December 2008 Investor Letter

Fourth Quarter Market Conditions

To best express our thoughts on all that occurred during the fourth quarter of 2008, we thought that some background would help to frame our perspective.

We at Kanos recognized that we were entering a recession in December 2007 (see our December 2007 Investor Letter – "Crosscurrents"), and we thought that overleveraged US consumers would cut back on their purchases in order to "mend their balance sheets," thus causing a slowing US economy, which is why we sold most of our non-commodity-oriented investments, keeping only those in some portfolios which we thought were solid franchises that would survive a recession.

We also thought that the US Federal Reserve would fight the recession by lowering interest rates, thus creating cheaper (and probably a large amount more) US dollars, which would at some point become inflationary. Bernanke's lowering of interest rates starting in September 2007 did indeed prove out this thesis. In addition, we believed that increasing US dollar supplies would be invested in order to better hold a portfolio's value, and we identified commodity-oriented industries with favorable supply/demand characteristics: precious metals (especially gold but also silver) and energy (crude oil and to a lesser extent natural gas) as favorable for investment. We then bought solid companies that produce precious metals and oil as well as some equipment companies needed to find these natural resources for our clients' portfolios as well as for our own in-house portfolios.

Through July 2008, the strategy had produced very favorable results, and although we entered a time of correction for most commodities, it is the nature of markets to retrench along the way in a bull market. We had seen oil retrench 20% in late 2004, almost 25% after Katrina/Rita in October 2005, and approximately 30% (back to $50/bbl) in January 2007, so we were not surprised that crude would correct in mid-summer after rising more than 50% in price during the first half of 2008. We had also seen gold retrench 25% from an interim high in April 2006 of around $725/oz, and after reaching an all-time high in March 2008, gold had corrected 15+% before rallying back over $975/oz in mid-July 2008. In the midst of this July 2008 commodity correction, the Fed, under pressure to help financial institutions, unexpectedly injected money into the financial system and laid out in-depth plans to strengthen Fannie Mae and Freddie Mac (as well as other financial

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institutions), thus providing the market with a coordinated government plan to shore up large crisis-ridden mortgage finance institutions.

What happened to our portfolios? When the US Government and the Fed announced that they would support financial companies, especially by Fannie Mae and Freddie Mac but including large commercial and investment banks, the "trade" that had been working for hedge funds and big traders for much of the year, long commodities (especially energy) / short financial institutions (we had advocated this alignment of our portfolios for almost two years at that point) were "unwound" or sold. This caused hedge funds and other large pools of capital (large banking trading desks, mutual funds, insurance companies, etc.) to sell their commodity positions and buy back their short financial positions. This immediately led to a cascade of increasing forced selling for the reasons put forth below.

First, as prices of commodities and commodity-related stocks fell, leveraged players had to sell **increasingly larger** amounts of securities to meet redemptions, preserve profits and to lessen the leverage – because losses would lead to increased leverage in their portfolios. Here's an example: if portfolio A has 10 units of equity and 90 units of debt supporting a 100 unit position, if it loses 5 units due to a market downturn, instead of having 10:1 leverage (100 / 10 units of equity), I now have 19:1 leverage (95 / 5 units of equity [the portfolio loses the other 5 units of equity due to market losses]. If you had to stay at 10:1 leverage (or less), you would have to sell 45 units and pay back the debt on those sales (a huge amount, which illustrates the violence of "deleveraging") just to get back to your original leverage ratio. Just think what happens when you have 5-10% moves in the market every day like we often saw in late September through mid-November!

Second, as the markets fell apart one after the other, hedge fund investors started to redeem their stakes in hedge funds – giving notice or demanding their cash. This led to another wave of hedge fund selling to hit the market; having to get liquid, especially when one's positions are going against them – they sell whatever they can sell, regardless of what kind of value it is. Increasingly this fall, that meant selling large "liquid" energy stocks and commodity producers – the stocks that had done well for much of the year (they "sold their winners" as many advocate on Wall Street).

Third, hedge funds are generally paid a fixed fee plus a performance bonus. Many typical hedge funds charge "2-and-20" or 2% of assets for operations plus 20% of any profits made after recovering the 2% administration fee. However, this performance fee is only paid as long as the hedge fund continues to grow the portfolio; i.e. the performance bonus is subject to exceeding the fund's "high-water-mark". Thus, it is in a hedge fund's best interest to sell out of everything in a market panic, so that its performance does not drop too far from its "high-water-mark! And that is what happened to the market during the fall of 2008. Hedge funds also sold positions to preserve their high-water-marks.

Finally, the recession, which had dampened economic activity during the spring and early summer, spread slowly throughout the world, and when the financial panics of July, August and especially September hit the front pages, consumers (around the world) slowed their economic activity appreciably. The "straw that broke the camel's back" seems to have been the unexpected failure of Lehman Brothers in mid-September. After Bear Stearns was rescued and sold to JP Morgan Chase in March, it was widely thought that all the large investment banks (Lehman, Goldman, Merrill Lynch and Morgan Stanley) would not be allowed to fail by the Fed and US Treasury. When Lehman failed, its bankruptcy disrupted the money markets (one large money market fund, the Reserve Fund, "broke the buck" when one's principal ended up being worth less than $1 per share due to losses on Lehman commercial paper), hedge fund markets (Lehman was a large prime broker for hedge funds and "co-mingled" hedge fund assets were in many cases subsumed into Lehman's bankruptcy) and stock, bond and derivative markets (Lehman held large amounts of all of these securities, and many traders/companies had to find replacement trades to replace the vaporized Lehman trades that they had counted on.

