



## E-illumination 2006 Retrospective and Annual Rating

December 16, 2006

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It has been a good year for our clients and for K&A, when measured by any standard. As 2006 draws to a close it is appropriate to look back on what has been a very interesting year. Before we do; let me thank you, our clients and friends who receive this letter, for your faith in us. I think it goes without saying how much we appreciate you, but it should be said anyway. We wish you the happiest holiday season and a wonderful New Year.

Last year we introduced a new feature to E-illumination by separating our retrospective look back from our forecast for the coming year. In prior years we had combined them into one report. We will continue this year with the two-part format. So without further adieu let's look back twelve months and "rate" how we did in 2006.

First let's look at the performance of our model portfolios on a year to date basis through December 15, 2006. These performance numbers are my "internal" numbers that I track daily. They represent the simple annual return for our 5 actual model accounts, with all dividends reinvested vs. the dividend reinvested return for the S&P500.

Lest we confuse you with these numbers, they do not represent the Time Weighted Return calculations that we provide at the end of each quarter for all accounts within a model group. Nor do they represent the Time Weighted Return calculation that each of our clients, with portfolios in excess of \$250,000, will receive after December 31, 2006. Now if that is enough disclosure for you, here are the actual numbers.

Model	Hatteras	Mendocino	Halifax	Bonavista	Fresnel	S&P500
Return	14.56%	15.97%	15.57%	12.33%	23.15%	14.20%

I don't know how they look to you, but they look great to me. One reason that I feel so good about them is that the first four models are not designed to outperform the S&P 500, yet three of them have done so year-to-date. Hatteras, Mendocino, Halifax, and Bonavista share the common characteristic of being "balanced" portfolios often containing allocations to stocks, bonds, cash, or other asset classes. None of them are "all equity" portfolios, and therefore they usually tend to lag the S&P500. They are supposed to offer our clients "competitive total return with below average portfolio volatility".

That may lead you to ask why I use the S&P500 for comparison. The answer is simple; everyone does. It is just a very standard benchmark. It has been fun to lead the S&P500 all year, while doing so with these balanced portfolio models. I will tell you that we lost the lead in Bonavista, and the gap is narrowing almost each day for the other models. There are only 9 more trading days left in 2006, and anything can happen. I suspect that on December 31, 2006 we will have done exactly what we set out to do in January 2006. We will have given our clients competitive rates of return, with below average volatility. We kept the accounts out of trouble through thick and thin and they never went negative even as the U.S. and emerging market stocks, gold and oil were tumbling during the summer.

For readers unfamiliar with the markets or new to K&A newsletters, it might be easy to say, so what, everyone did well this year. First that isn't true; and second, for much of the year it looked

like stocks were going no where. The rally in the U.S. stock market didn't really get going until August.

That provides me the perfect segue to look back at what we thought might happen in 2006 as compared to what actually did happen.

- Inflation was our #1 concern going into 2006

We started 2006 with significant concerns that ***“Inflation is rampant and the official measures of inflation like CPI and PPI have been so manipulated over the past several years that no one seems to realize how much real inflation is in the economy. If the CPI were still calculated today using the same methods in the 1970’s through the early 1990’s the stated inflation rate would probably exceed 7 percent and we would all be panicking.”***

We were also saying that ***“Inflation is likely to go higher than the pundits currently expect, not related to the magnitude of movement of interest rates; but because the globe is being flooded with U.S. dollars.”***

Others were much less concerned than we were. Bank Credit Analyst (BCA), which is our backbone research service, stated flatly, ***“Inflation will stay low everywhere. This is critical because it means that central banks will not need to become restrictive. The Fed will likely go on hold before rates reach 5 percent. Policy will stay accommodative in the other major economies, creating a bullish liquidity backdrop to financial markets.”***

The Fed did not go on hold before rates reached 5 percent. The fact is that “official” inflation has remained higher than the Fed would like right through last month. In June 2006 the Federal Reserve Open Market Committee (FOMC) raised the Fed Funds rate to 5.25% where it remains today.

The December 12, 2006 minutes of the FOMC reflect the current thinking and concern that while inflation has moderated substantially, it still poses a potential threat. Here is an excerpt from those minutes, ***“Readings on core inflation have been elevated, and the high level of resource utilization has the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand.”***

***Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.***

- So what if inflation is high you might ask?

We spent a lot of time and effort in our annual report last year discussing higher inflation and its causes, including the fact that the globe is awash in money supply from many resources. We really had two main points to make in focusing on that discussion. The first was that the U.S. could not afford a recession and that the FOMC dilemma was to fight inflation without triggering a recession. We thought they would do everything in their power to make sure that we didn't even get close to recession. The second point was simply that the globe was (and remains) awash in money supply, and that condition tends to inflate asset prices. We were clearly right about both points.

