March 2008 Investor Letter

Wow! We thought we had seen some wild markets in 2007, but the first quarter of 2008 showed some of the wildest market action in a long time. All markets, the stock market, bond market, commodities markets, etc. gyrated as "tectonic" shifts in sentiment caused both huge drops and wild rallies during the quarter. While we did not end up with the gains in our portfolio that we had built up during much of the quarter, we feel that the good market action of energy and natural resources during the first quarter was a prelude to what will happen in the financial markets for the next year or two – and where we will accrue value in your portfolio.

"More of the Same….With Some 'Crazy Ivans'"

Review of First Quarter Markets

The first quarter of 2008 was one of the wildest seen in years in the investment world. Stocks had large moves to the downside and upside, the fixed income markets kept introducing new surprises, gold traded over $1,000/oz and oil went from costing over $97/barrel to spikes up over $108/bbl!

In spite of a rally in late March, the stock market took it on the proverbial chin during the first quarter as a number of events impacted the markets negatively. Rising prices, led by energy prices, coupled with the realization that the US economy was noticeably slowing led traders to sell stocks due to their fear of slowing profit growth in their portfolio companies. The Federal Reserve, trying to ease the pain of this economic slowdown, announced a number of actions, both traditional and non-traditional, to try to stimulate the banking system, and through it, the US economy. The Fed lowered interest rates more than 1% during the quarter, introduced a new lending facility to banks, started taking more risky collateral in exchange for the Fed's loans, and even introduced a lending facility for investment banks – banks that have no deposits and have no US Government guarantees associated with them. These efforts were only mildly successful in the short-term to help the economy and financial markets.

Late January saw the low of the stock market when huge selling occurred around the world (while US financial markets were closed for the Martin Luther King Holiday) – it turns out this extreme weakness was caused by multi-billion dollar sales of positions by French bank Societe Generale which was liquidating positions built up by a purported

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"rogue trader". Emergency Fed rate cuts the next morning helped the US market recover, but mid-March saw another swoon in the stock market when the investment bank Bear Stearns had rumors swirl around it that it was having liquidity problems. These rumors seemed to feed on themselves, and at the end of that same week, Bear approached the Fed for liquidity to keep its trading operations going. The Fed refused and told Bear Stearns that if it could not borrow the money in the marketplace then it must sell itself. The buyer, and most logical candidate, was Bear Stearns' bank, JP Morgan Chase, who agreed to buy Bear for $2.00 per share AND with the Fed guaranteeing $29 BILLION of loans on Bear's books. The Fed later argued that Bear Stearns had such a huge "book" of stock, bond and derivatives trades that its failure (without any help by the Fed in the form of guarantees) could have hurt the functioning of the US financial system, potentially shutting down parts of it. This Fed "rescue", while not explicitly putting up government funds but backstopping JP Morgan Chase with up to $30 billion of taxpayer money, ignited a rally in financial stocks that has lasted into the second quarter.

Market Conditions

However, there is still trouble in the financial markets, and we believe that Bill Gross, the head of the largest US bond manager PIMCO, characterized the state of financial institutions by using the analogy of the game of Old Maid in his March 2008 monthly market commentary:

> There's a parlor card game most boomers know as "Old Maid." It was a fun game for Eisenhower generation kids to play and unlike "War," involved a surprising amount of skill and human interaction. **If you had the "Maid" the object was to dump it on someone else, but doing that involved numerous deceptions not totally unlike today's shenanigans involving our capital markets and their imploding financial conduits. *[Emphasis mine – KS]*** First of all, you had to pretend you didn't have it in your hand. A calm, "no problem" facial expression was a requisite, but then you still had to entice your opponent on your left to pull the old lady out of a handheld mini-stack of perhaps 6 or 7 of your remaining cards. Placing "the card" at either end was one tactic, but the most successful maneuver always seemed to be exposing one edge of a middle card just a little bit higher than all the rest – the bait. Once dumped, you could breathe a temporary sigh of relief until, until…well until it was your turn to draw again from that all too suspicious player on your right.
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> Old Maid now has a second life mimicking our financial markets, and at PIMCO we've played it frequently in our Investment Committee over the past several months. "Who's got the 'Old Maid'?" we ask over and over again – not to make us feel good that we don't – but to make sure we won't draw it when its holder tries to pass it on. This shunned lady in asset form was originally identified as a subprime mortgage, aggregated into levered financial conduits which in turn were guaranteed to be AAA hotties either via their securitized structures or the solemn pledge of monoline insurance firms. No Old Maids in those hands, investors were assured; they were Babes with a stacked deck. Ah, but Father Time has a way of exposing plastic surgery and there have been implants aplenty in recent years. Most of the silicone to be sure involved mortgage-related assets – first the subprimes, then the Alt As, and now perhaps even levered primes. **Yet those that claim that the Old Maid necessarily resides in a deck composed of mortgage loans are missing the larger point. This parlor game is best defined by leverage and not the assets that have been dealt out to more than willing players over the past decade. That subprimes have garnered the headlines is**