As companies, funds and individuals started to worry about where their money might be safe, they rushed to the relative safety of US Government Treasury bills, notes and bonds, getting out of all "riskier" assets – stocks, corporate/municipal bonds, commodities, etc. which led to large losses in those assets during October. More than 93% of all New York Stock Exchange stocks hit 52-week lows on October 10th, which many now consider the possible bottom of the market. October saw little recovery, but in early November, the market rebounded. However, nervousness about slowing economic activity and continued bad news from financial companies drove the markets to a new low on November 20th. In late November and December, the financial situation appeared to stabilize, and these last lows held, allowing the market to rebound into the end of the year from very "oversold" conditions.

We at Kanos monitored the markets and felt that what we were watching was one big global margin call, and that the fundamentals underpinning our positions were bruised but not changed appreciably. While energy demand dropped slightly more than we had seen in late summer, prices of energy commodities plunged through support level after support level. Gold also dropped below $700/oz briefly in late October, as large traders sold gold and other commodities to meet margin calls. Momentum sellers joined the selling and drove down prices even further. This plunge in commodity prices was thought to be caused by traders extrapolating the autumn demand slowdown to a severe global recession. But we believe it was the temporary strength of the US dollar which rallied from its mid-July multi-year low to highs in both October and again in November, as investment managers around the world 1) fled to the relative safety of the US dollar (compared to more speculative third-world countries), and 2) demanded US dollars to repay the debt used to leverage their portfolios. While violent and sudden, we think this move to US dollars is temporary due to the declining attractiveness of the dollar which the US government and Federal Reserve are producing in prodigious amounts to try to stimulate the US (and world's) economy to try to arrest any worsening of the recession

underway. We expect the US dollar to resume its bear market at any time, and our positions to benefit when this occurs.

Precious Metals

For the year, gold prices were up 5.7% (although gold hit an all-time high in March during the Bear Stearns "turbulence" and ended more than 15% lower than that level) at $860/oz. Silver, after trading over $20 in March, dropped precipitously during much of the rest of the year as traders worried about large reductions in the "white metal's" industrial demand. Silver closed the year at $11.20/oz after falling as low as $8.66/oz in mid-November. While Kanos had some investments in the exchange-traded-funds tracking precious metals prices, we had much more of our capital invested in large, well-capitalized (and growing) precious metal mining stocks. These were punished during the year as rising mining costs completely offset higher precious metals selling prices, meaning the miners did not profit from higher gold and silver during the first half of 2008. However, the second half of 2008 / early 2009, with plunging costs and (relatively) stable metals selling prices, is expected to provide precious metal mining stocks a chance to show growing profitability as energy prices (the largest component of mining costs) are far lower than what they were just six months ago.

Energy

While we felt vindicated during the summer that our views on dwindling crude oil supplies and stubbornly high energy demand led prices to rise to levels undreamed of just a few years ago, the events of the last six months of 2008 have humbled us as crude oil has dropped by more than 70% in price from its July high of approximately $147/bbl (natural gas has fallen more than 50% in the same time frame).

First, demand dropped off much more substantially than most mainstream forecasters thought; the global slowdown and "dropping off a cliff" of economic activity described above caught virtually everyone by surprise. However, during the first half of 2008, demand was strong, as evidenced by US crude and products inventories, which during the April/June 2008 period were lower than anytime since May 2005 (when crude oil reached its highest production rate) – since that time, worldwide crude oil production (excluding natural gas liquids) has not exceeded the 74.24 million barrels per day (after EIA revisions – although currently July 2008 may have exceeded it, subject to revisions going forward). Demand held firm in spite of almost three months of >$100/bbl pricing before July 2008, so the amount of drop-off in demand is truly surprising. We also postulated that the virtual lack of sunspots during much of 2008 would lead to a cold winter, and it has <u>in spades</u> – 2,148 daily records for snowfall in the continental US during December (according to NOAA); many cities in North Dakota, Wisconsin (including Green Bay and Madison), and Oregon had their snowiest Decembers <u>in history</u>. Chicago through mid-January 2009 has been 12.7% colder than normal (as measured by heating-degree-days) and an incredible 42.4% colder than January 2008 (according to the Weather Almanac).

Boston shows similar mid-January HDDs, which were 14.2% colder than normal and 38.9% than last year. However, inventories have built since mid-summer in crude oil and products, and natural gas inventories have not been used as quickly as thought due to the extreme drop-off in industrial demand for transportation (oil and oil products) and energy for manufacturing (natural gas).

Second, supply, while experiencing some production problems due to natural depletion and delays in new production projects, proved more than adequate for dropping world demand, and crude oil prices dropped from approximately $90/barrel to a shocking $44.60/bbl at year-end (after trading as low as the mid-$30s/bbl earlier in December). Three OPEC cuts have not helped as fewer countries than needed have complied with their new quotas. The price dropped until enough supply was shut off to balance demand plus the ability to store excess.

Commentary

"Mr. Keynes, meet Mr. Friedman; You will be working together going forward; Please proceed to the helicopters"

The Mr. Keynes referred to above is, of course, John Maynard Keynes. Keynes was an economist and economic theorist who most famously championed that governments, when faced with domestic economic weakness, must increase spending to take the place of private sector spending, thus helping its economy recover more quickly than if left solely to private enterprise. Keynesian economics are embraced in many places around the world as the best set of principles to use to help manage an economy.

The Mr. Friedman referred to above is, of course, Milton Friedman, the "father" and founder of the University of Chicago School of Monetarism in which Friedman advocated that the control of the money supply was the way to manage an economy. During periods of economic weakness, increasing the money supply would (with increasing "velocity" or cycling of this money) increase economic activity and thus restore economic strength. When an economy looked too strong or looked to be "overheating", removing money from the money supply (in measured amounts) would help slow down the economy, hopefully cushioning a slowdown in the economy.

Keynesian fiscal stimulus has been used many times in US economic history to try to stimulate our economy, most notably in the 1930s (to get the economy out of the Great Depression) and in the 1970s (to try to restart the economy during the period known for "stagflation"). Former Federal Reserve Chairman Greenspan used "Friedmanist" Monetarist means to stimulate the economy through adjusting the money supply (lowering interest rates during the recession of 1991-92, during the Russian debt

crisis/hedge fund crisis in the US in 1998, after the Nasdaq bubble/recession of 2001-2002, etc.).