Here is the bottom line—financial assets around the globe are doing well. Economies around the world are doing well. Asset prices have remained high. We believe the U.S. economy is headed for a very soft landing in 2007, and the rest of the world seems ready to have another good economic year in 2007.

A whole lot of that condition relates to the management of interest rates and supply and flow of capital around the globe—not only by the U.S. Federal Reserve Bank, but other central bankers, governments and private entities around the world.

If you are interested in making your own judgment about what we said then compared to what has actually happened in the global economy and financial markets we encourage you to go to our website at <http://www.kaassets.com/illuminations.htm>. Scroll down to the bottom of the page and you will see last years report, Part 1. You can read it for yourself.

Let's take a look at the 10 specific market conditions we sighted in last year's report and see how we did in forecasting what would happen in 2006. Here they are:

**1. The four year stealth bull market in gold will finally go public. It had to break over \$500 to get the public's and the media's attention. Our minimum target for gold is \$720 and it could approach \$1000 per oz. before this cycle is over. That could take another 2 to 4 years.**

Gold hit \$720 in May! As everyone who follows K&A closely knows, we sold all the gold holdings in May and took a substantial profit for many of our clients who owned gold. Gold has since dropped substantially and now seems to be backing and filling. Cash gold closed at \$610 per oz. on December 15, 2006. We started building back small positions in our model portfolios in August.

We also said, **"Gold is not going up as a predictor of inflation; it is going up as a defensive measure against a world flooded with paper money that is falling in value."**

We stand by that comment today and we still expect gold to hit \$1000 per oz. within the next 1 to 3 years; taking a year away from last year's 2 to 4 year expectation.

**2) Oil and gas prices may bounce all over the map, but their inevitable path is upward. It would not surprise us to see another oil or gas shock in 2006 that will take prices over \$70 per barrel for oil and \$18 per mcf for natural gas. The shock will most likely be political and not terrorist related. For example, there is a growing anti-American sentiment in countries like Venezuela, Bolivia and possibly even Mexico. If two or more of these countries decided to divert their oil sales from America to say, China, we could find ourselves in a supply crisis.**

OK, you be the judge. Do you see anything in that paragraph that didn't happen in 2006? Well, maybe as I write this it would be hard to say that there is a current "supply crisis". The globe is actually well supplied with oil and gas today. But in May, as prices spiked well over \$70 it did not look that way, and we suspect there will be days in the future when there will be concerns over supply again. We stand by the statement that the inevitable path is upward for oil and gas prices.

**3) Commodity prices in general will remain high due to increasing global demand. Commodities and hard assets including precious metals, timber, water, oil and gas were a major investment theme at K&A in 2005 and will remain so into 2006.**

Commodity prices have remained high throughout most of 2006. There was a period following the peak in gold and energy prices during which most commodity prices started to drop precipitously from the highs that occurred in May. K&A acted tactically to reduce commodity related positions by taking profits at the time. By August we were building back many of the commodities related

positions in the various model portfolios. Our overall asset allocation to commodity related positions is smaller today than it was at the beginning of 2006, but it is still substantial in most models. It is safe to say that commodity prices in general will remain high due to increasing global demand. Hard assets including precious metals, timber, water, oil and gas were major investment themes at K&A in 2005, 2006 and will remain so in 2007.

**4) Water will enter the vernacular as the next big thing in investing. Globally there is simply not enough fresh water to go around. Companies that supply water and companies that supply technology to purify and deliver water should do extremely well over the next several years.**

We wrote that paragraph in January 2006 and since then we have seen numerous other authors and money managers say much the same thing. We still think water will be the next big thing, but it would be hard to make the case that it exploded onto the scene in 2006. I'd rather characterize the situation as water walked onto the investment stage in 2006.

We did achieve some good results for many of our clients in the world of water during 2006. Powershares Global Water Portfolio (PHO) is the 7<sup>th</sup> largest holding at K&A. It is currently held by all 5 model portfolios and is up approximately 15 to 19 percent in the various models, depending on the time of initial purchase.

We also held Suez (SZE) in Hatteras and Mendocino during 2006 and sold it extremely profitably. Suez has since been the target of all kinds of merger and acquisition talk and may be going away as a separate operating company. It is now seemingly set to merge with state-controlled [Gaz de France](#), a French utility company. We have stepped aside while that situation sorts itself out.

We lost faith in Aqua America, Inc. (WTR). We were concerned about the stock being too expensive. We continue to monitor this stock and may add it to portfolios in 2007 if we can get the right entry point.

