KANOS CAPITAL MANAGEMENT, LLC

December 2006 Investor Letter

Our portfolios rebounded in the fourth quarter as energy prices recovered from their fall lows and materials prices climbed back from their mid-year retrenchment. While we were happier with our performance this quarter, we at Kanos felt that the market did not fully recognize the value of our positions. Thus, we had minimal changes in the account, and we believe that our positions will reward us further in 2007.

"Fear and Greed"

Fear and greed – two strong emotions that tend to influence how people act in the financial markets. We have seen the effects of both fear and greed on our portfolios during 2006, and I want to examine how these emotions have and will affect us in the future. As many have seen, a number of financial markets have experienced a lot of motion over the past year. However, the VIX, which measures the future expectations of volatility of the S&P 500 stocks, is at historically low levels, so the stock market is not expecting to have lots of up and down movement in the future. But other markets have – we'll examine two that affect us.

Since Hurricanes Katrina and Rita hit the Gulf Coast last year, crude oil prices have gyrated wildly. Oil prices moved up near $70 after the storm, but the realization that there were still adequate supplies drove prices down to the $50's soon afterward. Expectations for winter cold drove prices up last December, but prices fell when early 2006 weather was warmer than normal. A hot summer and expectations for more hurricanes drove prices to $77 in July 2006, but lack of hurricanes and the end of hot weather in the summer then drove prices back down into the low $60's by late 2006.

Likewise, natural gas prices rose after the 2005 hurricanes, reached $15 per MMBtu last December, crashed to $7 after a historically warm January 2006, rose to over $8 after a hot summer, dropped to $6 when no hurricanes materialized in the fall of 2006, and then rose to $9 after a cold November 2006.

Finally, gold prices started the year under $600 per ounce, rose to $740/oz in mid-May 2006, fell back to the $560s during the summer, rose to $650 in the late fall, but then fell back to the low $600's in December 2006.

These descriptions of price action detail how fear and greed drive prices at times, and how extreme their moves can be. Those two strong emotions drove traders to push prices up at times as greed took over (fear also in some cases, as people feared that there would not be adequate energy supplies, so they bought at high prices, driving prices even higher), and at times fear took over and people sold positions quickly and indiscriminately, driving prices down severely at times.

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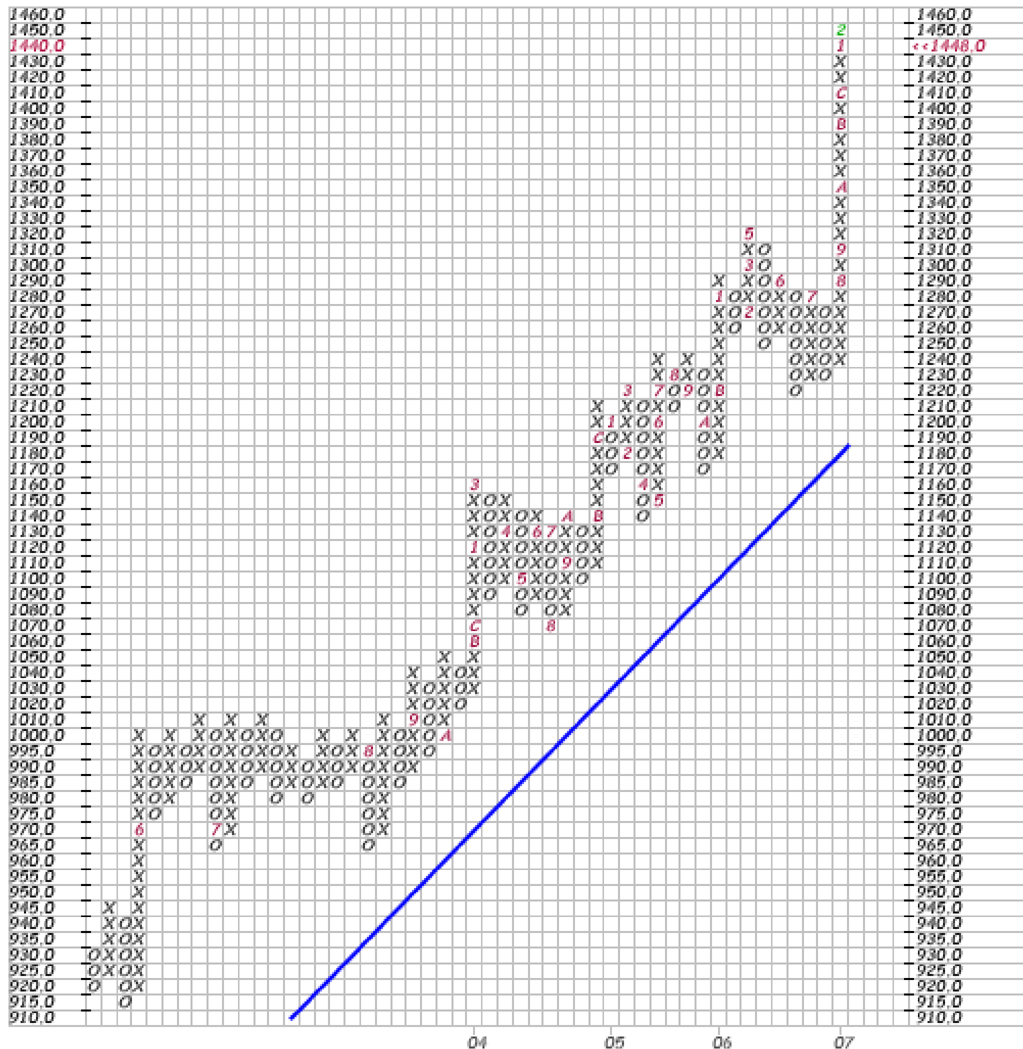
So, what's the point? Well, in this case there are two points: 1) in spite of these extreme moves, we believe that these underlying commodities will drive profits in our companies and the stock prices of those companies higher, and 2) markets tend to go up and down a great deal, even if they are headed generally in an upward or downward direction. We at Kanos believe that in spite of the turbulence of prices, the companies we own will turn out to be good profit generators that others will want to own, driving up their stock prices. We also believe that the stock market is overdue for some corrective action. The "point & figure" chart below graphs the level of the S&P 500 versus time – the x's represent upward price action, the o's show downward action. This index has not had a 10% correction (8+ o's in a column) since mid-2003 (the very left side of this graph)!