Many investors have interpreted the virtual destruction of many large US and European banks, investment banks and mortgage lenders could cause deflation, where economic activity is slowed down so much that supply of virtually all things exceeds demand, and prices drop over time. The working definition of deflation is "too few dollars to buy things," i.e. dollars become more valuable because of the oversupply of goods. The reason deflation is considered insidious is because it makes debt much harder to service – if dollars are appreciating in value (as goods depreciate or deflate), future dollars cost more than past dollars, and debt become more and more expensive to service and pay off. Since the US government has so much debt and US debt as a percentage of GDP has risen over the last two decades, more expensive debt would mire the US in a long-term economic slump (similar to what we have seen in Japan since 1989), so the US Government / Federal Reserve are generally thought to try to avoid deflation at all costs.

Fed Chairman Ben Bernanke, Greenspan's successor, is well-known as a student of the Great Depression of the 1930s. The crisis preceding the Depression is thought to have started after the Fed lowered interest rates in 1927 to ease a Florida land bust, which also caused the stock market to take off, peaking in 1929, after which it crashed. The US Government choreographed a recovery – President Hoover offered a large stimulus package after the crash (a Keynesian solution), but that didn't arrest the slowdown of the US economy (because the economy was deleveraging – stimulus couldn't help right away when people are trying to sell things to reduce their debt). Then in two of the great economic policy blunders that took a bad situation and made it much worse, 1) the US Federal Reserve, after having pursued a loose money policy in the late 1920s <u>tightened</u> the money supply (making credit tighter and business harder to transact), and 2) the US Congress passed the Smoot Hawley tariff that essentially started a trade war, virtually shutting off international trade and strangling Western economies just when they were the most fragile. Current Fed Chairman Bernanke and the soon-to-be-outgoing Secretary of the Treasury, Henry Paulsen, have shown that they are deadset against making similar policy mistakes that were made in the 1930s, so they have come up with a unique solution: apply Keynesian stimulus and monetarist stimulus at the same time!

The Keynesian stimuli include: 1) President Bush's stimulus package in the 2Q2008 when $170 billion was sent out to tax filers up to a maximum income, 2) the Trouble Asset Relief Plan (or "TARP") which Congress approved in the fall of 2008 in which $350 billion was used to invest in/re-liquefy financial institutions in order to shore up balance sheets and provide capital for lending (and which will include another $350 billion authorized in 2008 to be used in 2009 for buying illiquid mortgage bonds and help homeowners with mortgages), and 3) Obama's just-announced $825 billion stimulus plan (consisting of tax breaks/cuts, infrastructure build outs, etc.)

Monetarist stimuli include: 1) lowering the Fed Funds rate (the rate at which banks lend to each other which is regulated by the Fed injecting or withdrawing reserves into banks) to 0 – 0.25% (from 5.25% in 2006), 2) swapping US Treasuries on the Fed balance sheet for illiquid debt securities on banks balance sheets (providing liquid securities to banks to be sold or pledged as collateral for debts), 3) raising the FDIC guarantee from $100,000 per person to $250,000, 4) providing a number of liquidity pools for financial institutions (liquidity plan for investment banks, then Fannie Mae and Freddie Mac, then for banks and insurance companies, etc.), and 5) purchasing corporate, mortgage, asset-backed and other types of debt instruments directly from financial institutions, providing newly created US dollars to bolster financial institutions and provide excess capital that can be lent to reinvigorate economic activity.

These measures are all part of Bernanke's philosophy that he famously put forth in a speech to the National Economists Club on November 21, 2002 titled: Deflation: Making Sure "It" Doesn't Happen Here. As part of the speech, he wrote (during a time after the crash of the Nasdaq bubble when there was fear of the risk of deflation): "deflation is generally the result of low and falling aggregate demand. The basic prescription for preventing deflation is therefore straightforward, at least in principle: **Use monetary and fiscal policy as needed to support aggregate spending** ***[Emphasis mine – KS]***, in a manner as nearly consistent as possible with full utilization of economic resources and low and stable inflation." He goes on to say: "To stimulate aggregate spending when short-term interest rates have reached zero, the Fed must expand the scale of its asset purchases or, possibly, expand the menu of assets that it buys. Alternatively, the Fed could find other ways of injecting money into the system--for example, by making low-interest-rate loans to banks or cooperating with the fiscal authorities." ***[straight out of the recent Fed playbook, isn't it? – KS]*** "Because long-term interest rates represent averages of current and expected future short-term rates, plus a term premium, a commitment to keep short-term rates at zero for some time--if it were credible--would induce a decline in longer-term rates. A more direct method, which I personally prefer, would be for the Fed to begin announcing explicit ceilings for yields on longer-maturity Treasury debt (say, bonds maturing within the next two years). The Fed could enforce these interest-rate ceilings by committing to make unlimited purchases of securities up to two years from maturity at prices consistent with the targeted yields." ***[the Fed has announced just this kind of program in December 2008 – KS]*** In addition, he says "The Fed can inject money into the economy in still other ways. For example, the Fed has the authority to buy foreign government debt, as well as domestic government debt. Potentially, this class of assets offers huge scope for Fed operations, as the quantity of foreign assets eligible for purchase by the Fed is several times the stock of U.S. government debt." And finally: A broad-based tax cut, for example, accommodated by a program of open-market purchases to alleviate any tendency for interest rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices..... A money-financed tax cut is essentially equivalent to Milton Friedman's famous "helicopter drop" of money." ***[the famous reference to dropping money from helicopters if needed – KS]***

But the most pertinent passage from Bernanke's speech and playbook is this: "U.S. dollars have value only to the extent that they are strictly limited in supply. But **the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."** ***[Emphasis mine – KS]***

I think we can conclude from the happenings of the last couple of years, culminating with all of the fiscal (Keynesian) and monetary ("Friedmanist") stimuli, that the US Government and the US Federal Reserve are pulling out all the stops to try to stimulate the economy as economic activity drops. It has been estimated that the combined US Government stimuli add up to more than **$8 trillion** in liquidity, support and tax measures to try to arrest the decline in economic activity, part of which has been lent to foreign central banks to help in their efforts to stimulate their weakening economies.

