KANOS CAPITAL MANAGEMENT, LLC

September 2006 Investor Letter

First, I would like to say I was extremely disappointed in our performance this quarter. While we anticipated there might be some weakness in commodity prices (due to the seasonal drop in usage of energy in the early autumn), we were obviously surprised by the violent selling of all commodities, and consequently virtually all commodity-related stocks. We have sold some positions to satisfy some of our risk management discipline. We have also limited increasing our investment as we monitor pricing and valuation metrics. However, we believe that the fundamentals underlying our investments remain intact; we would be selling much more strongly if we believed that the fundamentals were deteriorating. So onto our outlook.

Market Conditions

Are We Or Aren't We?

The big question facing the US financial markets is whether we will soon be (or are already) in a recession. Let's look at both sides of the argument.

If we are, the US Federal Reserve (the "Fed") will soon need to lower short-term interest rates to lower financing costs in the slowing economy, which is weaker in part because of the cooling housing market [which the Fed has highlighted as a particular concern of theirs]. Thus, if the economy is getting softer and the Fed lowers rates, the US dollar should show some weakness as the investment climate in the United States is judged to be less attractive than before. As a sign the market participants expect this impending weakness, the US bond market has dropped almost 0.5% in yield recently. A lower US dollar will make things denominated in US dollars cheaper overseas. It will make US manufactured goods more competitive in global markets. Since most commodities are traded in US dollars, prices of all dollar-denominated commodities will be cheaper to overseas users due to a weakening dollar (all other things being equal).

If the economy is not going into recession, then the weakness in the housing market should be offset by strength in the manufacturing and services sectors. Capital expenditures and capacity expansions will not be put off, and the US should start to see economic re-acceleration. Longer-term bond rates should rise, and the Fed will have to start to consider whether they should keep short-term interest rates steady as the economy strengthens, or start to think about raising interest rates to keep inflation in check and keep the economy from growing too fast. The key point is that a non-recessionary US economy will require the same or a growing amount of energy, materials and other commodities as people start to drive more, build more, travel more, etc.

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Guess what? Both situations lead to higher commodity prices and thus should lead to higher stock prices of our commodity-based holdings! In the first case, a slowing US economy leading to lower rates should (at some point) drive down the dollar, leading to lower prices for dollar-priced commodities leading to increased foreign demand and higher US dollar prices. In the second case, a re-accelerating US economy should lead the world economy in using more materials as the slower growth developed world grows at a moderate pace while the "developing" BRIC countries (Brazil, Russia, India and China) grow at much faster rates (5% - 12% per year).

I thought Bill Herbert, Co-Head of Research at energy investment bank Simmons & Company International, said it well in a recent research note (bolded emphasis is mine):

> "Lots of noise about OPEC yesterday and, predictably, lots of confusion. Our advice is to focus on the fundamentals. Oil production challenges remain acute. The top five oilfields in the world are in decline (Ghawar, Burgan, Cantarell, [Ahwaz,] Daqing, etc.). Non-OPEC production challenges remain as acute as ever - IEA lowers it's ever optimistic forecast of non-OPEC output seemingly on a monthly basis. Adding fuel to the fire is the absence of adequate oilfield infrastructure, particularly deepwater rigs, to ramp up to the extent needed. Notwithstanding rising protestations to the contrary, ***energy demand remains stubbornly resilient. China's implied oil demand in August rose 9.2 percent in August, following four months of double-digit growth and auto sales were up 29 percent in August and 32 percent in the first eight months. US gasoline demand growth continues to chug along at ~1.5% per annum.*** Thus, there is a very thin cushion of spare oil production capacity. The result is sustainably higher oil prices relative to historical precedent. Geopolitical challenges add to the risk premium for oil***. These are not transient issues - the fundamentals are structural and likely to persist for many years."***

The last point that Mr. Herbert makes is important – geopolitical risks have eased to the back of the "mind" of financial markets, but events could lead to higher prices (or price upsets) at any time.

