June 2006 Investor Letter

Portfolio Point of View

I would like to apologize in advance for the length of this letter, but I thought that by providing answers to question that many of our investors have asked me separately over the quarter, that everyone reading this letter would get information that would be helpful to their understanding of our portfolio performance. KS

"Reversion To The Mean"

According to the website MathWorld.com, "Reversion to the mean, also called regression to the mean, is the statistical phenomenon stating that the greater the deviation of a random variate from its mean, the greater the probability that the next measured variate will deviate less far. In other words, an extreme event is likely to be followed by a less extreme event." According to the website Investopedia.com, "Reversion to the mean in investing is a theory suggesting that prices and returns eventually move back towards the mean or average. This mean or average can be the historical average of the price or return or another relevant average such as the growth in the economy or the average return of an industry." This phenomenon is thought to affect prices in the financial markets frequently, and that is one of the big factors that affected our performance this quarter.

The second quarter of 2006 showed a large amount of volatility in the portfolios managed by Kanos. This volatility resulted in times of large quarterly "marked-to-market" gains and losses during the quarter. While we managed to limit our losses overall, we believe that our performance this quarter was subpar as financial markets reversed course in mid-May, punishing investments in a number of sectors, including our overweights in energy, materials, and other commodity-oriented companies.

We thought that this recent market action provides a good opportunity for us to present again to you our investment strategy and then address our assessments of the market presently.

First and foremost, we are investors, which to us means trying to figure out business conditions in various industries and positioning your investments to capture the long-term benefits of favorable conditions in those industries determined to be attractive. (It may also mean taking opposite positions in those situations determined to be unattractive). While the above explanation is a mouthful, it represents our investment mission.

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Thus, as investors many times we have to try to filter out "noise" in the markets; this usually means trying to ignore shorter-term market dynamics. These dynamics take many forms and may include: 1) investments dropping in value temporarily as a number of Wall Street traders "rotate" money out of our sector into another; 2) violent price rises as speculators join favorable price action and drive up prices dramatically (but usually temporarily); 3) seasonal shortages or surpluses of a firm's products which distort results for one or two quarters; 4) technical market signals which drive "technical" traders to buy or sell an investment for non-fundamental reasons. While we spend time examining these dynamics to determine their nature, we are most concerned with the fundamentals underlying the business in which we are invested. Thus, we try not to let market dynamics force us out of positions before the fundamentals indicate that we should exit.

We are much better investors than traders, and if forced out of a position temporarily (if the investment is losing – for risk management purposes, if investment is winning, for "timing the market" purposes), we will usually have a hard time buying back into the position unless it drops meaningfully from our exit point. And when reversion to the mean happens in the markets, investments often "snap back" in value and leave us without a position when the long-term fundamentals we have identified continue to look attractive.

Thus, as markets have become more volatile, investors like ourselves must continually check our investment theories to make sure they are still true, and then we must steel ourselves for positions going against us at times. While we at Kanos would prefer to have our clients have portfolios with reduced volatility, we believe that most in the financial markets are unsure of the future, and without more obvious trends to invest in, Wall Street tends to trade in and out of positions, leading to increased volatility as "hot money" traders go in and out of investments trying to capture small profits.

One of the financial writers we read often, John Mauldin of InvestorInsight.com, recently published an article in his "Outside the Box" series that we believe represents the ideals we strive for as value investors. The article was called, "The Perfect Value Investor" and was written by James Montier, Director of Global Strategy at Dresdner Kleinwort Watterstein in London. I would like to quote some of the article so that you can get a better flavor of some of our thought processes. Montier identifies the following as "some of the characteristic behaviors of some of the best value investors."

Trait I: High concentration in portfolios

Contrary to the proclamations of classical finance, these investors tend to run highly concentrated portfolios. No portfolio diversification for these guys. Tracking error has little or no meaning to this group of investors. Across these funds, on average, nearly 40% of the assets are in the top ten holdings. Across a wide universe of [mutual] funds, the top ten holdings account for only around 10% of assets. The average number of stocks held is around 35 (and this is raised by the presence of three international funds, it would be closer to 20 for the domestic-only funds). In contrast, the average US domestic mutual fund holds around 160 stocks!

This seems to reflect a different philosophy on two counts. Firstly, these value managers seem to need a reason to invest - not investing is their default, so in order to actually go out and buy a stock, these investors need to be convinced of the merits. Presumably in accordance with Graham and Dodd's guiding principles, this is represented by a margin of safety. [G&D's "margin of safety" is the extra value attributed to stocks bought by value investors that partially "protect" them from losses in stock price if adverse things happen to a stock they own – KS] As Graham wrote, *"The margin of safety is the central concept of investment. A true margin of safety is one that can be demonstrated by figures, by persuasive reasoning and by reference to a body of actual experience".*

Secondly, the average fund management outfit appears to be run either by the risk management department or the marketing department. One client was relaying to me the joys of his risk managers telling him that he had to deploy more risk, because he was under his risk budget! Of course, when markets fall, those very same risk managers with their trailing correlation and volatility will be the first in line to tell you to sell your positions. The result of these bizarre dynamics is that the average fund manager is more worried about tracking error and benchmark risk, than about finding the best investment for his clients. So their default is likely to be ownership. Hence they need a good reason not to invest in a stock. The fiduciary responsibility to the client is forced to take a backseat.

