KANOS CAPITAL MANAGEMENT, LLC

December 2005 Investor Letter

Market Overview and Portfolio Point of View

Wow – we had a wild ride during the 4th quarter of 2005, as stocks of all types went on a roller coaster ride due to uncertainty over energy and commodity prices as well as the extent of rising interest rates and the strength of the U.S. and Chinese economies. More specifically for Kanos portfolios, we generally had a flat quarter, as many of the energy and materials companies we hold had large up moves during the 3rd quarter and digested those moves in the 4th quarter. Our smaller positions in technology and healthcare did better, but make up a smaller portion of our portfolios than general market indices.

Economic Situation

Worldwide demand for energy products coupled with Gulf Coast hurricanes had driven energy prices and energy stocks to highs at the end of September. In October, energy prices plunged as damage, although extensive, was not considered as bad as first imagined. Speculation turned to reality during November and December when demand for energy failed to drop off and supply was slow to return, driving energy prices back up to elevated levels. Our energy investments recovered almost all of their early quarter losses, and we feel that fundamentals of both supply and demand point to increasing energy prices during 2006.

Materials prices, especially metals prices, also dropped during October, as fear of high energy prices and demand destruction caused by these prices were thought to dampen demand for industrial metals and other bulk commodities. Similar to energy, demand for these commodities did not drop, and commodity prices staged a large recovery, helping stocks recover their losses incurred earlier in the quarter.

Most interestingly, the US Federal Reserve continued to raise short-term interest rates, "removing accommodation" from the money system, which had led to a higher US dollar and flat gold prices for much of the year. While the dollar continued to rise during the quarter, gold prices also rose, "decoupling" from its inverse relationship to the dollar and assuming more independent price action. While market pundits are confused as to the action of gold prices, we believe that higher gold prices do and will represent a flight to quality away from currencies as well as consumer demand for tangible items like jewelry. Gold prices ended the quarter at 25-year highs, and although prices are high compared to recent history, we believe the fundamentals of demand for gold, coupled with flat-to-down gold mine output, point to higher gold prices in the future.

Finally, the broader market staged a modest rally, with the Standard & Poor's 500 Index rising just over 2%, as investors bet on continued strength in the economy. The Dow Jones Industrial Average was up less as one of its components, General Motors, fell

*5151 San Felipe, Suite 1300, Houston, Texas 77056 * Phone: (713) 963-9631*
*Mobile: (713) 305-4001 * Fax: (713) 963-9920 * E-mail: kanoscapital@houston.rr.com*

to lows not seen since the early 1980s. Generally, the broader market ticked up but there was very little real movement in sectors as investors balanced continued earnings growth with high valuations, a sense of gloom over continued growth in 2006, and rising interest rates. We also believe that inflation is also a factor, as money supply growth accelerated at the end of the year putting more dollars into the economy that may push up prices more so than governmental statistics currently show.

We continued to buy some quality companies in the energy and materials sectors on weakness and saw some appreciation during the quarter in these names. We are still investing in undervalued companies and continue to put cash to work to take advantage of opportunities, believing that underlying fundamentals will lead to appreciation and increased valuation ratios (from their currently depressed state).

We were a little disappointed in our performance this quarter, since we believe that many of our positions were unnecessarily punished by very bearish expectations which have not proven to come true. As always, we believe that opportunistic buying and "riding your winners" enhances the ability to earn large gains, and we hope to continue to successfully add positions to our portfolio riding good fundamentals.

Thoughts for the Future

While we saw large gains in energy and materials commodity prices during 2005, continued strength in the industrial economies of Asia (namely China and India) and the consumer economy of the United States should continue to drive growth in demand for these materials. As we have said before, years of underinvestment in production facilities (oil & gas wells, mines, distribution infrastructure, etc.) will continue to put a lid on growth of supplies, putting upward pressure on prices of these industrial building blocks.

Having put forth the bullish case for continued commodity prices, we also are cautious about the ability for demand to grow at the pace of the last few years. We would like to invest in more diverse sectors of the stock market, and we continue to look for situations where we believe we can realize value. However, we have not found enough of those situations to have a portfolio balanced like the larger indices, so we continue to run a more concentrated portfolio, trying to grow your money in positions we believe will lead to appreciation and income.

Again, we want to express our thanks to you for allowing us to serve as your investment managers. We try to give you good service and profitable investment ideas, but welcome your input on how we can serve you better.

The Managers of Kanos Capital Management