We at Kanos have been playing aggressive defense with portfolios, concentrating on investments that would protect us from inflation and from dollar devaluation. This has led us to concentrate our portfolios in energy, materials and international equities, which have performed well over the past couple of years. However, in the just-finished third quarter of 2006, markets started to react to growing evidence that the US economy would slow down but not enter recession. This would lead to a condition that has happened only once in the post-World War II period, a "soft-landing" for the economy, which many in the financial community have labeled a "Goldilocks" scenario, in which the US economy is "not-too-hot, not-too-cold". This led to large financial institutions selling their holdings in energy and materials because the economy is slowing (fewer houses being built, fewer materials to transport, less demand for energy) but not going into recession (buying technology stocks that might continue to grow at their past historic

rates, buying consumer discretionary stocks because the US consumer is still able to spend discretionary income that would drop much lower in a recession). Also, much of the geopolitical angst that the world had faced earlier this year concerning possible energy supply disruption and nationalization/strikes at mines in less developed countries seemed to abate during the past quarter, taking risk premia out of the commodities markets and hurting stock prices of producing companies. We remain skeptics that the slowdown in housing will not cause some kind(s) of financial upset – such conditions have always led to trouble at financial institutions in the past. In addition, we believe that geopolitical upsets have retreated but have not gone away, and that there are plenty of chances for disruptions to cause higher prices in the future.

Going Forward

We have been concerned about the level of the US Dollar vis-à-vis other currencies and gold due to the large deficits being produced in the United States. I know I probably sound like a broken record, but in spite of the rhetoric you hear out of Washington about cutting deficits, the (true) budget deficit, the current account deficit the US runs with the rest of the world, and the national debt continue to grow at unsustainable rates, so the fiscal health of the US government continues to look worse.

We are also concerned about the valuation of US financial markets (and to a lesser extent world financial markets) as we believe valuations have become stretched with respect to what we see as a slowing of world economic growth. John Hussman, a money manager who runs the Hussman funds, sums up these valuation thoughts succinctly in his recent outlook (bold emphasis is mine):

> "On the valuation front, the current P/E ratio for the S&P 500 is 18 times record earnings (on record profit margins). Historically, the combination of an inverted yield curve and a P/E ratio over 15 has been associated with negative market returns, on average. The current observation, moreover, is even further outside the oval. ***The only time we've observed an inverted yield curve and a P/E at or above 18 times record earnings was at the 2000 market top.*** The runner-up (just below 18) was near the heights of the "Go-Go" market leading into the '69-'70 bear market."

Thus, we have been trying to PLAY DEFENSE, limiting our investments to themes which will both take advantage of weakness of the US Dollar and better relative performance of the world (non-US) economy over the US economy. That has continued to lead us to energy and materials companies which are great profit generators and relatively well protected against dollar weakness. According to financial research company Standard & Poor's, the overall growth of profits in the largest 500 public companies in the US (the S&P 500) is expected to grow 13.3% from 2005 to 2006 – and more than half of that profit growth is in energy (41.4% of S&P 500's profit growth) and materials (12.8% of profit growth). Thus, the purported health of the US economy as represented by the large companies of the S&P 500 is being supported by the companies in which we have substantial investments. As these companies' earnings power is

recognized, these holdings will increase in value versus other large US companies that have large valuations but poor (and possibly dropping) profit contributions.

Financial markets operate by combining all the elements of valuation, technical and fundamental analyses but especially FEAR and GREED. During the quarter, our portfolios were caught in a time when **fear of (short-term) trading losses and the greed of participating in the better recent performance of large capitalization US stocks have overpowered the fear of the abovementioned longer-term concerns around the US economy and US dollar.**

