



Entering the Twilight Zone

Here is how Mr. Serling might have introduced this newsletter:

You wake up from a peaceful sleep remembering that the planet was awash in liquidity. Your business is doing great. Your house is appreciating 1% per month. You go “ca-ching” every 30 days adding up just how much more you are worth. The only thing wrong is that it is costing more to fill the gas tank of your giant SUV. But it is worth it because you LOVE the vehicle.



After enjoying breakfast you head to the office and upon arriving the world is suddenly upside down. Your assistant chastises you for not warning him that his job was going to be eliminated. He just received his two-week notice. You log on to your managed investment account at Jones Sachs Lynch Stanley and Fisher only to find it is down 35% for the year. Your realtor calls you to recommend that you slash the listing price of your house by 20% and tells you that she tried to warn you about the pending collapse in real estate prices. The gold bars you bought only a few short months ago as “insurance” are worth almost 30% less than you paid for them.

The only thing you know for sure is that suddenly you can afford to pay for gas for the SUV.

You have entered “THE TWILIGHT ZONE”.

Actually I suspect that K&A clients DON'T have those feelings. But I am meeting more and more people that clearly do.

Imagine this scenario for a moment. You are a 54 year old guy. You own a big Chevy pickup free and clear. You own two dirt bikes, a small “weekender” mobile home, a boat, two “ski doo’s” (snow mobiles) and your wife drives a 3 year old full size SUV that is paid for—and you are renting an apartment (and you can hardly pay the rent).

How did you get all the toys and wind up living in an apartment? Hey, you financed your house with essentially a zero down mortgage, took out a home equity line and bought all the toys—for CASH! Then you lost the house in a foreclosure but you still own ALL the toys.

Does that sound credible to you? Well try this one.

You own a similar set of toys (free and clear). Your house has been foreclosed. You move out. You rent a house. The bank that had the loan on the house you previously owned calls you up one day and says, “Let’s talk”. They offer to let you move back into your house (which they HAVEN'T BEEN ABLE TO SELL SINCE THEY TOOK IT BACK FROM YOU) so long as you promise to dutifully pay them EACH AND EVERY MONTH a significantly reduced payment, on a lower principal balance, with a lower interest rate than you originally negotiated with them the day you first bought the house.

Hey, I know people that have gone through these things. You may too. The only problem is that they aren't in the Twilight Zone. They are in the good ole' USA in November 2008 and things seem like they are going to get a lot worse before they get better.

Where does that leave us as investors?

Bonds are the new Stocks

Over the long haul there is absolutely no question that stocks have outperformed all other financial asset classes but they don't do it all the time. We happen to be in one of those times when they aren't outperforming bonds. Here is an interesting set of numbers:

Total Real Return Indexes for Stocks, Bonds, Bills, Gold, and The Dollar, 1802-1997, based on 1 Dollar Invested in 1802:

Stocks: \$558,945
Bonds: \$803
Bills: \$275
Gold: \$0.84
The Dollar: \$0.07

According to this study owning stocks over the VERY LONG HAUL has CLEARLY outperformed other financial assets. But it didn't always work over shorter periods of time (like 10 to 20 years!)

Robert Schiller observes in *Irrational Exuberance*, 2nd edition, that short-term interest rates outperformed equities for a total of about 40 years in the 20th Century (1900-1920, 1929-1939, 1966-1976).

That means that T-bills and CD's outperformed stocks in those periods of time.

Source: <http://justforfunds.blogspot.com/2008/01/long-term-return-figures.html>

We are now in the 4th decade that short-term interest rates are outperforming stocks.

Actually the Lehman Brothers Aggregate Bond Index has outperformed the S&P 500 during the time that K&A has been publishing our performance numbers for our models.

Since January 1, 2002 the TOTAL RETURN on the S&P 500 is 1.59%. That is not 1.59% per year. That is 1.59% TOTAL for the whole time. The total return on the Lehman Brothers Aggregate Bond Index is 37.77%. (January 1, 2002-September 30, 2008)

The great news is that our models have performed more in line with the Lehman Brothers Aggregate Bond Index than they have with the S&P 500.

