KANOS CAPITAL MANAGEMENT, LLC

June 2005 Investor Letter

Market Overview and Portfolio Point of View

Wow! What a ride the second quarter of 2005 gave us. Markets of all kinds were up in March 2005, but April to May to June was a time period when different influences drove stock, bond and commodity markets in large moves, both up and down.

Our value bent has driven us lately to companies that produce natural resources, where we believe that long term trends toward higher prices and constrained supplies in the face of slowly increasing demand. As you know, this means that energy and materials companies have been our favorites this year. We will review the factors affecting the economy and the natural resource sectors in which we are invested and then give our thoughts for the future.

Economic Situation

The US economy continued to gather a little strength during 2Q2005, with employment growing slowly while increasing personal consumption continued at its recent pace, driving corporate profits to double digit gains. This strength in the economy also translated into investor confidence in the US. This led to higher overall US corporate profits, which grew year-on-year in the 15 – 20% range for much of the Standard & Poors' 500 companies, the largest companies in the US. This led to the US Federal Reserve also continuing to raise short term interest rates, removing the accommodative monetary stance that it had maintained for the last couple of years due to perceived economic weakness. Higher short term interest rates appear to have contributed to the attractiveness of foreigners holding dollar-denominated securities, and the US dollar rallied strongly versus a number of foreign currencies, including the euro and yen. Interestingly, longer term US government debt also rallied (perhaps reflecting the aforementioned dollar purchases), with the 10-year US Government bond dropping as low as 3.9%. Generally, when long term rates drop to get close to short term rates (the so called "flattening of the yield curve"), this is a signal for economic slowing in the future. Thus, Alan Greenspan, the chairman of the Federal Reserve Board, has referred to this occurrence as a "conundrum", where the economy looks vigorous enough for the Fed to boost short term interest rates, while long term interest rates drop at the same time, potentially signaling future economic slowdown.

It is in this economic "conundrum" that we find ourselves, and trying to deploy your money profitably. One would think that rising corporate profits would lead to (or at least signal) some inflation – however, government statistics say there is little inflation. Commodity prices, driven in part by increasing US economic activity and in part by developing countries further industrialization and modernization (read China and India, most particularly), have continued to be strong; however, worries about future growth

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caused a number of industrial materials to have severe price corrections, like steel, some industrial metals, lumber, etc. (as well as some of the supporting industries – like shipping companies and distribution companies of these products). Energy prices should be at least partially pro-cyclical, rising due to increasing demand from economies around the world, but prices have gone as high as $60/barrel (reflecting fears of supply for winter) and as low as the low $40s (reflecting the fear of too much supply and flagging future demand). The stock market has bounced around in a relatively tight trading range, as if market participants cannot decide on the future direction, in spite of growing profits.

We believe that short term economic growth has driving recent corporate results, but that the excesses of the late 1990s/early 2000s still are in the world's economic system, limiting a strong economic expansion until excesses are further wrung out. In spite of this, we also believe that long term lack of past investment in commodities have left supply short in a number of these commodities while demand has continued to grow (albeit sometimes at slower rates than at other times), and commodity companies in general will continue to generate profits in excess of recent past historical performance. We believe that disinflationary pressures of Asian manufacturing will continue to suppress prices to consumers, squeezing corporate profit margins and leading to reduced corporate profits for manufacturers (and possibly retailers). Pricing power still appears to reside at the consumer and the natural resources producers, with those companies in between having to absorb cost increases and squeezed margins.

Finally, in spite of recent trends, we continue to believe that both US consumers and the US government continue to live beyond their long term means, spending money as monthly cash flow allows, but not building (and probably reducing) liquid net worth. This reduction of wealth and growth in debt may be sustainable in the short term, but the imbalances building up – the federal budget deficit, the trade deficit and the current account deficit, all of which require approximately <u>$2 billion per day</u> of foreign monetary inflows will eventually prove unsustainable, driving down the value of the US dollar. Since the euro seems wounded after some European no-votes on the proposed pan-European constitution and European economic malaise, and the Japanese government has not supported the yen due in part to that country's weak economic conditions, precious metals seem to be a logical beneficiary of paper currency weakness around the world.

Our Investments

Energy companies did very well during the 2nd quarter, as continued strong demand around the world, especially in the US, caused higher energy prices and good profits at energy companies. One main theme of our investing, oil refining with an emphasis on companies that could refine heavy sour crudes, did especially well, with refiners Valero and Premcor rising strongly during the quarter. Not to be outdone, crude oil producers also did well, as crude stayed in the $40 – 60/barrel range, finishing in the high $50s/bbl as hurricane season in the Atlantic Basin start to spawn some early storms. Other energy related companies did very well, with our oil drilling, pipe supply and pipeline construction investments rising in price substantially.

Continued strength of the dollar hurt our precious metals positions, as gold and silver prices dropped to multi-month lows during April and recovered only part of those losses during the rest of the quarter. Precious metal mining companies did not recover as much as the metals prices themselves, and increased costs of energy, machinery and materials (see commentary above) squeezed margins. We believe that the bad news is in these stocks, and that eventual price increases in the underlying metals will drive leveraged gains in the shares.

Other materials stocks recovered much better during the quarter, with industrial metals (especially uranium) increasing substantially, and the companies supplying these were up during the 2nd quarter.

Technology shares, led by semiconductor and internet companies, went up in price during the quarter, which we did not expect. We believe enduser demand for technology products (as typified by results at consumer retailers like Best Buy and Circuit City and wholesalers like Ingrain Micro, etc.) have been uneven (some months looking strong, others looking weak), but technology bulls believe that the bottom in demand has occurred. Thus, in spite of mixed indications of rising demand by technology endusers, technology stock buyers increased valuations in a number of technology companies, and the Nasdaq recovered quite a bit of its 1st quarter losses.

Our other investments are in a number of industries: water, collections, tobacco and income funds had small gains during the quarter. We will look to expand these other sectors as valuations become more attractive.

Thoughts for the Future

Our expectations for future US economic activity are that a slowing in corporate profitability and slowing consumer spending will lead to slower economic growth in the US. While a summer rally may happen in the stock market, economic forces mentioned above in this commentary are expected to blunt the US dollars rise, lead to higher long term interest rates, and a headwind the for US stock market. Stock market bulls currently project “more of the same”, with low US interest rates, a voracious US consumer appetite for everything, and continued corporate profits through increasing sales, some pricing power, and increasing foreign demand. The problem with this viewpoint is that there are a number of things working against this viewpoint: recent US dollar strength has made US products more expensive internationally, the consumer has been spending collectively above his means (fueled in part by gains in housing prices, some of which can be realized by cash-out refinancing or refinancing at low interest rates which allows more monthly cash flow for consumption), and growing US budget and trade deficits will at some point weigh heavily on the dollar.

Meanwhile, we are looking for investments with growth potential, some kind of pricing power, and a reasonable valuation. We believe that some fertile grounds for this profile might be healthcare and pharmaceutical companies, which we have liked but disagreed with the valuations assigned to these in the past. On weakness, we will look to be putting some your capital to work in this large and important sector.

As we said before, last quarter taught us again that patience can pay off. The fundamentals of the US and world financial markets, although showing some upticks in economic (and thus, specific company profitability), the valuation of the markets still appear to point toward more economic activity than specific sector analysis can identify. We will continue to be defensive, but looking for opportunities to make your money grow through both appreciation and yield.

We thank you for your business, and we hope to reinforce the confidence you have shown in us with attractive returns on your capital going forward.

The Managers of Kanos Capital Management