> **only because they were the asset class that failed first.** Now as the U.S. economy slows to what Alan Greenspan labels "stall speed," levered structures holding commercial loans, and auto and credit card receivables are the new Babes in waiting – waiting to be exposed for what some of them could be: Old Maids with collagen carelessly injected by Moody's and S&P.
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> That this topic as I've described it might seem to resemble a "LOL" *New Yorker Magazine* cartoon involving a most serious topic is hopefully forgivable. Sometimes you have to laugh at the human comedy in order to comprehend it. But let there be no mistake: this description of Old Maids and PIMCO's Investment Committee's attempt to avoid holding one is serious business and the game playing does involve some of the same skills that little kids learned by playing cards generations ago. Pretend that you don't hold the Maid? Banks have been playing that game for nearly 12 months now and only recently have entered the confessional to expose some of their sins. Are the monolines showing any of their cards? No – just ask MBIA's CEO – they're doing just fine thank you. "But by the way," he'll say, "take a card, one of these good ones on the end or maybe the one in the middle with the exposed edge." Bank loans for sale by Wall Street at distressed prices? Nah, those Harrahs and Clear Channel loans are money good – "as a matter of fact all of the $150 billion or so we have in inventory are great assets" the banks will say. We'll just hold on to these maids – unless you pay 95 cents on the dollar that is. Don't wanna take a loss you know.
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> And so the game goes on and on. **Its most recent twist involves an asset class known as Auction Rate Preferred Stock and the astounding revelation that its holders didn't even know they were playing cards to begin with**. Holders of ARPS – mostly wealthy investors, but also the likes of Bristol-Meyers and other visible corporations – thought they were holding AAA assets with money market liquidity. In this case, most of the assets probably are AAA, but the liquidity has suddenly evaporated, transforming them from a 30-day to potentially a 30-year asset. The assets on these Maids it appears are real but they have come with a marriage license. Whoops! Another Old Maid in masquerade.
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> The investor's task, however, is not to pillory or even desert the game, but to accomplish three primary tasks: 1) continue to ask "Who's got the Old Maid?", 2) understand and forecast the game's economic and policy consequences, and 3) formulate a portfolio (to paraphrase Will Rogers), that maximizes the return on capital as well as the return of capital.
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> Slow credit growth is a harbinger, however, for slow economic growth (if any) and that in turn leads to the necessity for low short-term interest rates for an extended period of time. I think Ben Bernanke knows that restarting the U.S. growth engine almost by definition requires nominal GDP growth of 5%. He'd prefer that nominal rate be composed of 3% real and 2% inflation, but desperate times sometimes require compromise: 2% real and 3% inflation may be the best he can hope for in 2009 as soaring commodity prices and a declining dollar add to the equation's complexity. If so, a bond investor should expect a prolonged, several year period of low short-term rates (Fed Funds averaging 2½%) with vulnerability on the intermediate and long-term portions of the U.S. curve due to inflationary fears and the diminishing support of foreign central banks and SWFs. If, as a bond investor, I expected 3% inflation (2% in 2008 – higher in the out years), a 3% 5-year Treasury would not seem very appealing. Nor, I should add, would a 3.80% 10-year or a 4.65% 30-year bond.