We think that this trend regarding stock and bond returns is likely to continue for a while. Even if we are wrong there is significant appeal to the reliable interest rates tied to bonds given the unpredictability and high volatility of the stock market.

Therefore we are in the process of building out the largest allocations to bonds that we have seen in the K&A models in many years. We even added the Pt. Reyes model to our investment choices. It is dedicated primarily to fixed income and preservation of capital. Here is a brief description of the model:

“The Point Reyes model is for investors seeking current income, protection of capital and low volatility. The model is primarily focused on taxable fixed income investments including money market accounts, domestic and foreign corporate bonds, U.S. government agency notes and bonds, U.S. treasury notes and bonds, and foreign government bonds. The model may also invest in preferred stocks and convertible preferred stocks. Up to 20% of the model may be allocated to common stocks of companies that have historically paid high dividends.”

At the present time the Hatteras model has an allocation of approximately 12% in **tax free municipal bonds**. That might not sound like much until you take into consideration that only 12.5% is allocated to stocks as of November 3rd. The rest is still in cash.

The Mendocino model is approaching a 30% allocation to **corporate and agency bonds** while now holding approximately 12.5% in stocks (November 3rd).

The Fresnel model has never owned bonds during its roughly three year life span. It does now. It has a current allocation of approximately 15% in **high yield corporate bonds** and just over 12.5% allocated to stocks. (November 3rd).

The average yield on the bonds we have purchased for Fresnel is approximately 9%.

The Halifax model currently has a 9% allocation to bonds and only 12.5% allocated to stocks as of November 3rd. The rest is in cash.

We are targeting roughly a 30% allocation to bonds for all four of these models and will continue buying bonds for them until we bring them in line with that allocation. The differences between the models are the types of bonds that they own. (see bold print in paragraphs above).

All the bonds are short term in duration. Most are 1, 2, or 3 years, with an occasional 5 year maturity. None are longer than 5 years. We believe that higher interest rates are an inevitable consequence of the "reflation" that the central banks around the world are attempting. Particular here in the United States. Bloomberg reports that during the most recent quarter the U.S. sold 10 TIMES the Treasury bonds that it sold during the same period last year. That ratio is not likely to hold in the future, but there is no doubt that Federal debt levels will be ramping up steeply. It is quite possible that yields will have to follow to attract the money required to buy all those bonds.

Therefore we are keeping maturities short so that we are not caught owning bonds that yield less in a rising interest rate environment. If the scenario plays out as we expect the bonds we are buying now will mature, pay out, and the money can be reinvested at the new higher yields.

The ETF model owns a 5% allocation to the Blackrock Dividend Achievers Trust (BDV); a 5% allocation to ISHARES Trust S&P U S Preferred Stock Index Fund (PFF) and a 5% allocation to iShares Dow Jones Select Dividend Index (DVY). These are trusts that are made of of common and preferred stocks with higher yields. The BDV is currently yielding about 10%; the PFF is currently over 11% and the DVY is about 4.65%.

The Point Reyes model has a 20% allocation to very sold shorter term corporate bonds and a 12% allocation to preferred stocks that have all been purchased at a substantial discounts to par value, raising the average yield on them to over 8%.

The bottom line is that we want CURRENT YIELD in most of the models. We want to be paid reliable interest and dividend rates that are well above the average return on stocks over the past several years.

The New World is the only model that has no focus on dividends. It remains committed to its investment goals related to cutting edge technology, alternative energy and "green" businesses.

LOOKING FOR HIGH DIVIDENDS

Does the current focus on yield mean that K&A has abandoned the broader stock market? The answer is no. Even as we retreated to cash several times during the past year, we never considered exiting the stock market permanently. We are merely emphasizing yield in the models right now.

The stocks that are in the models are highly diversified and often very different from model to model. The common characteristic is that we have been able to buy stocks that are paying much higher dividends than we were often able to find in the past. Based on their original purchase prices here are the blended yields for the current holdings in the four models listed below (November 3).

Hatteras	Mendocino	Fresnel	Halifax
4.95%	5.44%	4.27%	4.94%

We are combining higher yielding stocks with good bonds to build large allocations in all the models that are focused on assets that will “pay our clients to wait”. In other words as long as you own these assets in the repetitive models they will be collecting substantial interest and dividends while you wait for the bonds to mature and the stocks to appreciate.