As is often the case, [noted economist and speculator John] Maynard Keynes sided with the value investors. He wrote: "*To suppose that safety-first consists in having a small gamble in a large number of different companies where I have no information to reach a good judgement, as compared with a substantial stake in a company where one's information is adequate, strikes me as a travesty of investment policy."* Keynes letter to F.C. Scott, February 6, 1942 (The collected writings of John Maynard Keynes).

This was a view shared by [noted financial author Marshall] Loeb in his classic, The Battle for Investment Survival. He opined, ***"Diversification is an admission of not knowing what to do, and an effort to strike an average". [emphasis is mine – Kirby Shanks]***

Trait II: They don't need to know everything, and don't get caught in the noise

The investors in this group seem to be aware of the need to focus on a few key items of information, rather than attempting to try and overload themselves with noise. Lowenstein quotes Marty Whitman of the Third Avenue Value Fund as saying, "the fund doesn't have superior information; 'the trick' is to use publicly available information in a superior manner". To this end, these funds don't employ legions of analysts wasting time forecasting next quarter's EPS; instead, they spend their time trying to understand the valuation and associated risks.

Trait III: A willingness to hold cash

Their willingness to hold cash – currently they hold around 11% cash, nearly 3x the level held in the average US mutual fund. The average hides a wide range of current cash levels. For instance, FPA Capital is holding nearly 39% cash whilst Legg Mason Value holds a mere 1.1% cash. The guiding principle amongst our group of value gurus is, to borrow [noted investor Warren] Buffett's expression, "holding cash is uncomfortable, but not as uncomfortable as doing something stupid".

Trait IV: Long time horizons

I have often remarked that inherent within a value approach is the acceptance of long time horizons. You never know when a stock will reflect a sensible value. A good example was provided by the UK market in early 2003. The dividend yield on the UK market was higher than the 10-year government bond yield, suggesting that dividends were expected to decline on a decade view. This struck me as just plain wrong. A plethora of valuation work showed the UK to be unambiguously cheap. The presence of forced sellers was making the UK market a bargain. However, as with all bargains, they can repay you in one of two ways. Firstly, prices could correct. Secondly, they could just generate a high return via paying out high dividends for a long period of time. You never know which path will be taken. Hence the need for long time horizons.

Our selection of value managers all display long horizons. The average stock-holding period amongst these funds is over five years. The maximum is 17 years, the shortest 3 years. All compare favorably with the mutual fund industry's average stock-holding period of just 1 year (according to Morningstar). Back in the 1950s/1960s, investors used to do exactly that: invest. The average holding period was 7-8 years. However, today it appears as if everyone has become a speculator, with an average holding period of just 11 months.

Trait V: An acceptance of bad years

Nearly all of the [managers] have witnessed periods of negative returns, and/or underperformance relative to a benchmark (although note Trait I on the disregard for such items). Many of them saw large redemptions during the [tech] bubble [of the 1990s], but were prepared to stick to their tried and tested approach to investing. Jean-Marie Eveillard (manager of the First Eagle Global Fund) [has said], "I would rather lose half my shareholders than lose half my shareholders' money".

Despite very impressive performance data, many of the funds have underperformed the index in as many as seven years out of the last ten! Absolute losses are relatively rare, with only 2 or 3 years seeing negative returns in the last 10. In a paper published by [investment firm] Tweedy Browne, they report a study that showed for a group of value investors with excellent long-term track records, that underperforming an index some 30-40% of the time was perfectly normal. This fits well with our previous study of underperformance using an artificial universe of skilled fund managers who, despite having an information ratio of 0.5, saw 70% of their numbers witness 3 or more years of consecutive underperformance.

The excerpts of this article have one overarching theme in my opinion: **patience**. These managers (and your manager) strive to exhibit patience after doing the research, making investment decisions, buying into positions, checking that these investments meet our risk and research goals, and looking for more ideas.

We at Kanos hope that we are serving your investment needs, putting your capital into investments that we believe will make good long-term returns while taking the appropriate amount of risk. The investment world is a riskier place than it has been at many times in the recent past, and according to a recent article, the stock market of the last couple of months of 2006 is more volatile than it has been for 55 years (meaning back to the 1931 aftermath of the Great Crash of 1929). We are trying to do all the worrying over your investment portfolio for you; we hope that you know that we are trying to protect against loss of your capital at all times.

Current Market View

After a stellar April 2006 performance, financial markets in the second quarter of 2006 reversed course in mid-May, punishing investments in a number of sectors, including our overweights in energy, materials, and other commodity-oriented companies. This nosedive has been caused by increasing fears of rising interest rates and slowing economic growth in the US (and thus presumably worldwide).

We are extremely concerned when your investments lose value, so we have gone through a re-evaluation process to ensure that our investment theses are still intact and that we hold investments that will prosper in the future. After going through this evaluation, we believe that while we may encounter more short-term turbulence, our investments are well-situated for the environment going forward. "How?", you say. Let's investigate.

We decided to examine our basic beliefs to see whether our investment thesis was intact. Afterward, we looked at the makeup of our portfolios to see whether our portfolios were set up well. Finally, we examined some possible future scenarios that could occur and how our portfolios might react.

Our primary investment thesis at present is inflation is a problem and that the US dollar is vulnerable; thus, investments that preserve value vis-à-vis the US dollar will help preserve your net worth. We believe the dollar will decline in value over the long term because the United States has been running a large current account deficit (mostly made up of a large trade deficit) which currently runs over $2 billion PER DAY of foreign capital being shipped to the US, with foreigners taking US dollars (which are often held in the form of US Treasury bonds) in return. So many dollars have built up overseas that foreigners appear to be less likely to hold significantly more dollars in the future. Add to this that the US Government is spending an increasingly larger amount over what it collects – the US budget deficit, and there is even more inflation concerns and pressure on the dollar. Finally, US wars in Iraq, Afghanistan, and other possible hotspots means temporary (hopefully) large further outlays to finance these wars. These processes put more dollars in circulation as the government creates money and spends it.

Both of these deficits put pressure on the dollar because they are inflationary, eroding the amount of good a dollar can buy. Thus, we have targeted our investments to sectors we believe will preserve your wealth.

Energy is the lifeblood of the transportation (and heating) systems of developed countries, and the developed world uses 59.2% of current petroleum production. Large developing countries, mainly India and China, are increasingly modernizing and using more energy. This demand increase over the past few years has used up the supply cushion built up over a number of years, and prices have risen. In spite of historically high prices, US gasoline demand has continued to increase, up approximately 1.5% since last year when gasoline prices first approached $3.00/gallon. Layer on top of this demand serious supply concerns, as the world pumps out as much “light, sweet” crude oil as possible but prices continue to rise; a number of experts are concerned that the world as a whole is near to (or past) its maximum daily production of oil and that supplies will have a hard time keeping up with demand. We believe that high prices have not yet led to appreciable changes in demand, and that supplies may have some serious trouble keeping up with the demand in the near future. Thus, we have investments in oil and gas production companies, royalty trusts (where we get paid for actual oil and gas of which we own a fractional part), refining companies (where there is value at present due to the lack of refining capacity, especially for “heavy, sour” crudes) and oil service companies (which provide the tools to oil and gas companies to drill new wells and access discovered supplies). Concerns in the energy sector include the inventories of natural gas (and thus coal) that have built up due to one of the warmest winters on record this past year. While there may be some serious short term pain in natural gas as these inventories are worked off, we believe that normal demand, coupled with the possibility of hurricane-related disruptions and possible cold winter this winter, will return the North American natural gas business to the supply / demand characteristics that affect the rest of the world’s energy concerns.

Precious metals are traditionally a store of value, especially against paper currencies. Thus, we have used investments in gold and silver exchange traded funds to hold “cash-like” exposure in a non-US dollar, non-euro, non-Japanese yen “currency”. We have also bought gold and silver mining companies which should be able to grow their profitability on a leveraged basis as precious metals prices go up and costs increase at a slower rate.

Materials companies and industrial companies in general are benefiting from the combination of many years of underinvestment in commodities coupled with the growing weakness of paper currencies especially the US dollar. Industrial commodities, including copper, zinc, and iron have hit multi-decade high prices as the developing world joins the G-8 countries in a continued building boom and modernization/industrialization phase of development. Industrial companies are providing the tools for extracting, processing and transporting these commodities so needed in the construction, manufacturing, mining, energy and homebuilding industries.

Other industries at first blush look attractive. Large pharmaceutical companies continue to attract our attention, for example. However, we have continued to avoid committing new money to these companies because although there are significant new drugs being approved for usage, some of their largest sellers continue to come off patent, thus robbing these companies of many of the large profit drivers that have allowed them to be such great stock market performers of the past. We remain concerned that valuation ratios, such as price/earnings multiples, for example, will continue to contract as sales growth fails to reach the heights accomplished in the past 15 years. Meanwhile higher interest rates make stock market investments in general look less attractive (vis-à-vis bond investments as well as increased borrowing costs due to higher interest expenses).

Technology shares for the most part also look like many stock prices will drop as the underlying businesses fail to live up to stock market expectations as expressed through price/earnings multiples, price-to-cash-flow multiples, and sales growth expectations.

Thoughts for the Future

As reflected above, we believe that the financial markets will continue to "thrash about", as traders try to decide what the Federal Reserve will do in the future, how interest rates and currencies will move, and whether the US economy (and the US residential housing market) are softening, and if so, how severely.

The Managers of Kanos Capital Management

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