Kanos investors know that we have been anticipating this trouble in the financial sphere and that the trouble would spread to the economy (we predicted in our last letter to you in January 2008 that the US economy had already entered recessionary conditions during the fourth quarter of 2007). We were well-positioned as financial losses and slowing

growth in US corporations led to falling stock prices across most sectors but sectors deemed safer harbors did well, like energy and natural resources. More traders saw that commodities and commodity companies could benefit from rising prices caused by bullish fundamentals (rising demand and limited supply growth), providing protection from downward price movements seen in many US stocks caused by the deteriorating fundamentals in a slowing US economy. Gold started the year around $800/oz and reached a high near $1,040/oz in mid-March before profit-taking and asset re-allocation moved money out of gold and it closed around $920/oz. Oil, after failing to reach $100/barrel on a number of prior occasions, reached this "century mark" in late February after the winter in the northern hemisphere caused more usage of energy products than had been forecast while supply disruptions and interruptions cast doubt on the reliability of supplies in a number of countries around the world. Crude oil closed the quarter around $102/barrel after trading as high as $108/barrel.

Energy stocks and precious metals stocks, which make up the majority of Kanos portfolios, performed well during the quarter but still did not show the gains that the underlying commodities exhibited. Why? We believe that there are two main reason: 1) new high prices of the commodities "cannot last" in the eyes of many traders, so selling pressure has increased as price levels have risen, and 2) investors are concerned that cost pressures for exploring for and producing these natural resources will grow as fast or faster than the rise in selling prices of the commodities they produce. In other words, these companies are not expected make higher margins, even with a rise in commodity prices. We believe that many in the market are mistaken, because the multi-year rise in commodity prices have led to higher margins at commodity producers in many cases. Second, we believe that prices of energy and metals in the future will continue to appreciate as inflationary pressures continue to build in economies around the world – so while we expect costs of mining and energy companies to rise, we continue to think that selling prices will more than keep pace with costs and that profit margins will expand, raising profits and hopefully attracting more buyers, which could have the added benefit of expanding P/E ratios, further pushing up the stock prices of our holdings. We would have had an even better quarter but for the mid-March "rotation" by traders out of commodities and commodity companies which caused our positions, which had shown large gains during March (to go with those seen in February) to fall in most cases to losses.

Thoughts for the Future

We don't believe that the recovery in stock market prices near the end of the first quarter ended the large amount of uncertainty in US financial markets. Thus, many unanswered questions continue to swirl about: Are we in recession? If so, have we just entered or are we hopefully growing out of it? Does the strength of the world economy trump the weakness of the US economy? Is growth in BRIC (Brazil, Russia, India and China) economies sustainable for the next few quarters? How much farther will US housing

prices fall? Is all the bad news in the US financial companies' stock prices? Are commodities in a "bubble"? Have we stayed too long at the "commodity party"?

First, like we said in our last letter, we believe that the US economy is still in recession. US housing prices have fallen over 10% in the last twelve months (and in some areas the twelve-month drop approaches 20%), causing Americans net worth to fall. Financial markets, especially debt markets, that had been driven by growth in mortgage backed bonds of various types have suffered as falling prices of these bonds and the consequent uncertainty of future prices in these markets has led to large losses to bond holders, freeze-ups in other fixed income markets (like auction rate securities – a $330 billion market that has basically stopped trading) and the cessation of future lending. The Fed, trying to help the markets get over these problems, has lowered its Fed Funds target interest rate 3.00% since last summer (to a current 2.25%) and put together huge new lending facilities making tens of billions of dollars available to financial institutions to try to keep liquidity high and thus, lending continuing. The unintended consequence of the low cost of credit and rising amount of credit available (new government lending facilities) is a continued large supply of depreciating dollars. As foreign holders of US dollars see more and cheaper dollars appearing, they have sold their dollars to try to preserve their purchasing power or wealth (sound familiar? That's what we at Kanos are trying to do for you). Thus, the dollar has been dropping versus currencies around the world. This has caused two major reactions: 1) US exports have become more attractive around the world since they are priced in US dollars and foreigners can buy more dollar-denominated exports with their appreciated currencies – this is what governmental officials will "tout" as the benefit of a weaker dollar, and (more importantly) ALL dollar-denominated things become more attractive to foreigners with appreciated currencies, like the raw materials that are the basis for our food, energy and materials. Thus, the falling dollar has continued to cause inflation in dollar-denominated commodities, driving up the cost of many of our basic necessities. Our cost of living has continued to rise, as food prices have risen sharply already in 2008, energy prices have doubled in the past twelve months, and costs of all kinds of materials we buy / use daily are rising. US consumers have had a hard time maintaining their lifestyle for a few years, and many had used mortgage-equity withdrawals in the past couple of years to keep up. Now these MEWs are gone, and US consumers are devoting more of their incomes to paying for the increased prices of necessities. Wages have not kept up with rising prices due to wage deflation imported from around the world for the last few years – Chinese and Indian workers earned 1/10th what US workers earned 10 years ago; now US business has had to become more efficient and the wage gap has virtually closed, but that has not allowed for US workers' wages to grow any faster than 2-3% per year, which is about the rate of US government-published inflation but below what we believe to be consumers' realized rate of inflation, which is more like 4-7% per year.

