March 2005 Investor Letter

Market Overview and Portfolio Point of View

"It was the best of times; it was the worst of times …"

- Charles Dickens, A Tale of Two Cities

The first quarter of 2005 typified this sentiment for us. To wit, energy prices rose during the quarter, with crude oil prices and gasoline prices reaching multi-year highs. Energy company stocks initially rose with better commodity prices and financial results, but by the end of the quarter, many of these companies had dropped back in price, no longer reflecting completely the good fundamental environment for the energy sector.

Prices of many other raw materials also rose in price, and metals and materials stocks initially rose with high prices for industrial metals, precious metals and other raw materials, but the stocks toward the end of the quarter then underperformed.

Technology shares, led by semiconductor and internet companies, went up in price during the quarter, while fundamentals continued to deteriorate. End user demand for technology products (as typified by results at consumer retailers like Best Buy and Circuit City and wholesalers like Ingram Micro, etc.) has been tepid at best, but technology bulls believe that the bottom in demand has occurred. Thus, in spite of any real indications of rising demand by technology endusers, technology stock buyers kept valuations high, even for semiconductor companies, which had a poor quarter but are exhibiting even poorer results lately.

In the first quarter of 2005 we realized value in many of our positions in energy and materials. While the investment climate continued from 2004, with many economic "cross-currents" affecting the markets in unexpected ways, our energy and, to a lesser extent, our precious metals positions benefited. However, we continue to be reminded of the patience that investors must possess during turbulent markets. Kanos management continue to subscribe to our main investment premise, that US deficits will lead to a weaker dollar, thus giving advantage to commodities like oil and gold, while putting upward pressure on long term interest rates. The dollar rallied during the quarter, putting pressure on our metals positions; however we still believe that the long term direction for the dollar (versus the metals) is down, even though it may continue to rally against other currencies.

Our positions in the energy sector have continued to produce good results, especially the refining companies. Exploration and production companies had good gains, and our positions in energy trusts have provided both price appreciation and income. International oil companies, especially ExxonMobil, provided extreme price

*3641 Inverness Drive, Houston, Texas 77019 * Phone: (713) 963-9631*
*Mobile: (713) 305-4001 * Fax: (713) 963-9920 * E-mail: kanoscapital@houston.rr.com*

appreciation due both to refining margins and production earnings due to commodity price appreciation. With crude oil moving from $42/barrel to the mid-$50s/bbl (due to rising demand from Asia and supply concerns), energy prices moved very high, but stocks only reflected prices for crude oil in the high-$30's / bbl, showing investors' skepticism toward prices in the high-$40's and $50's. Although we have not formulated any price forecast for energy products, we still believe that fundamentals, especially growing worldwide demand for motor fuels / gasoline, point toward sustained higher energy product and crude oil prices. While we anticipate violent corrections periodically, we believe the tenets of our investment thesis toward energy are and will continue to be in force.

Our investment in metals stocks, especially gold stocks, turned in a mediocre performance, in contrast to the great 3rd quarter where prices rose above $450/oz. Our patience in staying with these positions has paid off in the past, although gold mining stocks have underperformed even as gold has held above technical support levels in the mid-$410's/oz. We believe that fundamentals for higher gold and silver prices remain in place, and that with patience, we will realize large gains on these positions.

Overall the US economy appeared to muddle along during the 1st quarter, as some companies reported better earnings while many technology companies, especially retailers of tech products and software companies, preannounced poorer expectations of quarterly performance. In addition, inflation has started to pick up, and the trade and current account deficits have continued to grow. In contrast to these bearish developments for the dollar, the dollar has stayed strong as the Federal Reserve has continued to raise interest rates "at a measured pace" and Asian central banks have continued their buying of US Treasury debt.

Thus, our expectations about an anemic US economy has made us consider being more aggressive to realize the possibility of lower stock prices. We entered the short side of the market once again in some portfolios, concentrating on the semiconductor and internet companies due to their growing inventories and flagging end use demand, respectively. These short positions contributed to our good performance this quarter, and we continue to believe that a number of other companies will fall short of expectations during the 2nd Quarter, leading to increasing expected short exposure by Kanos.

Going forward, we expect that the trading range which has characterized the stock market for the past couple of quarters will resolve itself. While the economy appears to have gotten better, it has been a weak performance due to slowing consumer demand for goods. We expect the stock market to be weaker during the summer, while we believe that energy stocks should benefit from slight increases in demand coupled with less supply, materials stocks to benefit from tighter supplies and demand from Asia, and metals stocks to benefit from weakness in the dollar and other currencies. We continue to emphasize these sectors to grow your portfolio.

Looking Forward

The investment climate in the fall of 2004 is still muddled. Oil prices have continued to rise as supply concerns weigh on the oil markets and demand continues to appear to be growing. Metals prices are also continuing to rise, as the US dollar appears to be ready to weaken further, as flagging fundamentals in the economy make the US a less attractive place for international money flows, and the twin deficits (current account and trade) weigh on world financial markets.

As before, we continue to believe in energy and mining companies, and selective US multinational companies. We also believe that a number of preannounced earnings shortfalls are continue to show the weakness of end demand for some technology stocks, which we believe gives us ample opportunity to continue to have short technology positions in our portfolios.

We will be looking for opportune times for moving US dollars to foreign currency CDs, now that any upturn in the dollar appears to be minimal. We may move as much as 20% of our cash position to foreign currency CDs in order to diversify our US dollar holdings as well as increase our yields on cash.

The main thing that last quarter taught us was <u>that patience can pay off</u>. 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 a more robust economy 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