KANOS CAPITAL MANAGEMENT, LLC

December 2007 Investor Letter

Review of Fourth Quarter Markets

The 4th quarter was wildly volatile in the financial markets, as the continued growth in world economies was offset by a slowing in the economy of the United States. The stock market set new all-time highs in the early days of October, then broke its August lows in late November, only to settle almost mid-way between those two extremes. Credit markets continued their near paralysis as mortgages and bonds backed by mortgages continued to show weakness. Natural resources, after initially showing strength due to US dollar weakness during September/October, showed strength (crude was strong, then weak, then strong), weakness (base metals prices dropped most of the quarter), and range-bound trading (gold traded between the $780s and $840s). The portfolios managed by Kanos enjoyed a good quarter, hurt only during stock market weakness in November.

Our thesis on energy, that demand would not subside in the face of stronger prices, continued to pay dividends for our portfolios. Crude oil traded in the mid-$90s per barrel, retreated to the mid-$80s in late November, and then closed the year near its all-time high at $96 per barrel. US demand, while dropping slightly since summer, stayed at a high level (gasoline usage at approximately 9.3 mil bbls/day), and crude supplies, as measured by the US Energy Information Agency weekly reports, dropped for the last six weeks of the year, confirming tighter supplies and no real slack in demand. Distillates, which are diesel fuel and heating oil, were used more than analysts had forecast leading to dwindling supplies in storage and all-time highs in price during December. Gasoline supplies built during the period, but high crude oil prices held gasoline prices at elevated levels. Finally, natural gas, with record amounts in storage, appeared to bottom out as usage exceeded estimates and increased perceptions of future demand lifted prices. These factors led to our energy stocks moving up smartly in October and then again in December, capping a great year for our portfolio companies. The market appears to be further embracing our concern that demand continues to be strong while supplies in many different parts of the world show increasing reasons for concern. Mexican production has been erratic and dropping, and Middle Eastern supplies have not been showing up in nearly the quantities that analysts expected in the fourth quarter. Russian and Canadian supplies have been steady but not rising, as many expected them to do during the fourth quarter. Finally, the northern hemisphere has experienced relatively normal winter temperatures, exceeding the demand forecasts of a mild winter, causing higher usage of energy than expected. We believe that the supply and demand situations will not change

5151 San Felipe, Suite 1300, Houston, Texas 77056 Phone: (713) 963-9631
Mobile: (713) 305-4001 Fax: (713) 963-9920 E-mail: kirby.shanks@kanoscapital.com

appreciably even with prices in the $90s per barrel, and only when gasoline prices jump into the $4 per gallon will consumers really think about truly cutting down on their usage.

Metals prices have been a mixed picture this fall. Base metals, such as copper, zinc, iron ore, etc., have had an up and down year. As evidence emerged during the second half of 2007 that the US economy is slowing down (compounded by the US housing industry being in severe contraction), prices for these metals dropped in the fourth quarter far below the highs set earlier in the year. However, the US dollar reached its lowest point in history during the fourth quarter (before rebounding slightly in December), making all materials priced in US dollars cheaper for those buying with other (non-US dollar) currencies and setting up a rebound in demand during 2008 if economic growth continues in Asia and South America.

Precious metals, after getting close to all-time record levels not seen since 1980, closed out a very good year, slightly off their highs but closing for the first time over $800/oz for gold and $1500/oz for platinum. The fading value of the US dollar, brought on by the US Federal Reserve's lowering of interest rates, US budget and current account deficits and growing concern of foreign reserves overweight in dollars, has driven up the value of the precious metals. While some European governments have been selling gold for the last few years to re-allocate some of their reserves into other currencies, many Asian countries have indicated that they believe their gold reserves should be increased. This reserve buying, coupled with buying for investment purposes by people trying to diversify out of all currencies, has driven gold near its all-time high prices, although adjusted for inflation, the 1980 gold price highs equate to a $2,000/oz price in 2007 dollars.

