June 2007 Investor Letter

"Reversion To The Mean – This Time In OUR Favor"

Portfolio Results

Our positions were "up" for most of the quarter but at quarter-end took a dip, so our performance numbers do not really reflect the good quarter we had. Stock prices suffered late in the quarter as traders feared that price increases in energy, metals and materials had gone up "too far, too fast". However, we believe that fundamentals behind our positions are stronger than in the past, and we strongly believe that the companies we own will show these strong fundamentals in improving stock prices due to both higher profits and expanding valuation multiples.

2nd Quarter Highlights

Our confidence in world macro trends was rewarded during the second quarter of 2007, reversing a number of trends displayed during the first quarter. Most importantly, energy prices (after suffering mightily during 1Q2007) gained notable strength led by gasoline prices and the demand for transportation fuels throughout the world. Booming world economies led to more demand, and increasingly inadequate facilities to produce supply led to rebounds in the prices of crude oil, gasoline and even natural gas. These same macroeconomic forces led to continuing strong demand for base metals (such as copper, iron ore, zinc, nickel, etc.), boosting their prices. However, precious metals rose and then fell during the quarter, impacted by large sales of gold by central banks. While a temporary phenomena, these sales served to squelch the growing springtime rally in gold, which affected silver prices also.

Thus, the Kanos portfolios performed much better than in the first quarter, but moderation in precious metals prices and a late June swoon in equity prices of energy and materials stocks pushed down our returns for the quarter. The equity markets in the US also had a good spring, with strong gains throughout most sectors as traders bet that the slowdown exhibited during the first quarter of 2007 (only 0.7% growth in US CDP) would rebound. Mergers & acquisitions and company buyouts by private equity firms led the bullish parade, as a number of large companies were purchased by financial or strategic buyers and led traders to bid up the stock prices of other potential buyout candidates. Finally, the tech darlings, those companies with extremely high financial

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ratios that momentum traders love – Google, Apple, etc., finished the quarter on a flourish, as traders bought into "nosebleed" valuations to participate in new trends: iphones, net communities, etc. However, energy and materials were the clear winners during the quarter, and they have been the leaders during 2007 due to demand from overseas countries for materials and fuel to build out their economies.

A Look Forward

We believe that the fundamentals of our investment thesis (falling dollar, slowing production of energy/material supplies, booming international development and temporarily high valuations of cyclical/tech companies) are starting to come together in the investment markets. We saw some of this in the second quarter as energy and materials prices advanced, but we believe that we will see more this year as international demand for commodities denominated in US dollars push the prices of those commodities to new heights.

Meanwhile, we are extremely concerned about the financial situation in the US, especially as it relates to housing and mortgages. The so-called "subprime" problem is not confined to subprime – it was a period of lax lending standards to all mortgage borrowers, fueled by low interest rates and rising home prices that, when projected, seem to allow anyone to own a (large) house. Combined with fraud in some cases and over-exuberance in many more, people bought houses they ultimately will not be able to afford. The subprime part of this mess is just the first (and most predictable) part – subprime borrowers, by definition, are the least likely to be able to survive any financial reversals, like high interest rates or job loss, etc. We will see this credit problem spread to the "Alt-A" (above subprime, below prime) mortgages and then to prime mortgages as adjustable rate mortgages reset in the second half of 2007 and 2008. We believe that these credit concerns will then affect the large universe of credit, which may help constrain both residential and commercial real estate lending and financing for private equity, among other things.

So, we are wary of the US credit situation, while tempered by the promise of improved US corporate profits due to booming development of overseas economies, namely China, India, Brazil, Russia and southeast Asian countries. However, we also believe that US corporate profits will start to be negatively impacted by rising costs of labor and materials as inflation, caused in part by a falling dollar, starts to crimp profits and ultimately lead to lower valuation multiples.

Thus, we think that equity markets may correct during 2007 while the new paradigm of increased inflation but high overseas demand for US products changes the investment landscape somewhat. We also think that the amount of high-yield debt that must be placed to permanently finance the already-announced leveraged buyouts of companies will be harder and harder to sell to investors, leading to higher interest rates and slowing buyout activity – which has been one of the main props under this stock market. Once stock prices have adjusted and the economic landscape has been adjusted to a more constrictive credit environment, we believe the US economy will start to grow again at more historic rates.

Update at press time: Crude oil prices have pushed ahead into the mid-$70's as fuel use continues to grow and traders worry about crude supplies and possible disruptions. The US dollar is starting to drop near 30-year lows and gold looks to have ended its spring price swoon.

The Managers of Kanos Capital Management