Second, we don't believe that housing prices are anywhere close to a bottom. Why? Housing, especially in California and Florida, was built during the boom to take advantage of low rates coupled with lax lending standards. Thus, affordability was very

different during this period – if you are able to borrow up to 125% of the value of the house, only have to pay interest (or sometimes even less) and don't have to have your income verified, a much larger population of people can afford larger houses. Lending standards have retreated to the more sane levels of yesteryear: you must have a downpayment to buy a house (meaning loans will be under 100% of the value of the house, down from as high as 125%), you have your income verified (and buyers who don't qualify can no longer get loans), and subprime, Alt-A, and pay-option-ARM mortgages are either no longer available or very limited in availability. Thus, if you have to save for a down payment, have to pay principal and interest and can only get a mortgage supported by your verifiable current income, affordability is way down, meaning houses will have far fewer buyers who qualify for mortgages to buy them. In addition, rising prices of consumer staples and necessities is leaving a lot less money available to pay mortgages, so affordability is further hurt by rising inflationary pressures. The one element which will help support housing prices will be the entrance of foreigners to the US housing market en masse. Foreigners who never imagined they could afford vacation homes (either in resorts or US cities) in the United States will see that their euros or rubles or Canadian dollars, etc. will buy a lot more in the US than in the past, and we believe that at least some of the glut of condominiums and coastal resort housing will be absorbed by purchases by European, Asian and Latin American purchasers. However, the huge number of properties built or under construction from the past few years will still take years to absorb by domestic and foreign buyers.

So, housing will take at least a couple of years to become vibrant again. Consumer balance sheets, loaded with debt of mortgages on their current homes and credit cards used to finance their lifestyles, will have to be repaired though saving and economizing. To us, this means that the recession we are in will last much longer than others think because any recovery will be very slow and extremely shallow. We think that will mean consumer discretionary companies (autos, appliances, recreational equipment, etc.) will perform poorly in the next few quarters as sales continue to lag. We believe that at least some areas of the developing world that have a rising number of people entering the middle class will start to consume products the developed countries had been importing from these countries, meaning demand for manufactured products that US companies make may instead be satisfied by domestic sources that formerly were primarily exporters. So developing middle classes in countries like China, Malaysia, Thailand, Singapore, etc. would not consume US products to the extent that these countries imports would support US manufacturing during the US recessionary downturn.

Financial companies have had Fed help in making conditions favorable for repairing their woes: the current "steep" yield curve, with banks being able to borrow cheap (2%) short-term money and invest in higher-yielding longer-term debt (10-year US bonds at 3.75%) or loans (30-year mortgages are currently 6 – 6.5%). However, a US economy bumping along without much growth will not allow financial institutions to grow nearly as fast as they have in the past decade, and their profit centers are much more limited – most mortgage origination/securitization is non-existent, IPOs are few-and-far-between, and

trading is more treacherous than in the past. Healthcare companies have rising costs, and consumers are having a harder time affording healthcare these days – so we believe that healthcare companies will have a harder time making money during this continuing "malaise" economy. Technology companies will also have a hard time since many tech companies are really consumer companies (Apple, