June 2008 Investor Letter

Second Quarter Market Conditions

The second quarter of 2008 was far less volatile than the crazy first quarter, but the general markets showed a slow deterioration in spite of a strong advance in May. Two large influences seemed to steer the markets downward: deteriorating financial conditions and rising raw materials prices. Continued weakness in housing prices coupled with rising long-term interest rates and more stringent lending standards led to poor performance of financial companies. The gloom of the underperforming financials pulled down the general stock markets, both in the US and around the world. In addition, the price of raw materials, led by the 38% rise in crude oil during the quarter, hurt profit margins in a number of industries and appeared to "eat up" dwindling cash flow in US consumers' pockets. In spite of protestations by the US Federal Reserve that inflation was not a long-term concern, future inflation expectations appear to us to be spreading into the US economy, mirroring the building inflation that characterized much of the 1970s.

While stock market bulls continued to try to put on a brave face during the quarter, the weight of poor financial news, the deteriorating US employment situation, rising food prices due to poor weather conditions and increased demand from improving world diets and other uses such as biofuels, continued increase in energy prices and the lack of any leadership out of Washington during an election year has led to the malaise in US financial markets. World stock markets have also reflected the situation of the world's largest economy – most stock markets around the world are off as much or even twice as much as US markets as investors fear that world growth has slowed and US consumers will cut back their historically very resilient spending tendencies.

Review of Second Quarter Markets

Kanos continued to concentrate your assets in investments which we thought would help mitigate the damage that inflation typically inflicts on financial portfolios while continuing to try to protect against the still-weak US dollar. Thus, commodity-based and raw materials issues, including companies involved in extraction and production of raw materials, mostly in the precious metals and energy segments as well as exchange-traded funds that track metals prices and market segments continue to dominate our portfolios, with some large multinational companies also in the mix.

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Energy

Crude oil prices continued to rise as small drops in demand in parts of the developed world (most notably the US) were offset by continued strong demand in the rest of the world, especially the Middle East and Asia. Supply, also a real concern, was upset with interruptions in Nigeria (the fourth largest international supplier to the US and one chief source of light, sweet crude that works best in many US refineries), falling exports from large US suppliers Mexico and Venezuela, and production problems around the globe, highlighted by shutdowns in Canada's oil sands, the North Sea and Russia.

Natural gas had huge gains as prices reached over $13/MMBtu due to a long, cold spring in the Northeast US and increased usage for power production during June. Natural gas prices are mostly affected by domestic conditions since the US exports little natural gas (only to Mexico) and imports into the US in the form of liquefied natural gas (LNG) have dwindled this year since world LNG prices exceed US natural gas prices. Meanwhile, last winter's usage drove stored natural gas levels to lows not seen in a couple of years, so increased demand by utilities for storage for winter needs boosted prices even more throughout the quarter.

Rising oil and gas prices led to investor demand for energy stocks, including exploration/production, oil services and equipment/machinery/construction companies. Our energy-related investments led our outperformance this quarter.

Precious Metals

As the financial markets held their breath during the Bear Stearns crisis in mid-March, gold prices exceeded $1,020/oz and silver traded around $20/oz. After the Fed and the US government rescued Bear and set in motion more programs to provide safety nets for financial companies, gold and silver prices dropped dramatically during the second quarter as the financial world breathed a sigh of relief. Gold and silver prices often provide a "barometer" for concern (or even panic) in financial markets, and precious metals' price rise during the 1st quarter was one of those episodes; meanwhile, the second quarter was a time when prices dropped as newer, momentum buyers sold and those that were "late to the party" got out of their positions as their losses mounted.

Gold and silver prices reached their lows in early May and seemed to use the rest of the second quarter to build a base of pricing; the lows were not breached after May, but there was a lot of resistance to higher prices. India, traditionally the largest gold buyer in the world, briefly moved to 2nd place (after Vietnam) as buyers exhibited "sticker shock" for gold which would not break under $850/oz (and reached over $900/oz near the end of June). While we expected a retrenchment in precious metals prices, we were surprised at how quickly it occurred and how much worse gold mining equities performed than the metals themselves. Gold and silver mining companies have struggled with rising prices for equipment, energy and prospects/land, and Wall Street has been reluctant to buy these

companies in spite of historically high prices for sales of precious metals. That makes some companies in this sector extremely attractive, and we have been waiting for a good opportunity to put more money to work in these companies.