Does the recent stock market rally mean the bear market is over?

We wish that was the case but it is not. We are still very clearly in a bear market. The primary technical signal that we use to distinguish bull markets from bear markets is on a SELL signal for all major U.S. stock averages on daily, weekly and monthly charts. That doesn't mean that there won't be substantial rallies. It should be clear to everyone by now that some of the biggest stock market rallies actually take place in bear markets. We showed you this table a few days ago. It is a list of the 10 biggest 1-day percentage moves in the history of the DJIA. Two occurred in October of this year. All the others took place during the 1929-1939 period. That should be all you need to know to confirm that some wild rallies can take place in the worst markets.

Date	% Gain
3/15/1933	15.34
10/6/1931	14.87
10/30/1929	12.34
6/22/1931	11.90
9/21/1932	11.36
10/13/2008	11.08
10/28/2008	10.88
10/21/1987	10.15
8/3/1932	9.52
9/5/1939	9.52

The key to winning in markets like this is not to get taken in by these rallies, but to recognize them for what they are.

In July we told you “It's a Bear” and explained that the great bull market of 1982-2008 was ending “right before our eyes.” Here is an update of the chart that we originally presented in that newsletter.



In July the long term rising trend had just broken. You could barely see the breakdown on the chart because it had just begun.

But now the market has cascaded downward and the break in the long term trend is much easier to see on this chart. The cascade has been so quick that the market is now more “over sold” than at any other time except the market bottom in 2002-2003. We are so “over sold” that any rally that occurs would make sense. People are buying up what appear to be bargains.

Within a month after we made the call regarding the end of the great bull market of 1982-2008 Richard Russell of Dow Theory Letters recognized the same trend and made

the same call. Since that time two other analysts that we respect have made similar calls using different technical analysis than we do.

Richard Suttmeier, Chief Market Strategist for ValuEngine, has told ValuEngine clients that we are now in a “multi year bear market”. Richard uses different criteria than we do to make that claim, but his conclusion is the same as ours.

In late October Rick Bensignor published his analysis of the end of the 1982-2008 bull market in a report to his clients and on RealMoney.com. His methodology is a little different from ours but his conclusion is the same. The bull market is over and we are in for a long term bear market

Rick Bensignor is president and chief strategist at Bensignor Strategies, a technical trading advisory firm that provides macro and micro technical and behavioral perspective across all asset classes, including on-the-fly analysis in real time. He was previously chief market strategist at Morgan Stanley Principal Strategies, responsible for providing the firm's proprietary traders with strategic investment and tactical trading ideas.

In July we were a lonely crowd of ONE in calling an end to one of the longest and best bull markets of all time. We even received some ridicule from other managers for making that call. We aren't feeling so lonely at this point and the market has certainly proven our point.

Sustained rallies do happen in bear markets

Bull markets don't go straight up and bear markets don't go straight down. Sustained rallies happen in both types of markets. It is critically important in a bear market not to "chase rallies". When stocks are going up it is a good time to take profits, convert back to cash and wait for them to retreat again. Buying the "dips" can often be an effective tactic.

We think that it is highly likely that the U.S. stock market, as represented by the S&P 500 can rally back to the 1080 to 1125 range before December 31st. We are at about 963 now. So we could have a 12 to 15% rally ahead of us. If that happens we would be evaluating the current conditions with an eye to exiting the stock market again.

We also believe it is currently critically important that the S&P 500 does not retreat below 890 again before the completion of the rally we are expecting. If it did, then all bets are off.

We are not ready to make forecasts for 2009.

The big issue is that all the stimulus packages have not fixed the basic problem we are facing

We now have close to \$2 Trillion in stimulus from the Fed and the federal government but the "credit crisis" has not been fixed. It won't be until housing prices stabilize and normal conditions return to the mortgage markets. Getting that done will take a huge amount of stimulus aimed directly at homeowners.