So, how does this relate to our portfolios? As you can tell from Bernanke's speech, as well as the very clear language from the Fed's most recent meeting, what the Fed's / US Government's call to arms: liquefy, liquefy, liquefy and we'll worry about whatever mess that creates later:

> The vote encompassed approval of the statement below to be released at 2:15 p.m. [December 16, 2008]:
>
> **"The Federal Open Market Committee decided today to establish a target range for the federal funds rate of 0 to 1/4 percent.** ***[Emphasis mine – KS]***
>
> Since the Committee's last meeting, labor market conditions have deteriorated, and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further.
>
> Meanwhile, inflationary pressures have diminished appreciably. In light of the declines in the prices of energy and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate further in coming quarters.
>
> The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, **the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.** ***[Emphasis mine – KS]***
>
> The focus of the Committee's policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level. As

> previously announced, over the next few quarters **the Federal Reserve will purchase large quantities of agency debt and mortgage-backed securities** to provide support to the mortgage and housing markets, and it **stands ready to expand its purchases of agency debt and mortgage-backed securities** as conditions warrant. The Committee is also **evaluating the potential benefits of purchasing longer-term Treasury securities**. Early next year, the **Federal Reserve will also implement the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses**. The Federal Reserve will continue to consider ways of using its balance sheet to further support credit markets and economic activity." ***[All emphases mine – KS]***

This liquidity is being used to fight deflationary forces and force people who want to earn a return to bypass government bonds (because of their negative real yields [where interest rates are below the prevailing rate of inflation]). Thus, investors are forced to consider corporate bonds, preferred stock and common equities – this is how the Fed is trying to do to get the financial markets to return to more "steady-state" conditions.

As stated before, the US Government / Federal Reserve is extending credit, guarantees and newly-created dollars to the US financial system as well as foreign central banks for delivery into their financial service sectors. This is being done because the private sector (banks, insurance and financial companies, leveraged pools of capital (hedge funds, etc.), pension funds, industrial and consumer companies, and individuals) are all having to deleverage simultaneously. The US Government and Federal Reserve, accompanied by foreign central banks and some foreign private sources of capital, are having to take on leverage in order to provide capital to the private sector. We believe this will have to eventually affect the level of the US dollar negatively for two main reasons: 1) The Fed has stated that they will leave the stimulus in "the system" until it definitely is no longer needed – to us, that means that they will keep stimulating until inflation has taken hold. This is the only true way to be sure that deflation has not taken hold, and 2) since the US consumer has collapsed as the ultimate consumer for the rest of the world, foreign countries, especially the developing world, will look to stimulate their domestic economies to "take up the slack" of consumption. How will they do this? – through government domestic subsidies and programs, which will rob the United States (and other debtor countries) of the US dollar support and relatively low interest rates that foreign central banks have provided the US by recycling dollars received from their countries exports to the United States. In other words, if traditional exporting countries are not able to sell exports into the US, there are fewer dollars to continue to recycle into US Treasuries/agencies and other US debt, and current foreign currency reserve (overwhelmingly held in US dollars around the world) will be sold to pay for domestic stimulus programs. This "double whammy" of reduced exports and spending reserves denominated in dollars on domestic programs will eventually push down the value of US dollars.

Thus, we believe that the continuation of the downtrend of the US dollar is inevitable, and our strategy of trying to invest in things that will be attractive with US dollar weakness will continue.

In addition, it appears that in spite of the deflation scare caused by falling asset prices, inflation in everyday life is alive and well. A number of labor unions have threatened strikes during December 2008 / January 2009, including the United Steelworkers Union representing 30,000 chemical and energy industry workers [at refineries], because cost-of-living raises of 2-3% per year (plus other added benefits) were deemed too low. In addition, while raw food costs have dropped precipitously from mid-year highs, packaged food costs and restaurant prices have not only not dropped, but in many cases have risen during late 2008. These factors all point towards inflationary forces having only "withdrawn to the shadows", and that increasing amounts of Federal Reserve-generated liquidity will quickly re-ignite inflation across the spectrum of consumer prices.

Thoughts for the Future

The turbulent financial markets of the last few months have produced some interesting juxtapositions of the relationship between investment types, changing (at least temporarily) relationships that many in the investment world took as gospel. Some of these relationships include: 1) stocks yielding more than government bonds, a circumstance which has not occurred in the US financial markets <u>since the late 1950s</u>; 2) yield spreads between corporate debt / preferred stocks / municipal debt have risen to levels above US Treasuries that have never been seen; and 3) the US Dollar has strengthened in spite of <u>0% interest rates</u> and the Federal Reserve making it very clear that they will be creating dollars and making credit available in every form possible and in large quantities.

We believe all of these need to be addressed, and we will do so in inverse order. We believe the last two relationships are a product of the credit crisis, and both will revert to more traditional relationships as the US and foreign economies settle out in a world with less credit and thus dependent on more fundamental sources of demand for economic output.