We finish this section by repeating that globally there is simply not enough fresh water to go around. Companies that supply water and companies that supply technology to purify and deliver water should do extremely well over the next several years.

**5) Corporate America is filthy rich and sitting on tons of cash they don't know what to do with. If the U.S. economy is to stay healthy in 2006 it will be because corporations start spending some of that cash in productive ways that will make our economy grow, and in turn take up the slack created by a downturn in consumer spending. There is good reason to believe this actually might happen and therefore there is reason to be optimistic about U.S. economic growth rates at least through the first half of 2006.**

We got the filthy rich part right. We "got it" that corporate America needed to open their wallets and spend in 2006 to keep the economy rolling. We underestimated just how much impact "filthy rich" corporate America was going to have.

2006 has been one of the biggest years in the history of the planet for corporate mergers and acquisitions (M&A). Private equity buy-outs have dominated the news all year long. These conditions have not been unique to the U.S. They have been dominating economic news around the world.

Corporate America has also spent billions on share buy-back programs, reducing the public float of stock, and increasing earnings relative to remaining shares. Much of corporate America has stepped up and significantly raised dividends paid to shareholders.

Can it be argued that all corporate spending has been done in "productive ways that will make our economy grow"? A case can be made that some spending has not been "productive" and

many companies have actually cut back on research and development spending. But it is hard to argue with the overall positive impact of corporate spending on the U.S. and global economy in 2006. We see this trend as likely to continue into 2007.

We have to admit that we have been pleasantly surprised again, by the endurance of the "American consumer". We keep waiting for a significant slowdown in spending that has simply not occurred so far.

***6) We would be happy if the broad stock markets simply held their ground in 2006. We honestly can't predict that they will go up. We think it could be another very long year for the U.S. stock markets.***

For much of the first half of the year it looked like stocks might not hold their ground in 2006, and it was certainly starting to look like a very long year as we went into July. For example the S&P 500 closed at 1248 on December 30, 2005. On July 18 it stood at 1236. Things were even worse over on the NASDAQ Composite. It had closed out 2005 at 2205 and had fallen to 2054 in mid-August. Things weren't looking good.

In retrospect you might appreciate our caution a little more by understanding that the NASDAQ Composite had closed 2004 at 2178 and the S&P 500 had closed 2004 at 1213. The upshot being that the markets went no where in 2005 and were now languishing half-way through 2006.

But that all changed in July and August of 2006 and the U.S. stock markets have been on a tear ever since. We sensed the change and immediately started increasing the allocation to stocks in all 5 model portfolios. We have said in other newsletters this year that it is not our job to be dogmatic. Our job is to make you money. So we are quite happy now that the stock market not only held its ground, but successfully climbed the proverbial wall of worry in the second half of 2006.

***7) The Chinese are for real and so is their economy. Their torrid pace of growth may slow, but there will be no "hard landing" in China during 2006. We continue to believe that China is a place to invest for the long haul.***

Going into 2006 there was a lot of talk among economists, professional investors, government and the diplomatic community that China's economy was set to slow down dramatically in 2006. We didn't believe it; and it didn't happen. "Official" numbers put economic growth in China at about 10.5 percent this year. The Chinese government recently announced that they are working to wring out excesses in their economy and to slow the pace of growth to 8 percent in 2007. We say, good luck, and think it may be difficult for them to accomplish that.

During 2006 we actually increased the allocation to Chinese based equities in all 5 of our model portfolios.

As we head into 2007 we remain confident that there will be no "hard landing" for China next year either and we continue to believe that China is a place to invest for the long haul.

***8) The Indians are for real and so is their economy. Their torrid pace of growth may slow, but there will be no "hard landing" in India during 2006. However, the Indian stock market has also been going up at a torrid pace and it may be ready for a breather.***

We were not invested directly in India when we made that statement and we still aren't. There has been volatility in the Indian stock market during 2006, as we suspected there would be. But if you started the year invested in Indian stocks through American exchange traded funds or mutual funds, you are probably doing quite well for the year.

The India Fund (IFN) steadily rose through much of the first half of the year, and then swooned by falling almost 42 percent through the summer. Things were not so dramatic over at the Eaton Vance Greater India Fund, which had a 25 percent hiccup this summer. Both funds have recovered quite nicely from their summer doldrums. These are good proxies for the overall behavior of the Indian stock markets.

We were right in our thesis on India for 2006. The markets did take a breather, but the economy really hasn't and there are pundits who think that India's economy will grow faster than China's during 2007. We will talk more about this when we make our 2007 forecast.