The US stock market had a poor fourth quarter, punctuated by a new yearly low that violated the level set during the panic sell-off in mid-summer. The market was led lower by the financial sector as credit woes spread from the subprime mortgage market to other sectors of the mortgage market and financial institutions which held these mortgage investments on their books. The basic materials and energy sectors had a good quarter (as mentioned above) as did technology stocks, which were judged to be immune from the downtrend due to the large international components to their businesses. However, the stock prices of consumer discretionary companies (autos, travel, etc.) and retail businesses (clothing, groceries, electronics, etc.) were hit hard as the US economy started to noticeably slow during the quarter.

Crosscurrents

Banks down strongly, large-cap technology stocks up strongly. Manufacturing companies laying off people, unemployment rate constant at a low 4.7% (as reported in government statistics). Energy prices way up, energy demand constant. Inflation reported at under 3% (in US government statistics), food/energy/precious metals prices

hitting all-time [nominal] high prices. US economy apparently slowing down, Chinese and Indian economies still apparently growing at double digit rates. Fed easing interest rates, stock market still within 7% of all-time highs set in the latter half of this year. All of these apparent contradictions are occurring right now. There are so many elements that can be used that we are 1) already in recession or 2) will avoid recession and accelerate from this low growth (but still expansionary) period. Which interpretation is correct?

Many people consider a recession to be a period when we have at least two quarters of negative real growth, or in other words, when real economic activity shrinks for at least two quarters. However, the National Bureau of Economic Research (the arbiter of when recessions begin and end) judges recessions to occur when a number of things happen: industrial output shrinks, unemployment climbs, retail sales weaken and personal income drops. Using these elements, we believe we are already in a recession; here's why.

Industrial output for the US has shrunk over the years as cheap manufacturing was moved to places with extremely cheap labor and new facilities were built closer to the raw materials they used in their manufacturing processes. Thus, the US is much more concentrated in some industries than the country used to be. Two of those large industries that generate large components of national growth are the automobile industry and homebuilding industry. These two industries boomed during the 2002-2006 period when very low lending rates and the upswing in economic activity after the 2001-2002 recession and the 2000 technology bust drove demand for new cars and new homes. Home ownership in the US grew from a decades-long trend of approximately 66% to almost 70% ownership by 2006. Spurred by cheap mortgage financing and lax credit standards, Americans bought new homes, second homes, vacation homes and rental property homes at the highest rate in history. The homebuilding industry could barely keep up for awhile, but after more than three years of huge growth in homebuilding and rises in pricing, the housing markets around the US started to get saturated. Saturation led to markets in California, Nevada, Florida and many other US locations to start to "get soft" (in late 2005) as demand started to wane and home prices started to drop. The homebuilding industry was caught with growing inventories, lots of raw land, and falling prices for their products. As falling demand accelerated and prices followed, the industry has been forced to lay off thousands of construction workers, marketing people and administrative staff. The industry has to taken massive write-offs on land and unsold inventories of houses.

The auto business starting in 2002 also took advantage of cheap financing and the economic "glow" from rising housing prices to sell more and more vehicles (especially trucks and large SUVs where their profit margins were highest). However, the companies' high cost structures and poor margins on most car lines did not allow the manufacturing divisions to profit appreciably from this sales boom. The financing arms of the large auto manufacturers were the only segments making large margins on these vehicle sales, as cheap financing allowed GMAC, Ford Motor Credit, etc. to expand. As

Americans spent more on homes, furnishings for those homes and more discretionary items (boats, for example) due to rising home prices and the wealth effect that people felt from more valuable homes, these auto financing companies expanded their lending to include mortgage and personal loans in addition to traditional car loans. When gasoline prices continued to rise (especially post-Katrina) and home prices stopped rising, the car companies saw demand soften, and they had to fall back on aggressive financing to sell cars. Vehicle sales continued to weaken, and like the homebuilding business, the financing side, which had been a tailwind for many years, started to deteriorate in quality and become a headwind for profits, pulling down the profitability of auto companies just when their falling sales drove the auto manufacturing segment to losses.

These two large industries continue to drag down US industrial output as we speak, and the continued poor performance of these companies will require further downsizing, write-offs, layoffs and reduced output. We believe US industrial output thus will weaken, as these two large components contribute further weakness to US manufacturing.

Unemployment has been steady according to US government statistics at approximately 4.6-4.7% for the past few months, but there is a story behind the story. The US is gaining approximately 200,000 employment-capable people each month, but the amount of jobs created each month has fallen from around 180,000 per month earlier in the year to 95,000 per month over the past several months. In other words, payroll growth is slowing down, and this statistic is further skewed higher by the fact that people who were once looking for jobs but are no longer are not included in the pool of employment-capable. In addition, this overall statistic is modified by a number added to the observed job growth using what is called the “Birth/Death” adjustment to job creation that models how small businesses are creating or destroying jobs; this is a highly subjective adjustment and is hard to judge how accurate it is.

The US has been able to show such strong employment statistics recently due to the rise in “shadow unemployment”, where workers not counted by official statistics are laid off, making unemployment seem better than it really is. These workers are illegal aliens, building houses and infrastructure that are no longer being built due to the housing bust.

Curiously, the unemployment rate is low and holding at what is historically considered a very low level while at the same time not having caused much wage inflation. How? Wage inflation appears to have been kept in check by the ability for manufacturers to move operations overseas, leaving rank-and-file workers in the US little ability to negotiate for higher wages.

Stock market bulls argue that this low unemployment rate means Americans are working and can continue to spend at or beyond their means (as they have done for the past five to seven years) because they have steady work and have survived the exodus of American manufacturing. However, as America has become much more of a service economy,

service jobs are more at risk than in prior economic slowdowns (because they make up a much larger percentage of the workforce), and the mortgage and financial industries are starting to show real trauma, which should lead to a steady exodus of workers from the companies in those industries. Thus, we anticipate that employment statistics will start to show rising unemployment as services companies start to lay off unneeded workers.

Retail Sales have been the lifeblood of the last few years of American economic expansion as the US consumer's contribution to GDP growth has grown from around 65% in recent years to nearly 70% in 2005. Why the increase? Mortgage equity withdrawals, as people refinanced their mortgages and were able to extract equity due to price appreciation of their houses. This extra money allowed people to spend more, which we observed through the increased share of retail sales to our economy. However, as the housing bust has taken hold in the US, retail sales have started to turn down. The stocks of retail companies were very poor performers as Wal-Mart, specialty retailers and virtually every segment in between (with the exception of luxury retailers) have shown sales weakening in 2007, especially in the fourth quarter. Economists are most concerned about retail sales with regard to a recession, because deteriorating sales will impact manufacturing and retail employment. Look for the Fed to lower rates faster if retail sales start to really sag. Which brings us to….

Personal Income has proven to be rock solid the last few years, supporting the expansions in the 1990s and 2000s, although we believe it will be less supportive in this economic environment. Steady to rising personal income has allowed the US public to buy large houses, increase spending and carry more debt (which could be supported by steady / rising incomes) over the past few years. However, while personal income may continue to rise, we believe it will be the least relevant of the indicators of recession for the following reasons: 1) while incomes have gone up, debt levels have gone up too, so rising incomes are more burdened by larger interest and principal payments, 2) inflation will cause nominal income to rise, but we fear rising inflation (especially in energy and food cost increases) will actually lower disposable income, and 3) weak consumer balance sheets are in need of repair (think: savings) so rising incomes will have to be used at some point to pay off debt and save for retirement, not allowing as much spending in the future and hurting economic growth.

Thus, we see these four facets of the economy: industrial production, unemployment, retail sales and personal (disposable) income pointing downward, and we believe that the US economy has already entered a recession. The credit contraction caused by falling home prices and thus falling bond prices has led to less day-to-day lending available for conducting business, and problem debt products have led to a flight-to-safety in short-term investments. Banks unwillingness to lend to each other (due to their fear of poor credit quality of the bank counterparty) has driven up the interbank rate (known as Libor [London Inter-Bank Offered Rate]) to be higher than central banks lending rates, meaning banks are having to pay each other more than normal to borrow overnight reserves. When credit is tight and home prices are dropping, economic growth is

diminished, and we believe that it will continue until the poor investments of the last few years are "washed out" of the economy.

In contrast, corporate balance sheets are quite strong and finished product inventory levels are not overly high, but shortages of raw materials and the inflation that these shortages are causing should squeeze corporate profitability in the future at the same time demand from consumers continues to drop for the reasons discussed above. Stock market bulls will argue that with the corporate sector in good physical shape and inventories low, but corporate profitability has been at an all-time high for the past year (even higher than 1990s levels), and with softening consumer spending / retail sales, the corporate sector will start to show deterioration as the economy softens further.

Thoughts for the Future

Typically, as the country moves into recession, we experience a bear market. We believe the bear market started in late summer/fall and was reinforced when the stock market fell below the closing lows of the summer on November 21st. Obviously, a bear market will hurt stock prices, but which stocks and how much? We have anticipated that the forces that were in motion during 2006/07 would continue to this point, so our portfolios are skewed to try to lessen the amount of damage a bear market might inflict – we have invested in commodity-oriented companies that have worldwide businesses but should be able to withstand a weaker dollar and the ensuing inflation through price increases and expanded production. While energy demand typically lessens during recessionary times, we believe that the precarious position of world energy supplies will not let prices drop as much as people anticipate when they feel like demand will drop from a slowdown in the US. We also believe that the Fed will lower interest rates to try to stimulate economic activity, hurting interest income and making dollar denominated bonds less attractive, pushing down the value of the US dollar. The lower US dollar, accompanied by falling confidence in US investments, will cause dollar-denominated commodities to rise in price (all else being equal) and precious metals will rise even faster as gold, silver, and platinum are bought for safety and preservation of capital.

Many traders have been buying technology companies during the fall as the US economy has started to soften – their thinking is that consumers' thirst for electronics and corporate infrastructure investing will both hold up during an economic slowdown. We believe that this logic is flawed, because many types of "technology hardware" (semiconductors, for example) are components of consumer durables (like cars, appliances and consumer electronics) that are showing much slower sales than earlier in 2007. Large amounts of personal electronics are used by finance and real estate professionals, and with downturns hitting those industries, we believe future demand will suffer much more than traders think. Technology shares were always considered cyclical stocks, prone to highs during economic booms and lows during slowdowns, but the huge technology boom of the 1990s led many investors to think a change happened, and technology companies should

now be considered perpetual growth engines (in spite of the tech bust which occurred from 2000-2002). We feel there are still some days of reckoning in the technology sector that will bring large adjustments in share prices as supply and demand weigh on growing product inventories.

Financial companies have had a very bad 2007, and many believe that we must be near a bottom due to the amount of losses sustained so far. We believe that there has been a culling of bad investments, but that the process is not over because the buildup of these poor investments lasted many years, and it will take more than a few months to write them off. Financial shares have dropped in price this fall due to writedowns of low-grade mortgage debt and risky business investments, but a US slowdown will affect much larger sectors: credit card, home equity and auto loans will suffer as US consumers contend with higher cost pressures and falling home price values. Financials will not be on our shopping list in the near future.

We will continue to look for bargains around the investment universe in order to try to find less risky ways to grow your capital. We appreciate your patience and confidence in our investing process, and we hope to continue to grow your assets like we have in the past.

The Managers of Kanos Capital Management

© Copyright, Kanos Capital Management, 2007. All rights reserved.