Thoughts for the Future

"Slow Motion Train Wreck"

It appears to us that a lot of what is happening in the financial markets is a slow-motion version of what we have been writing to you about for the last few quarters.

Large US trade and budget deficits, coupled with falling housing prices and a financial crisis in the aftermath of a US housing bubble, have led to a depreciating dollar. Concurrent infrastructure and industrial development in the developing world, led by the blossoming of the Brazilian and Russian economies and the industrialization of China and India, has put large new demands on the world's supplies of raw materials and energy. Meanwhile, chronic underinvestment in natural resource and energy infrastructure and new supplies has led to rising prices in the face of rising overall world demand (in spite of slowing growth in the US and Europe).

What are the probable results for the US? 1) Large deficits mean constant new borrowing, meaning US interest rates should be pressured upward as bond investors must be incentivized to invest in a "growing more risky" credit (in this case, the US government); 2) The Federal Reserve and the US government are concerned about the effects of the housing bubble on the US financial system and on its borrowers – thus, the Fed and Treasury will do all it can to try to protect the financial system and "re-liquefy" the banking system by keeping short-term interest rates low so that banks can borrow money cheaply, lend money more expensively, and make money to replace their depleted capital. However, low short-term interest rates and increased US debt put pressure on the level of the US dollar as international investors look to more attractive interest rates to invest cash; 3) increased building and development around the world demands raw materials including copper, steel, cement, aluminum, etc. along with manufactured goods like trucks, building vehicles, generators, cranes, pipes, roofing materials, process controls, etc. Increased demand for all these elements drives up the worldwide price for these goods. However, development of mines, oil and gas wells, etc. have had long-term underinvestment as the world worked off the surpluses from mines and energy found in the 1970s/1980s and earlier, meaning shortages of heretofore plentiful materials pushes up prices even more (according to a recent study by Stifel Nicolaus commodities analyst Barry Bannister, real US commodity prices (i.e. inflation-adjusted) were the lowest since 1800 in the year 2000, and are still lower today than ANY OTHER TIME IN US HISTORY SINCE 1800). With the US being the supplier to the world over the past 50+ years, these materials are priced in dollars, so increased demand from infrastructure needs

coupled with tight supplies due to underinvestment coupled with a depreciating dollar leads to INFLATION.

The Federal Reserve and the US government have ignored inflation up to this point because they have been so busy/worried about the financial system and US borrowers. There has been a lot of talk about the Fed "having" to raise short-term interest rates to "stop inflation". The US Treasury has been encouraged to intervene in the currency markets to "prop up" the US dollar. However, the Fed will not raise interest rates at least for the rest of this year. Why? The Fed is most concerned about the banking system (and now included in that category are the large investment banks), and most large banks have had to write down tens of billions of dollars of loans and securitized loans as homeowners have had trouble making mortgage payments. This destruction of bank capital is what toppled Bear Stearns, what caused the seizing of IndyMac Bank (due to its large loan portfolio of Alt-A mortgages) and what has caused the stock prices of Citigroup, Bank of America, Wells Fargo, Wachovia and Wells Fargo to plunge during the year. Raising short-term interest rates will make these banks cost of capital higher, thus constraining profitability. Higher rates will make fixed mortgage and other fixed income instruments (bonds, securitized loans, etc.) worth less [when rates go up, bonds go down in value], thus hurting bank capital and causing more writedowns. And of course, higher short rates will make adjustable rate mortgages more expensive for new homeowners, diminishing enthusiasm for new home purchases. We believe that the Fed is not going to actively fight inflation (with anything besides strong words) because inflation helps debt become less onerous as having more inflated dollars makes it easy to pay back fixed debt obligations. Also, the Fed chief, Ben Bernanke, is a student of the Great Depression and deflation, and we will use everything imaginable to fight the horrors of deflation. We believe the Fed actually welcomes (what they consider moderate) inflation to fight any deflationary influences by keeping short-term interest rates low for many more months. As we mentioned above, Stifel Nicolaus' Barry Bannister has shown that commodity prices are still near the lowest inflation-adjusted price in US history, and another part of his study shows that US commodity prices compared to US hourly wages are still relatively low; the commodity prices-to-hourly wages ratio has its 1970's low at 0.27 (in 1971), its high at 0.47 (in 1974) and dropped just below 0.40 in 1980. The <u>ratio is currently only 0.24</u> after reaching a multi-generational low under 0.15 in 2001-2002. Thus, we think the Fed doesn't believe inflation is a real concern yet – thus, no reason to raise rates for awhile.