US Treasury securities have become the only haven for large pools of capital which got liquid (forced or by choice) and needed to insure safety. When we think about other investments formerly used for cash, we can see why some might consider them unsafe: 1) money market funds – one of the first (and largest independent) money market firms, Reserve Management Co., had its $62 billion "flagship" Primary Fund, "break the buck" and face liquidation after its Lehman Bros. commercial paper proved worthless, 2) banks – Wachovia, Washington Mutual, IndyMac Bank and others had to be rescued by the FDIC at the brink of insolvency, while banks such as Citigroup and many others appear to be only viable due to massive (and ongoing) government loans – deposits in large banks are not guaranteed for amounts over $250,000, so large depositors of failing banks face the possibility of the total loss of their capital, 3) Fannie Mae / Freddie Mac "agency" bonds – these supposed US Government-backed mortgage companies had to be bailed out by the government implicitly, but have not had their debt explicitly backed by the Treasury, as evidenced by a large spread in the yield of Fannie and Freddie debt over

comparable maturity Treasury debt (meaning people are still nervous that they could face some default risk even now), 4) commercial paper – a traditional place for pension funds and other large pools to "park" cash overnight; but with the Bear Stearns and then Lehman Brothers crises, followed by the collapse of AIG and virtual collapse of many large "money center banks" and more pessimistic outlooks for many of America's large industrial companies, commercial paper has become much more difficult to assess for credit quality, and so those looking for absolute safety have avoided it as an asset class and 5) adjustable rate securities – these were considered to be almost like money market funds until a number of the auctions used to price these debt or preferred stock securities failed, leaving investors locked into their positions and no obvious way to get liquidity while preserving full value. All these traditional places to park cash have some form of safety issue that has affected it within the last few months, so ultra-safe (for return of your capital) US Treasuries have benefitted from these fears.

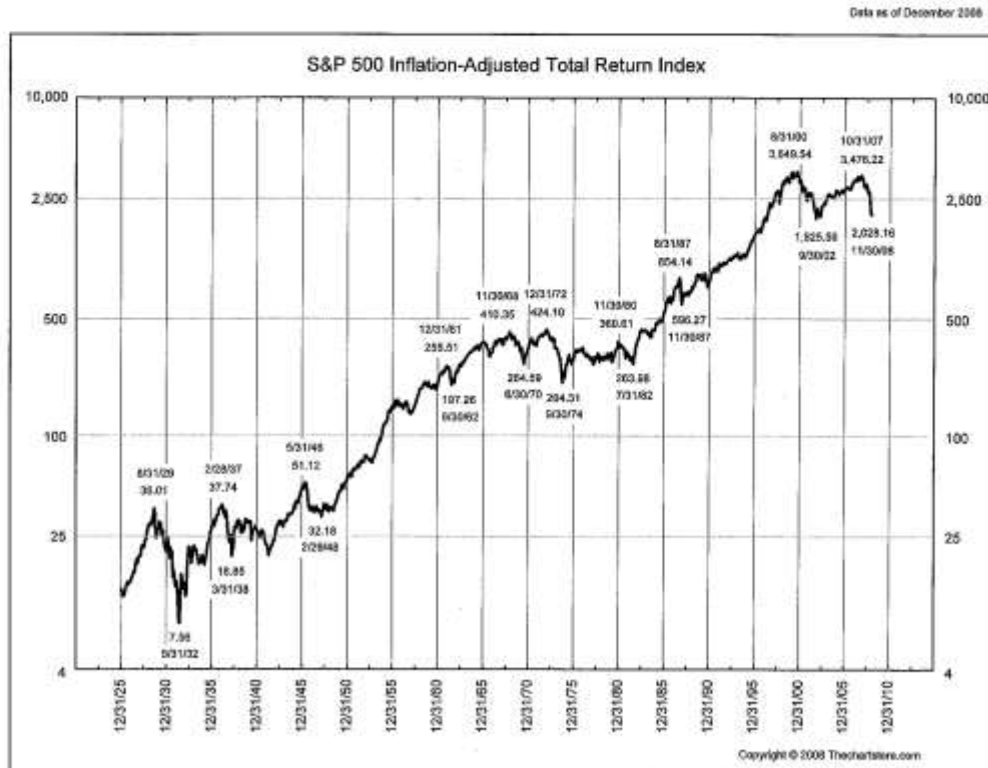
We believe Treasuries will start to increase in yield during the next eighteen months as the financial markets bottom out and the worst of the worldwide recessionary conditions occur. When defaults on various different assets types listed above slow (and eventually shrink to low levels), US Treasury holders will be tempted out of their ultra-safe investments into higher yielding ones.

The reason for the strength in the US dollar is two-fold in our minds: 1) the belief that "the US is at the forefront of the global financial crisis and will thus be the first economy to recover from it, meaning its economic prospects will be more attractive than the rest of the world's." We believe this belief is unfounded because the US is an overleveraged consumer society (consumption making up approximately 70% of our GDP) in the process of deleveraging. That means that the ability of the US consumer to "recover" is a multi-year process that can only occur gradually; consumers must pay off debt before they can consume at their prior rate, and they are likely to try to build some savings before returning to "maximum consumption" in order to cushion any blow that may occur in their lives (like sudden unemployment); 2) need for US dollars to pay off obligations taken on in dollars – lots of leverage was taken on in US dollars because of its low cost (lower interest rates in the US) and easy availability (the Fed was "too easy" with money under Greenspan and continuing under Bernanke, which allowed banks to grow to maximum leverage by making loans easily available). As deleveraging occurs, debts must be paid back with US dollars, and non-dollar borrowers must "buy dollars" after selling assets to pay back in dollars. Note: this same phenomenon is happening in Japanese Yen (which is even stronger than the US dollar due to reason #2). However, we think that a large amount of this deleveraging has been forced to occur in the past six months, and the remaining deleveraging will be overcome by the "waterfall" of US dollars created or to be created by the Fed in the next few months.