**9) *Emerging markets will continue to emerge; particularly in Asia where all boats will continue to participate in the rising tide of emerging growth throughout the region.***

We have been right about this one too. We didn't have specific positions in the models, other than in China, when we said this. Actually many "emerging markets" took a fall during the summer just as India's market did. The exchange traded fund call the MSCI Emerging Market Index (EEM) rose steadily from January into May and then tumbled over 25 percent into the summer.

We added the EEM to all five model portfolios at one point or another in the second half of 2006. It recently broke out to new all time highs.

**9) *Because of our uncertainty regarding interest rates we will be avoiding the purchases of most bonds for the time being. Shorter term municipal bonds may be the exception.***

We actually ended up buying a short term federal agency note as a "place holder" in portfolios when the markets started to swoon in May. We collected 5.46% interest for our clients while gold and oil were tumbling, and the stock market was trying to make up its mind about whether it was ever going to get going again.

We sold out of that position in all 5 models during October and November and have since allocated the bulk of those funds to various equity positions.

**10) *Our final, and maybe most important theme, is that we continue to be focused on the dramatic excesses and imbalances that threaten our national economy and that of the globe. But this is not new for us. We have been concerned for years and we have written extensively about our concerns. Wages are not going up fast enough. Debt loads are incredible. International trade balances are way out of whack, etc, etc.***

If you have known us for any length of time you know that we have included a statement like this in almost every annual retrospective or forecast that we have written. We don't do it for the exercise. We do it because we are concerned and continue to monitor trends that we consider to be potentially dangerous for the U.S. economy and for our clients.

We have also tried very hard to take advantage of some of these otherwise unfavorable trends to make money for our clients. The big run up in gold and oil prices during the first half of 2006 were perfect examples. We bought heavily into the run up and sold at or near the peak.

As of this writing the imbalances we monitor have caused us to stay aware and to exercise caution. But we don't think they caused any compromise or diminution of investment returns in 2006. In fact, just the opposite is true. It was our allocations to gold and oil early in the year that have contributed to our "balanced" portfolios leading the S&P500 at this point.

So we continue to monitor trends that we do not think are healthy or favorable in the long run, and we also continue to invest tactically to take advantage of these situations and not be disadvantaged by them in the short term. So far, so good!

There you have it. That is our retrospective of 2006. I don't know how you would grade us, but as I write this I am thinking we scored a big "A" this year.

As far as I am concerned we got all the major themes right during 2006, and we got the investment results we were after for our model portfolios. It doesn't get better than that. Last year I gave us a B for our annual "rating". I am glad to see we moved up, even if in our own eyes. After all, I think I am our toughest critic.

We enter the Christmas and New Year holiday season feeling good about 2006 and looking forward to 2007. I know that I speak for all of us at K&A in wishing you the happiest holiday season and a very good and prosperous New Year.

All the very best,

Paul Krsek  
For K&A Asset Management, LLC  
December 16, 2006

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***Special Disclosure and Considerations regarding this 2006 Retrospective and Rating***

*Please be aware that not all accounts managed by K&A are members of the "model" groups we refer to in this report. There are a number of accounts that we call "unmodeled". Each of them has some circumstance related to the account that prevents us from putting it into a model group.*

*For example, some accounts are simply too small to be a member of any model group. In the past K&A did not require any minimum account or portfolio size. We do now. The minimum new account size for Mendocino is \$250,000. The minimum new account size for Hatteras is \$500,000. The minimum new account size for Fresnel is \$750,000.*

*The minimum "portfolio" size for a combination of Bonavista and Halifax is \$250,000. That means that we currently accept "portfolios" that may have two accounts, which when combined exceed \$250,000. The accounts are often an IRA and a personal account, which are managed as a Halifax/Bonavista combo. We no longer accept any "portfolios" smaller than \$250,000.*

*Other accounts may be excluded from the models by virtue of the fact that there are holdings that do not fit the models. For example we have accounts in which we must hold positions that may have been established by a client prior to working with K&A, and which for one reason or another can't be sold. Examples include restricted stock, or stock with extremely low or unknown cost basis.*

*Other accounts may not fit the models because the client lives off the income generated from the investments in the account and therefore we do not reinvest interest and dividends.*

*K&A also manages some money for non-profit organizations that have their own investment policies that we must follow. This is a practice that we intend to discontinue. We are currently working with the non-profits who have accounts at K&A to adjust their investment policy statements to allow us to manage their funds using our Mendocino model. We will not be taking in new accounts from non-profits that do not fit at least one of our model structures.*

*Finally some accounts that K&A manages fit into our "Integrity Retirement Plan/401k" model. No discussion in this newsletter relates to these employee driven retirement plans. They are offered based on entirely different considerations as those discussed herein.*