However, housing prices were so "out of whack" that we see housing prices continuing to fall for many more months or years – why? Because the affordability of housing went to historical highs as low rates combined with lax lending standards causing the recently-burst housing bubble to take housing prices too high. Housing affordability, often measured by housing prices to average pay (which helps quantify people's ability to pay for houses with a more traditional amount of leverage), will not be re-established until housing prices drop to more historical levels. A recent analysis by Paulson & Co. shows that the 1975-2000 compound annual growth rate in housing prices averaged 1.4% per

year, but in the 2001-2007 period, compound annual growth rate of housing prices averaged 7.6%! This huge above-trend price anomaly predicts that housing prices will have to drop more than 30% just to get back to trend (and traditionally large changes in trend tend to over-shoot the multi-year average). Housing prices look like they will be correcting further in the near future. If housing prices do continue to drop, more pain will be felt in the financial arena as people abandon homes they no longer have equity in, banks will foreclose on those who cannot pay their mortgages and mortgages and mortgage-backed financial instruments will have to be written down further, causing more need for LOWER interest rates.

How else will this affect US investors? If China, India, the Middle East, Russia, Southeast Asia, South America, etc. continue to build out their infrastructure using petrodollars or utilizing their large amounts of cheaper labor, continued price rises for energy and other commodities will put upward pressure on prices. Since most commodities are priced in US dollars, downward pressure on US dollars will put additional upward pressure on commodity prices. Rising commodity prices will cause manufacturers to have to pay more for inputs, thus putting pressure on manufacturers to raise prices. These price increases will either work (more inflation to consumers) or not (squeezing margins at the manufacturers). Thus rising commodity prices should be good for those companies that can pass on price increases, but very detrimental to those companies who cannot pass on prices and see their margins squeezed. Thus, commodity price inflation is being pressured into the economy. The last shoe to drop, wage inflation, has not happened yet due to many companies' ability to outsource production (and thus, labor) to lower labor costs places. However, there are a number of workers who can never move: public sector workers. As food, energy and eventually finished goods prices rise, public sector unions will press for cost-of-living increases that will start to point out the real inflation rate (4-8% year) rather than the understated statistics put out by the US government.

Why do we call this a slow motion train wreck? Well, we believe that the Fed's attempts to solve the housing crisis and the financial company weakness will prove to be just postponing the inevitable. Lending more money to insolvent levered financial institutions can "save them" in the short-term, but eventually investment banks and banks will have to make money – and a few of their cash cows: IPOs, mortgage securitizations, auction-rate securities, etc. will not generate new profits for a very long time. Thus, the government intervention will prove to be merely postponing the inevitable. The charade that Fannie Mae and Freddie Mac will stay independent is also joke: if the government does not nationalize these two GSEs in the near future, the worsening housing market will make them fail, as mortgages are defaulted on and mortgage payments drop far below even current levels.