Stocks' yielding more than government bonds has been thought about on and off since the initial yield reversal happened in the 1950s. Since equity is subordinate to all debt in paying off obligations, intellectually it seems more logical for equities to yield more than

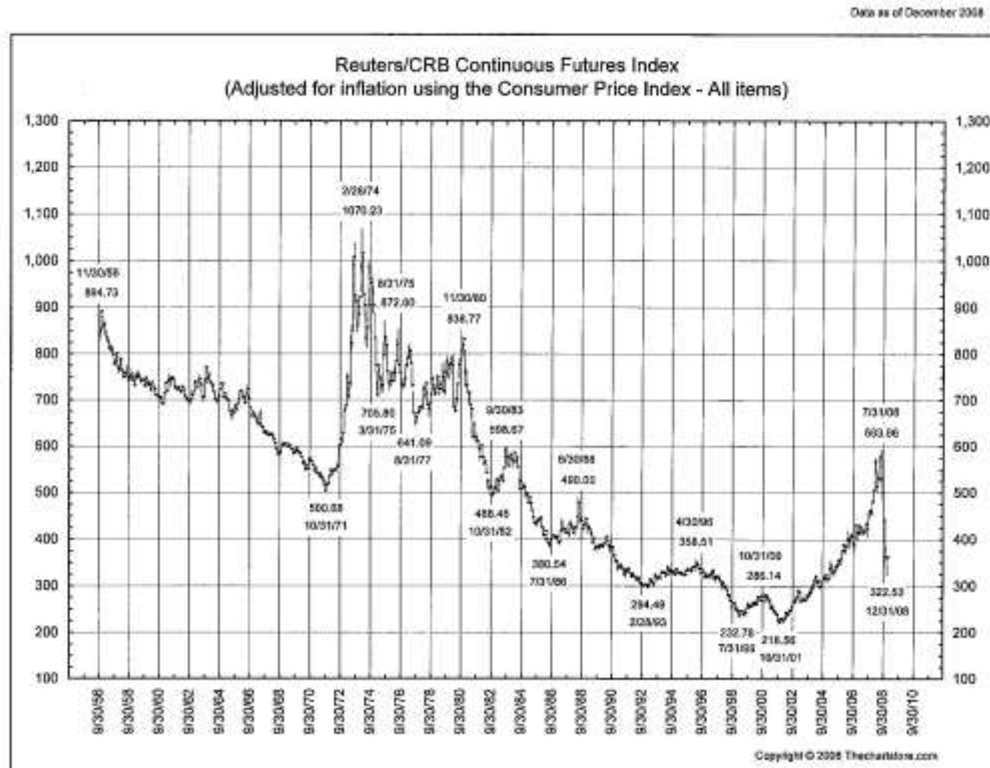
safe government bonds. We have never come across any consensus on why it occurred, but we believe that Marc Faber, the writer of The Gloom, Boom & Doom Report has what I think is a very good theory: he postulates that stocks having a higher yield than government bonds generally points to one of two things (or a combination of the two): expectations about dividend cuts for stocks or very low growth expectations for the economy / world. Obviously, in economic slowdowns, the dividends of stocks are at risk for being lowered because all other obligations, most notably accounts payable, bonds and preferred stock, all must be paid before common stock dividends are considered. So with less revenue and/or profits, common stock dividends can be threatened. But if investors have a low growth expectation, they will price equities so that they receive a return in the form of dividends since capital gains aren't expected because of the lack of growth. This makes the most amount of sense to me: the capital markets (not only in the United States, but also in Hong Kong, Malaysia, Singapore, Taiwan and Thailand, just to name a few) are pricing equities so that expected gains will be in the form of dividends, and growth is expected to be slow or non-existent for the short- to medium-term.

Faber believes commodities have a greater chance of providing return in the next few years than US common stocks, and he reinforces our thoughts about commodity-based investments in this way: while the Standard & Poor's 500 had its second worst performing year in history (after 1931), on an inflation-adjusted basis, the S&P 500 are still higher than any time in history except for the late 1990s equity boom and the Greenspan-induced credit bubble of the early 2000s; in addition, after-tax profit margin from current production is still at historically high levels (for all US corporations aggregated). See table below for S&P 500 Inflation-Adjusted Total Return Index 1926-2008 [only through November].



In addition, we believe credit woes and overcapacity will continue to dog the US economy, but rest-of-the-world economies will be affected to a lesser extent and will adjust much quicker than the US. The credit crunch will keep debt harder to "come by" and more expensive for most borrowers, meaning both residential real estate but also commercial real estate will continue to see difficult times. The US consumers' lack of buying power will hurt sales of products, especially at retailers, which we believe have far too many locations and too many product offerings. Retailers of consumer discretionary items (autos, boats, clothes, travel, etc.) will have a very difficult 2009 and a slow recovery after that.

However, the Commodity Research Bureau (CRB) Index, which includes weightings on a large spectrum of commodities, <u>on an inflation adjusted basis barely reached 50% of the level reached in 1974!</u> The CRB Index has retraced nearly 78% of its move from its inflation-adjusted multi-decade low in late 2001, so on a risk/reward basis, commodities look much more attractive investments than stocks going forward. See Reuters/CRB Continuous Futures Index (Adjusted for inflation using the Consumer Price Index – All items) for the 1956-2008 timeframe [through December] below. Thus, we believe the fundamentals and price action favor continued investment in commodities and commodity oriented companies and investments.



Here are our views of sectors in which we may invest:

Precious Metals

Gold, and to a lesser extent silver, should benefit from the woes in the rest of the economy, especially the financial sector. As investors look to park their wealth while waiting for good times to return, people will increasingly turn to gold as they see financial institutions go bust or become "wards of the state" whose ability to access deposits could change at a moment's notice. As governments make more and more liquidity available, prudent investors will sequester some of their holdings in non-paper money media, such as gold and silver (and collectibles, art, etc.). Precious metals mining stocks should benefit from the rising price of gold and silver, while finding their operating costs dropping due to the lower cost of energy, materials and other variable costs related to mining. We are less certain of the immediate future for platinum and palladium because of their primary use in catalytic converters in new cars; new car production could be low for a couple of years, hurting primary demand and driving down prices.