Richard Suttmeier, Chief Market Strategist for ValuEngine argues for a "mortgage mulligan" to fix the problem. Here is the four step plan Suttmeier published today as his recommendation to President-Elect Obama:

The economic challenge facing President Obama is to ease the American people through "The Great Credit Crunch" which has been totally mismanaged by the Bush Administration, by Congress and by the regulators of the banking system: the US Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC).

STEP ONE – Send Fed Chief Ben Bernanke on a helicopter back to Princeton and CHANGE the leadership of our Central Bank to someone you trust. Appoint your advisor and former Fed Chairman Paul Volcker as an interim leader of our Central Bank.

STEP TWO – Bring in a Treasury Secretary who can CHANGE economic policy to avoid this sampling of failed programs of the Bush administration. Finding a qualified person who was against these programs may be difficult, but we must CHANGE direction to avoid ultimately costing taxpayers trillions of dollars.

Failed Policies of the Bush Administration – All of these in just 2008!

1. **\$165 billion Economic Stimulus – Was supposed to create 500,000 new jobs. Instead the economy has lost jobs in every month in 2008 with the unemployment rate up from 4.7% to 6.1%.**
2. **\$200 billion Backstop for Fannie & Freddie – The GSEs are wasting this money buying toxic mortgage backed securities, causing Fannie Mae debentures to record wide spreads versus US Treasuries for its reference notes. The Conservatorship of the GSEs is a total failure.**
3. **The Housing Bill – including \$300 billion for HUD to Help Homeowners – The part of the Housing Bill became effective October 1. To qualify the homeowner had to have his mortgage originated between January 2005 and June 2007. I do not believe that this \$300 billion has been tapped yet, so it's not too late to use this funding elsewhere.**
4. **\$700 billion Rescue of the Capital Markets – Buying toxic mortgages is a waste of money. I liked the idea of "TARP-Protected" banks, but the Treasury made a mockery of this program, by providing funding to every bank holding out a Tin Cup. Some of the helped banks will fail in the years ahead.**

STEP THREE – Appoint a Chairman of the FDIC that understands that "The Great Credit Crunch" is not temporary, and that we need to CHANGE and restructure the banking system. The original intent of "Troubled Asset Relief Program" TARP was to buy up toxic mortgage backed securities. I am against this plan and was relieved when the US Treasury announced that TARP would take equity positions in major and healthy US banking institutions. This could have been the cornerstone for CHANGE to a smaller and stronger consolidated banking system.

STEP FOUR – Institute a "Mortgage Mulligan" to CHANGE the terms of mortgages that are defaulting, causing foreclosures and clogging the arteries of the Credit Markets worldwide. Establish this program to encourage first time home buyers through non-taxed withdrawals from retirement accounts. The "Mortgage Mulligan" should be open to all citizens with a mortgage. Giving taxpayers more money in their pockets every month will provide a natural fiscal stimulus, and we won't have to rev up the helicopters.

You may or may not agree with Suttmeier on all points. We don't necessarily agree with every point, but we have been very concerned that much of the stimulus so far is misdirected and that it may not be enough. We agree with Suttmeier that using public funds to buy "toxic mortgages" is a complete waste of money and not likely to accomplish anything other than ringing up more public debt. We love the idea of the "mortgage mulligan" and will be making that known to our elected representatives in Washington. Ground zero for fixing this crisis is in the individual households of America. If you agree we would encourage you to do the same with your elected representatives.

The bottom line is simple, this crisis will end when households in America stabilize. So far very little has happened to "stimulate" households. That must change or this crisis will go on much longer than anyone currently anticipates.

New leadership must and will emerge

At the present time there are no "leadership" groups in the markets. No sector of the equity market is leading. Energy is not leading. Metals are not leading. Soft commodities are not leading. A market without leadership is a stuck market.

YIELD RULES right now.

No opinion on Gold or Oil

For much of the time from 2003 to mid-2008 we were bullish on gold and oil. Frankly we made a lot of money for our clients because we were on the right side of those markets for a long time. We were also smart enough, or lucky enough to exit both markets before they both started their current downward trends. Given the steep collapse in price, particularly for oil, we would love to get on the bullish side of that trade again—but we haven't so far.

