlin says that he is not personally buying stocks right now and we have no idea what his personal holdings are.)

## Let me confess our big misstep in all of this

We are not perfect and we also do not BS you. The models suffered almost no damage in September and October. It was actually uncanny given how much the market rolled over in those two months. We have taken some hits in November however, particularly this past week. Why? First, we are adding back. Second, we have been telling you that we have been taking off the hedges. That has clearly been a mistake. We removed two hedges on Monday and paid the price for it. We completely misread the markets reaction to the announcement by the Chinese government that they were initiating a \$586 Billion stimulus package for their economy. Asian markets rallied huge on that news and we were expecting the same thing here. In fact the DJIA moved up 250 points almost out of the gate. As a general rule we do not trade the first hour of the market. We like to wait it out and see how the trend develops during that hour. It has been much more effective lately to wait out that hour. In fact it has been much more effective to do most of your trading toward the end of the day. But on that day we thought we were going to get run over on our hedges so we took them off in the first hour of the day. BIG FRIGGIN MISTAKE. If we had kept them on we would not have experienced much of the damage that has occurred this week.

The lesson in that—keep your finger off the SEND button in the first hour!

## Bonds are the new stocks

OK, that is four pages on stocks and we are not even to the good part yet. We have significantly increased the allocations in all the models to bonds. We are working to complete the 30% allocation target that we told you about in a previous newsletter. We may raise that target.

We are buying great bonds, with great yields as we round out the allocations.

Here is another quote from John Maudlin's *Thoughts from the Frontline Weekly Newsletter*:

**“Income is going to be critical. If you are going to put some money into bonds and other fixed-income instruments (not funds!), you should be doing it now. As I have been writing, there are simply steals out there in the fixed-income markets, as the margin clerks are forcing funds and individuals to sell any- and everything. The prices we see today will not be there in six months, and I doubt they will be there in three. If you are a fixed-income investor, you should be buying with both fists.”**

We agree, but we want to point out that the screaming bargains are in the corporate market. People are afraid to own stocks, and they seem just as afraid to own corporate bonds. Thus the cheap prices.

We are not afraid because we are looking at corporate bonds on a daily basis right now and being very selective in our purchases.

We are bought bonds today that have yields to maturity of 6.54%, 7.54% and 11.74%. They are all investment grade corporate bonds with approximately 4 years till they mature. Two of them were purchased for Mendocino and all three for Fresnel and Halifax.

We remain focused on tax free munis for Hatteras and they are difficult to find. Pricing has firmed up. But we are working on it. We recently made two very good buys for that model. We still think we can find some bargains.

We are focused on corporates and agencies for all the other models.

## Bargains in preferred stocks too

We are buying the preferred stocks of major bank holding companies at bargain prices. Now that TARP has passed, been funded, and \$125 billion of it force fed to nine leading banks, we KNOW they are not

going out of business. We KNOW they are the chosen ones. Their preferred stocks are screaming buys as far as we are concerned. Granted these stocks now tend to be more volatile than they might have been in years past, but their yields are higher too because of their depressed stock prices.

We are building out about 15% allocations for Hatteras and Pt. Reyes in preferred stocks, bought at bargain prices, with yields that tend to run from 6% to 9.5%.

## How might our models look going into 2009

We are buying bonds, preferred stocks and ETF's with high yields as investments. These are not trading vehicles. These positions will be the core positions in most of the models as we enter 2009. As John Maudlin says, "**Income is going to be critical**".

It is quite possible that we will be about 50% invested in all the models in fixed income type investments including bonds, preferred stocks and ETF's by December 31<sup>st</sup>. Pt. Reyes is likely to be closer to 90% invested in fixed income vehicles.

Whether we own stocks at that point, or are short the stock market, is still an open question. We will take it one step at a time, looking for this key rally to develop. Any stocks that we still own at the end of December are likely to be paying very high dividends and behaving well in the market, or they aren't likely to still be in the models.

## Overshoot Opportunity Approaching

Anybody paying attention to what is happening to the price of oil. IT IS IMPLODING. Last time we wrote that we didn't have a strong opinion on the near term direction for oil prices. Oil has dropped almost \$10 since we wrote that and is now in the mid \$50's. We now suspect that just as it overshot on the way up, it will do so on the way down. This is not a falling knife we intend to try to catch, but at some point oil is going to get too cheap in here. It and all the oil patch stocks will be screaming buys. Not just yet it seems.

Just a few months ago it was costing me \$75 to fill the tank of my Lexus SUV. Today it cost \$45. I entered the Twilight Zone.

That's more than enough for tonight.

All the best, PK

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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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