Some of the short-term fundamentals underpinnings of the energy markets did diminish during the quarter: end-of-summer seasonal dip in demand, lack of any hurricane interruptions of energy supplies, and inventory builds in case of hurricane-induced interruptions (in virtually all energy products) all had a depressing influence on short-term energy commodity prices. The easing of geopolitical concerns (or really the lack of any recent geopolitical upset) has allowed a large amount of risk premium to be taken out of the energy markets. While we have weighted these elements heavily in our analysis, we also believe that continued resilience in non-housing US economic activity should also lead to continued energy usage growth; albeit at a slower rate than in the past couple of years. Ultimately, the bottom line (in retrospect) was that the energy "trade" got much more crowded than we had anticipated because large investors found fewer good investments in the general market during much of 2006. As energy fundamentals softened this fall, a large number of "Johnny-come-latelies" sold their positions in a herd-like way, sending prices down much farther and faster than might have been predicted, considering the fundamentals. As energy commodity and stock prices fell, most other commodities (metals, grains, etc.) also plummeted in price due to market participants' view that softening economic conditions meant demand for all commodities would fall.

So, our defensive posture has cost us dearly in the past month and a half – the equity markets have reacted as though US economic will re-accelerate due to the perception that the Fed will lower interest rates in the near future. If the economy is going to reaccelerate then our energy and materials positions should see demand pick up again. One old financial sage has said: "Markets always act the way you think they will, just never when you think they will." That is a hard lesson to learn again, but portfolios reflect it currently. As mentioned above, we believe that the fundamentals support our investments, and with time, the prices of our holdings will more properly reflect their underlying values. Therefore, we continue to stay in the most promising of our positions, while continually re-evaluating them versus the fundamentals of the stock markets and underlying markets to maintain our ability to profit from positions while trimming laggards.

I have been working hard to try to stay in our long-term positions that I believe are promising while wanting to sell to limit the short-term paper losses. For the most part, I have not sold so that we could profit from our positions when the markets turn our way. However, I have felt the need in part to limit further losses and raise cash, so I have sold some holding and may sell more in the future to manage any further downside risk.

I want to thank you for your confidence in me in this trying period – our investment themes are long-lived and in the past have lasted many years longer than they have during this current cycle. Having said that, each historic advance has had a number of large price declines that have driven out weaker holders before the advances continue. I believe that is what we are seeing. <u>If you have heartburn over the volatility of our concentrated portfolio, let's discuss it and see if we can make you feel more comfortable or raise some cash so that we dampen volatility.</u>

I am also heartened by the following <u>contrary</u> indicator: people who concentrate little on the energy and materials markets have told me that "the commodities trade is over". First of all, it is not a "trade" for us – this is a multi-year trend that has not played out yet. Second of all, there is still growth in the demand for the materials that our investment companies produce, and price weakness only encourages that demand. Third, if a number of non-experts are making an investment call, that decision is <u>usually wrong</u> in the long-term (although it may look good in the short-term).

Finally, <u>we are investors</u>, not traders. While we think you should know how our investments are doing against general market indices, so much of equity markets' activities are influenced by very short-term influences: 1) large amounts of institutional and retail "hot money" (generally momentum traders) that stay in positions for only a few hours, days or possibly weeks before selling and moving their capital to other sectors, 2) the huge amount of interest in quarterly results and "making [or beating] the earnings number" which drives stocks up or down significantly based on short-term trends, 3) large institutional money managers' need to not underperform against his/her benchmarked index – this leads people to buy stocks that are going up and sell stocks that are going down [or buy high, sell low] – which is not usually optimal for making money long-term, and 4) constant financial press (CNBC, Investor's Business Daily, lots of magazines) and advertising that concentrates on making money in the markets <u>by short-term trading alone</u>. We try to transcend as much of this short-term "noise" as we can, while not risking too much of your hard-earned money. We hope we are succeeding and meeting your expectations.

Thoughts for the Future

As we said above, we believe the fundamentals supporting the US dollar are weakening, while we believe that commodity companies will return to increased profitability as the market recognizes that demand is still strong and supply is not infinite. We look forward to making your capital grow in the future as we look for investments that give us an adequate amount of reward potential for the risk taken on.

The Managers of Kanos Capital Management

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