The ruckus raised around short-sellers and commodity speculators is a series of smoke screens where politicians and regulators try to blame financial market setbacks and rising commodity prices on those people who benefit from them. However, what regulators

don't seem to understand and politicians generally don't want to know is that speculators and short-sellers are generally providing much needed liquidity to markets and their absence would cause much larger, more violent movements in the markets, making markets less attractive and thus more capital starved. The move to pass laws limiting traditional short-selling and limiting ownership of commodity futures contracts will prove to be a lot of wasted time that will have no effect on the long-term fundamentals that are the real reasons for the price movements. Commodities trading will move offshore if artificially constrained by US regulations (further weakening US influence in world financial markets), and short-selling may be limited but a number of different derivatives will still give traders ways to achieve short positions without breaking laws.

While the government and regulators might be convinced that short-sellers "caused" Bear Stearns to fail or Fannie Mae / Freddie Mac toward bankruptcy, if these companies hadn't made such poor business decisions on top of their hugely-levered balance sheets, short-sellers would not have been able to make money and would have moved on. In the oil market, as prices moved up over $140/barrel, "open interest" or the amount of oil contracts outstanding on the New York Mercantile Exchange DROPPED, meaning the amount of participation was lower as prices rose, not higher as political rhetoric would have you believe. However, the most obvious way to manipulate prices, hoarding, is NOT in evidence: oil and oil products inventories have been lower than average for much of the year, and as inventories have grown at the start of the 3rd quarter, prices HAVE DROPPED. This shows market mechanisms working, where short-term supply concerns lead to falling prices, not purported speculators' price manipulations that politicians are screaming about. I thought Matt Simmons, chairman of Simmons & Co. investment bank, one of the "godfathers" of the Peak Oil scenario and author of "Twilight in the Desert", made an interesting comment when interviewed on CNBC recently; when asked how he thought speculators were affecting the oil markets, he said (and I paraphrase): "Speculators have been doing a good job keeping the price of oil ***DOWN [emphasis mine – K.S.]***; without the locals and speculators in the market, the price of oil would probably be between $160 and $175 per barrel." This comment by a long-time market watcher illustrates an important point that many people fail to grasp: the government is wasting time and effort in formulating rules that may have an impact OPPOSITE to what they contemplate.

We have a solution, however painful it might prove in the short-term: if the Fed and Treasury were to let markets work while having the SEC and bank/financial regulators enforce current laws, this financial crisis could worsen, but would also clear out the poor investment decisions and worthless investments in the market faster. It would lead to a lot more financial pain in the US, as more people would lose their homes (and probably for many their cars, too), and the economy would slow down considerably because people would curtail their consumption much more than has happened since the 1970s/early 1980s recessions. However, the economy would emerge much more cleansed and healthy afterward. Part of the solution would have to be that the US populace will also have to demand of their elected officials more conservative fiscal

policy to try to arrest the increase in the budget deficit; hopefully the trade deficit would be reduced appreciably through lower consumption of imports and rising exports due to the more competitive price of the US dollar.

However, with the important election looming in November, and the feeling that "we can't afford" ANY real hiccups in the financial system (such as another large financial institution going under, a "blow-up" in one of the financial markets, etc.), we expect that our solution outlined above will be ignored and the futile actions of the government and financial institutions will continue to cause the economy to crash in slow-motion, and although wild volatility has driven our positions down some in July, we believe that buying commodities or commodities-based companies at attractive prices will yield very attractive long-term returns for the next few quarters.

Energy and Precious Metals

A short note on energy and precious metals in July: energy prices dropped sharply during the month as traders worried that continued slowing of the US economy would affect world export economies, thus limiting demand for energy supplies. While we don't disagree with this concept, we are more worried about energy supplies in the future, and we believe that depletion of current oil and gas deliverability will limit the daily amount of energy the world can call on, keeping prices above $100/barrel (at least on average) for years to come.

Metals prices have fallen as confidence in US financial institutions has been restored from near panic levels in mid-July. However, we believe the key to US financial health rests squarely on housing prices, and they continue to drop around the nation. California residential real estate prices have merely retraced to 2004 levels, and as (we believe) they drop further, new financial losses will emerge and confidence in financials will drop once again, providing a new "up" leg in precious metals prices in the fall.

The Managers of Kanos Capital Management

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