All market correct downward at times, and the high "pole" of prices in the top right corner of this graph is worrisome for further advances in the market. The chart above also shows the greed side of the equation – I wonder what this chart will look like when fear is injected into the market (hint – there will be a lot more o's on the chart, representing downward price movement).

The Federal Reserve appears to still be concerned about inflation, so it does not appear that interest rates will be cut anytime soon, while housing, one of the main engines of the US economy over the past couple of years, is still very weak. Consumer debt and mortgage debt levels are high, and resetting of adjustable rate mortgages this year is expected to add more of a burden on consumers. Thus, we feel that the Fed would like to lower rates to stimulate the consumer sector and to help out the weakened housing sector, but doing so will make money cheaper, reigniting inflation and leading to weakness in the US dollar. Thus, the Fed is in a quandary.

We believe that the Fed will ultimately cut interest rates this year, which could temporarily buoy the stock market, allowing it to go higher. However, we also believe that lowering interest rates will indeed reignite inflation and weaken the dollar, meaning that our commodity investments should appreciate in value. Rising wage costs for business is also expected to contribute inflationary pressures to the economy. Thus, we believe that our positions will outpace the stock market in 2007, and in spite of potentially lower interest rates during the year, the market will suffer a correction this year.

Market Conditions

Energy prices (especially crude oil prices) moved down sharply in the first few days of January 2007 as warm weather prevailed along the East Coast during early January. Metals prices fell in sympathy. However, as of this writing, both markets seem to have stabilized and having "shaken out the weaker holders" appear poised for a rise in 2007 (which is the opposite of 2006 where energy and metal prices rose strongly in the first few months of the year, and then had steep corrections afterward).

Meanwhile, the general stock market seems to move higher day by day, there are some elements of concern for the market, which I think are well-summarized by John Hussman of the Hussman funds in his mid-January Weekly Market Comment:

"[The market is vulnerable to correction after setting a recent record closing high because of the factors indicated below. The overall stock market is:]

Overvalued	S&P 500 price/peak earnings greater than 18
Overbought	S&P 500 at a 4-year high, and at least 5% higher

	than its level 6 months earlier
Overbullish	Investors Intelligence percentage of bullish advisors above 53%
Yield pressure	3-month Treasury yield higher than its level of 6 months earlier

Hussman believes we will have sharp correction in the next few weeks since his research indicates that when the four elements listed above are present, the market typically drops more than 10% in less than two months! In the Kanos portfolios, we believe we have already seen our correction, and that our portfolios will be well insulated when high-multiple technology and health care companies get repriced.

Our other concern is investors' perception that our current high profit margins (much of which are caused by low wage expense versus their historical norms) are sustainable. Typically, when profit margins reach a peak, P/E multiples contract because investors believe that margins are not sustainable (many of our energy company positions trade at P/E's below 10x because the majority of investors don't believe that energy prices are sustainable at these levels [of course, we do]). However, the market in general has a P/E multiple around 18x at a time when profit margins are near their historical highs, which would typically push P/E multiples below their long-term average of 15x. Thus, if profit margins move back to more typical levels (with no downward price action in stock prices), P/E multiples will be closer to 23x, very high for a slowing US economy.

Thus, we continue to have our portfolios set up for aggressive defense, keeping relatively fully invested in positions that we believe will benefit in good economic conditions (increased demand and supply concerns for energy and materials) or bad (commodities will be a store of value; energy usage could fall but developing world is using more and more, so demand should not fall too much).

Thoughts for the Future

Financial markets have been extremely fickle, with people buying voraciously in certain sectors and selling willy-nilly in others, only to switch three months later and do the opposite. Hedge funds, incentivized by high performance fees, have continued to chase "hot" sectors, fleeing other sectors when they believe momentum has waned. We at Kanos have continued to try to examine fundamentals and "ride out" the storms that occur occasionally in our portfolios, waiting patiently for the markets to recognize the values in our portfolios.

We believe that precious metals and energy are in long-term "up" cycles, as demand for these builds and supplies have a hard time catching up. As we write, gold and oil have reached levels ($660/oz and $59/barrel, respectively) from which they have the ability to break out to the upside (or continue on in their current trading range until demand builds

up to push up prices later on). We believe our patience will be richly rewarded during the spring.

Thanks again for your business and your patience. The markets are hard masters, and all have to bear the volatility to generate long-term, tax-efficient returns.

The Managers of Kanos Capital Management

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