



# K&A Asset Management, LLC

## Daily Illumination Newsletter

### Looking forward to 2009 (Part 1)

We look forward to 2009 with a goal of generating positive real returns in all the models regardless of what happens to the stock market next year.

Therefore we have our focus on bonds and their dependable interest rates as the key to providing relative stability and profitability to the models.

By now all our readers, particularly our clients, should realize that we have already allocated a significant portion of assets in several of the models to bonds. Here is a table that shows current allocations to bonds as well as our targets for entering 2009.

<b>Model</b>	<b>Current</b>	<b>Target</b>	<b>Bond Type</b>	<b>Maturity Range</b>
ETF	0%	50%	Convertible and Corporate	Closed end fund or ETF
Fresnel	22%	40%	Corporate Including high yield	1-5 years
Halifax	21%	50%	Corporate	1-7 years
Hatteras	14%	40%	Muni and Government agency	1-7 years
Mendocino	35%	50%	Corporate and Government agency	1-5 years
Mutual Fund	20%	50%	Convertible and Corporate	Open end mutual fund
Point Reyes	27%	80%	Corporate and Government agency	1-7 years

As you can see we have some work to do acquiring bonds during the month of December to get to the targeted allocations.

The only model that we have not established a bond allocation for is The New World (TNW). Its investment mandate is quite different from any of our other models and as of this writing we have still not determined whether bonds make sense for TNW.

We have been buying very selectively in all the "bond type" categories listed in the table and we will continue to do so. Keeping in mind that "selectivity" is a key to the process we are not going to hold ourselves to a December 31, 2008 deadline to reach our allocation goals. If we complete our purchases in 2008, that would be nice. But we want to be buying the right bonds so if we extend into January, so be it.

Our focus is pretty simple. We quote Bill Gross from Pimco, the largest bond portfolio manager in the U.S., who seems to agree with our thinking. Here is an excerpt from his latest report.

1. A continued above-average allocation to agency mortgage-backed securities – now yielding close to 6%.
2. An overweight position in bank capital – bonds and preferred stock in companies where the Treasury has an equity stake. With Uncle Sam as your partner, default seems remote.

3. A focus on the frontend of the yield curve. The Fed will stay low for an extended period of time while the inevitable inflationary pressures of government bailouts lay further out on the yield curve.

We add a fourth point of our own. The differential in yields between corporate bonds and treasury bonds has rarely been wider in history. We are intent on taking advantage of this unique situation. Therefore corporate bonds are of particular interest to us. We are interested in 1 to 5 year maturities for the models that can own individual corporate bonds. *The ETF and Mutual Fund models can't own individual securities.*

Here are excerpts from a recent article in Barons, regarding the current pricing of corporate bonds.

### **Bonds Priced for Depression Beat Stocks**

By RANDALL W. FORSYTH

*Investment-grade corporates may offer stock-beating returns.*

**“THE STOCK MARKET IS PRICED FOR a recession, but the bond market is priced for a depression. So says Rob Arnott, the brainiac who heads Research Affiliates, an institutional advisory.**

**That's not hyperbole. Corporate bonds rated Baa or triple-B, the low end of investment grade by Moody's and Standard & Poor's designations, offer the biggest yield premium since the early 1930s, notes RBC Capital Markets.**

**That's a problem for pulling the economy out of the credit crisis, but an opportunity for investors. Indeed, investment-grade corporates with near-record premiums arguably offer better return potential than common stocks, especially relative to their risks. "I haven't seen this many markets offering double-digit opportunities since 1989-90 or ever so briefly in 2002," says Arnott.”**

**“You have to go back to the early 1930s, when Baa corporates yielded 700 basis points over Treasuries, to find a comparable situation. And notwithstanding all the hyperventilation in the media that this is worst financial crisis since the Great Depression, there's never been such a full-court response to the threat of debt deflation -- the \$700 billion TARP, the bailout of Fannie Mae and Freddie Mac, the likelihood of trillion-dollar deficits and a doubling in the Federal Reserve's balance sheet in just over two months.**