Energy

Crude oil prices continue to be dominated by short-term demand (or lack thereof), pulling down "prompt" prices and causing storage to be filled to near-record levels. Prices have not been able to rally for any appreciable timeframe since July as speculators help drive down prices to the point where price levels, through economic shut-ins (primarily from Opec countries), forcibly balance supply with reduced demand. With lack of prompt demand, lower prices have caused both national and independent energy companies to cut back or postpone projects, cut capital spending on drilling (probably hurting both development of current fields and possibly maintenance of old fields) and even to lay off employees. We believe that these reactions to this unprecedented price drop will cause supply problems in the near future, possibly starting even in 2009. No chance, you say? Here is some evidence, in spite of historically high prices during 2008 and a rosy outlook during the first half of last year:

1) Output at Mexico's state oil company Petroleos Mexicanos [Pemex] fell 9.2% in 2008 [compared to the year before] its fastest drop since World War II. Pemex blamed bad weather and declining reserves at its biggest oil field, Cantarell. Pemex produced 2.79 million barrels of crude a day, down from 3.08 million barrels a day in 2007. Exports dropped 16.8% to 1.4 million barrels a day. Mexico is the third-largest oil supplier to the US, and oil is Mexico's biggest source of foreign income, financing about 40% of its annual budget. But sagging investment by cash-strapped Pemex has led to a steady decline in output since 2004, when it peaked at about 3.4 million barrels per day. (AP)

2) "In spite of record prices during 2008, Norway's total crude oil production fell 4.4% for 2008 and is expected to fall 9.7% in 2009. Gas sales, which are a smaller element for Norway, are expect to rise almost 3%", all according to the Norwegian government's Norwegian Petroleum Directorate. In other Norwegian energy news, "Statoil has reluctantly cut 2009 capital expenditures to $13.5 billion after spending $16 billion in 2008. They maintained their production target for 2012, but analysts are skeptical they will be able to hit it while reducing capital expenditures." (Reuters)

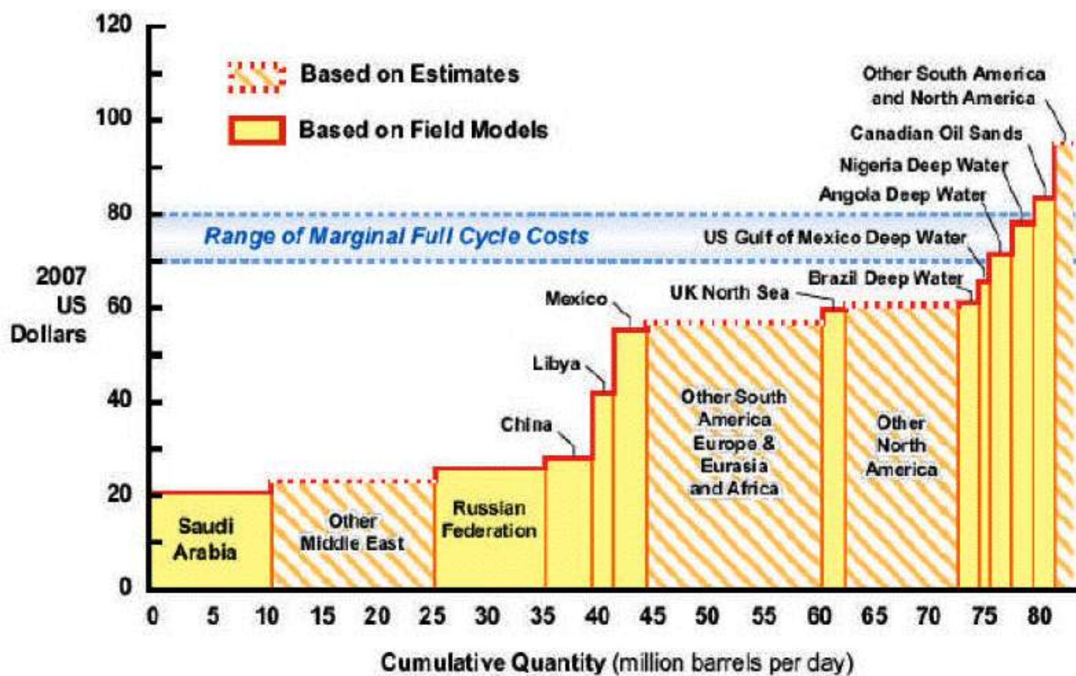
3) "Angola, the newest OPEC member and the one with the highest growth profile, plans to export less crude oil than its OPEC quota for March 2009 because of deliverability problems at their Plutonio and Palanca fields." (Reuters)

4) "Russian oil production fell approximately 1% in 2008, official data showed on Friday [January 2, 2009], the country's first annual decline [in production] in a decade… The decline is widely expected to continue because of aging reserves and plunging oil prices, which combine with heavy taxation to leave producers with limited cash to invest in maintaining production and opening new fields." (Reuters) ***Editor's note: Remember, Russia is the largest exporter of crude oil in the world, with Saudi Arabia coming in second.***

While we have seen our energy investments cut to pieces during the second half of 2008 after a stellar 1H2008 and profitable 2007, we still believe that the essential needs of modern economies around the world need petroleum products for transportation, heating and manufacturing which, while severely depressed in the US and Europe, still shows

signs of either flat demand or slow growth around the rest of the world. Combine any growth of energy demand with difficulty of maintaining supply (natural decline of wells coupled with underspending on maintaining current reserves as well as exploration and development to new reserves to replace lost deliverability), and we think that we could see a return to increasing oil prices at any time, and we expect prices to reach at least $60/bbl (if not exceeding this) before the end of 2009. In January 2009, it has already come to light that Venezuela is not paying its oil service company providers; this highlights how low prices will soon eat into daily oil deliverability – maintenance not paid for will soon cease and cause well problems. One final point in favor of the oil supply/demand balance: one of the prime drivers of reduced demand was historically high prices; the inverse is also true: low prices will in the future drive increasing ease of growth in usage.