We are revisiting all our research on basic supply and demand trends and will not be buying oil related stocks, or shorting them, until we are more committed to a price trend—up or down. Needless to say we will let you know when it happens.

We are just as confused about gold. We'd love to own it at these prices because we think it will be a good store of value for the future. But all our technical work tells us it could move down to \$650 before it finds a bottom. (from roughly \$750 right now). There is no clear trend in place for gold that we can see. Therefore we wait for resolution.

Natural gas prices are firming up however. After dropping to the low “\$6's” natural gas has rebounded to \$7.27. That is bullish for the natural gas related stocks and for drillers related to natural gas. As we add energy related assets back to the models they will likely be related to the natural gas market.

Changes for BONAVIDA

On September 30, 2008 we closed the Bonvista model. Any account that was formerly managed as a Bonavista account and was valued at less than \$225,000 on September 30, 2008 has been moved to the ETF model. Accounts with values higher than \$225,000 were moved to Halifax.

Bonavista has been our worst performing model group over the last few years. The main reason for this is that the group was primarily made up of smaller accounts. The overwhelming majority of Bonavista accounts were under \$200,000. It became clear to us over the past couple of years that these accounts can't absorb the cost of trading as easily as larger accounts. The cost of trading ate significantly into performance as our frequency of trading has increased due to the volatility of the markets.

We have been aware of the problem and that is one of the reasons we incubated the ETF model in 2007. We needed a substitute format in which we trade much less. The ETF model has proven a winner for smaller accounts, outperforming Bonavista in 2007 and so far in 2008. We think that accounts under \$225,000 will be much better served in the ETF model and much more profitable over the long haul.

The minimum size for new accounts coming into the Halifax model is \$250,000. Its performance has been superior to Bonavista for the past three years. We moved the Bonavista accounts that are at least \$225,000 in value to Halifax. Even though a few of the accounts are below the minimum they are close enough to grow to the minimum in short order. We believe Halifax is a great “new home” for these former Bonavista accounts.

Our comment on the election

As a company K&A is expressly neutral when it comes to all politics. We are well aware that we have clients who are Republicans, Democrats, Independents, Libertarians and Green. Our job is to do the best we can to make you money and preserve your capital REGARDLESS of who occupies the White House.

We will be monitoring President-elect Obama closely as he starts to put together his long term team and makes clear his early policy moves. We will be reacting from the point of view that we want to position you on the right side of the trades and investments that can benefit from those policies.

We will make one comment, given how the election turned out. We are frankly delighted that the USA has made the giant stride to elect a person of color to the Presidency. That is not to say that we preferred Obama over McCain. It is simply to say that we are proud of this symbol that something has clearly changed in this country and it is clearly a change for the good. We have moved on and that unto itself feels very good to us.

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

Disclosure and Disclaimer:

ELLUMINATION is the proprietary newsletter written for clients, friends, and affiliates of K&A Asset Management, LLC (K&A).

Paul Krsek is the sole author of ELLUMINATION. While the views and representations found in the newsletter generally reflect the attitudes and opinions of the K&A Asset Management, LLC members and staff, Krsek writes without editing and therefore is solely responsible for the content and opinions contained in ELLUMINATION.

ELLUMINATION does not represent the opinions of Fidelity, Fidelity Institutional Brokerage Group, NFS or anyone employed by Fidelity in any capacity. Neither Fidelity, Fidelity Institutional Brokerage Group, nor NFS, nor anyone employed by Fidelity in any capacity has participated in the creation of ELLUMINATION and they are not responsible for the contents or distribution of ELLUMINATION.

ELLUMINATION is written to provide general information to clients, friends, and affiliates. The contents of ELLUMINATION are not to be taken as individual investment advice. No investment decisions should be made based on the opinions or information offered in ELLUMINATION.

K&A does not represent that the information in ELLUMINATION is accurate or complete and it should not be relied upon as such. Opinions expressed herein are subject to change or modification without notice.

The investment portfolio models or management services mentioned in ELLUMINATION may or may not be available in some states, and they may not be suitable for all types of investors.

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 Andraea 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.

This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy any securities or other instruments mentioned in it.

Sincerely,

Paul Krsek
Updated: August 13, 2007