**Whether this is the road to enlightenment or perdition is a question I'll leave to others. It is what it is. All of Washington's horses and all of its persons are arrayed to prevent the 1930s from happening again, for better or worse. This suggests that corporate bonds shouldn't be priced as if it were.”**

The 5 year Treasury bond yields 2.04% as of this writing. A 5 year “A” rated AT&T (T) bond yields 6.857%. A 5 year “BBB” rated Altria (MO) bond yields 8.10%. In other words I can get more than THREE times the return by choosing AT&T over the U.S. Treasury. I can get more than FOUR times the return by choosing MO (makers of Phillip Morris cigarettes) over the Treasury.

Let me ask you something; is either AT&T or Altria going out of business in five years? I think not. Do they have more risk than the U.S. Treasury? Yes? Do they have three to four times the risk? I think not.

A 2 year Treasury bond yields 1.12%. On the other hand a 2 year “AA-“ Bear Stearns bond yields 5.02%. Bear Stearns is now a division of JP Morgan. They were put together in a shotgun wedding by none other than Treasury Secretary Hank Paulson. JP Morgan (JPM) is one of the “anointed” companies I wrote about in one of recent newsletters.

I don’t know about you, but I would be glad to take the risk to own a “AA-“ Bear Stearns bond paying 5.02% to maturity rather than to own a 2 year Treasury paying 1.12%. After all, Bear Stearns is now part of JPM and **JPM is not going to be allowed to fail!**

The current spread between the yields of shorter term high quality corporate bonds and Treasury’s is at an extreme and that is at the heart of one of our core strategies as we finish out 2008 and look forward to 2009.

We also like the preferred stocks of the 9 anointed major banking companies. The anointed include Wells Fargo (WFC), US Bancorp (USB), Citigroup (C), Morgan Stanley (MS), Goldman Sachs (GS), Merrill Lynch (ML), Bank of America Corporation (BAC), Bank of NY Mellon (BK), and State Street Corporation (STT).

The 9 are likely to become 8 very soon as BAC and ML are set to merge.

The U.S. government has made it extremely clear that they do not intend to let these companies fail. Therefore we consider their bonds and their preferred stocks to be core choices for the models.

### **Why the focus on shorter maturities in bonds?**

The current economic environment is clearly deflationary as asset prices in all categories continue to fall. Unemployment is rising around the world and therefore there is no threat of wage inflation. In the current environment inflation seems to be a remote threat. So why not just buy long term bonds and lock in yields for the long haul?

The answer is simple, at least to us. We simply find it hard to imagine that this low interest rate environment can last over the long haul. Governments throughout the world are printing money like there was no tomorrow in order to replenish capital in the various banking systems, shore up troubled industries, buy off bad assets, and who knows what else.



We have seen estimates that the U.S. Federal Reserve Bank has expanded its balance sheet from roughly \$990 billion before all the bailouts started to over \$2.2 trillion today. It is possible they will grow to \$6.6 trillion before all this is over. Where has all that new money come from? It is “fiat” currency. It literally comes out of thin air and it is all new debt—new bonds—to be bought by whom and at what price?

(cartoon from Global Money Trends, Gary Dorsch, Editor and Publisher)

We simply don't know if inflation will reignite as a result of gigantic increases in money supply throughout the world. But it is a distinct possibility and if it does yields on future bond issues could rise substantially. Therefore we want to be positioned to see current bond purchases maturing just as those higher yields are becoming available.

On the other hand, it is important to remember that all of the new "fiat" money being created by governments is merely replacing capital that had been in the system in the hands of banks and companies that simply wasted it. So unless it is invested more productively this time, and therefore does spur real economic activity and growth, the threat of inflation is quite dampened.

In any event we see absolutely no need to chase slightly higher interest rates that are available on longer term bonds. Under present conditions there is very little reward for taking the risk of owning longer maturities.

We are interested in good yields and price stability for the models, so shorter maturities make more sense to us. Throughout the week we will send you the next chapters in "Looking forward to 2009" that includes our views on the stock markets and commodity markets with a focus on oil and gold.

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.