The following diagram was produced by Cambridge Energy Research Associates, and we believe it is illustrative of why we believe energy prices must rise in the near future to reach a level that will support investment to maintain crude oil deliverability. As shown below, prices are expected to have to be at least $70/barrel to support the production (shown on the right side of the graph) needed to supply worldwide energy demands.



Other Investments

As talked about above, we see the US corporate sector finding it hard to generate profit growth in uneven, inflationary economic conditions we anticipate for the next couple of years, so our focus will not be concentrated on typical S&P 500 companies. Having said

that, we will look selectively at dominant corporate franchises if we think we can buy them cheaply; examples that come to mind would be: Microsoft (PC software with growth in virtualization/business software), CME Group (financial exchanges), EMC (computer storage and virtualization) and others. We will also continue to look at some appropriate fixed income investments that have floating rates or convertible features that will allow us to shield ourselves from inflationary impacts that erode fixed income investments but still offer historically attractive yields.

Alternative Energy

Kanos investors have asked us about our thoughts on alternative energy companies and technologies, given the increased media focus due to higher petroleum prices in early 2008 and President Obama's focus on increasing US development of alternatives.

As petroleum prices rose throughout 2007-early 2008, more and more alternative energy technologies came into focus as possibly being able to compete with traditional fuels. The alternatives with the most visible investment opportunities include: ethanol, solar, and to a lesser extent wind-energy and fuel conversion technologies.

Ethanol has emerged as the primary oxygenate additive for gasoline (to cut down on pollution) after MTBE was judged to be too toxic during storage prior to being added to gasoline during refining. So the "corn lobby", congressmen and lobbyists representing corn-producing Midwestern US states, successfully got legislation passed mandating ethanol usage in gasoline. The economics of ethanol production were based on plentiful excess corn production and generally high gasoline prices, the conditions prevailing during the early 2000s. However, ethanol has been found to have some downsides: 1) ethanol generally requires almost as much energy to produce as it eventually generates, meaning its utility as a fuel source is questionable, 2) it is corrosive, so it cannot be transported by pipelines (meaning it must be trucked, adding to the energy used to produce this energy source), 3) it does not produce the same horsepower in traditional gasoline-powered cars as gasoline, and its corrosive effects are harder on engines than pure gasoline, and 4) it uses corn for its feedstock, traditionally a food source for humans and livestock used to feed humans, meaning ethanol production comes at the expense of food stocks. Corn harvests in 2007-2008 proved to be less than bountiful for US corn producers, cutting available supply just as tens of new ethanol plants were being opened around the US Midwest, leading to soaring corn feedstock prices and thus soaring ethanol prices, which then tended to push up prices of gasoline with ethanol additives. As gasoline prices crashed with the crash in crude oil prices, ethanol producers, many of whom had locked in corn prices to make sure they had adequate feedstocks for their plants, found their economics upside down and many have entered bankruptcy. Thus, ethanol has proven to be a poor fuel additive and an even worse investment, and while we think that ethanol will be in our transportation fuels for many years, we don't think ethanol will be an investment theme we will pursue. Example of investments: Pacific Ethanol (PEIX) peaked in April 2006 in the mid-$40/share; it currently trades at around

$0.50/share. VeraSun Energy (VSUNQ) also peaked in early 2006 at around $30/share, went bankrupt in October 2008, and now trades $0.07/share.

Solar energy has much more promise as a clean alternative that will produce power from photovoltaic cells. Unfortunately, the breakeven from solar technologies is generally thought to be in the $80 – 100/bbl range, which means natural gas in the $10 – 16/Mcf range, due to the cost of the semiconductor materials used in the solar cells. With crude in the mid-$30s/bbl and natgas less than $5/Mcf, solar technologies currently don't make economic sense without some substantial government subsidies. While we believe technological advances will lower the cost of solar cells in the near future, the need for an industry to have government support to be viable is not one to which we as value investors want to devote investment capital. Examples of investments: First Solar (FSLR) sells thin-wafer semiconductor solar cells mostly in Europe, but has achieved $1 billion in revenues and a 40 P/E ratio; it currently sells for $138/share after hitting as high as $317/share in May 2008. Suntech Power (STP) sells photovoltaic cells and is based in China; it has almost $2 billion in revenue but much smaller margins and a P/E of only about 13x. STP trades around $10/share after reaching $58/share in early 2008. We may pursue select solar investments if we can find companies that offer growth at a reasonable price.

It is more difficult to find investments in wind energy, primarily because most of the leading companies are subsidiaries of larger companies. Wind energy makes even more economic sense than other alternative technologies, but has two major drawbacks: 1) the wind does not always blow, so wind is not "baseload" power since it may not appear for long stretches of time, and 2) the large windmills are generally considered unpleasant in appearance and people generally don't want them "in their backyards". There are no independent wind companies listed on the major US stock exchanges; there are some listed on the Nasdaq bulletin boards (for small companies). The best play seems to be Gamesa Corp (US: GCTAF) of Spain (which has nearly 20% share of the world wind turbine market) or Vestas Wind Systems (US: VWDRY) of Denmark which has about 33% of the world's turbine market. Vestas trades around $17/share after reaching $48/share in June 2008, and Gamesa trades $16/share after hitting $56/share in May 2008. We don't think that these companies offer a very good "bang for the buck" concerning wind energy at this time; we are still looking at an investment which will allow us to harness the wind and profit from it.

Final Thought

We want to thank you again for all of your trust and confidence in our ability to manage your capital. We are constantly scanning the landscape and keeping tabs on investment opportunities while trying to conserve capital to deploy when great opportunities appear. Let us know if you have questions, comments or observations regarding our positioning of your portfolio in this especially volatile market environment.

The Managers of Kanos Capital Management

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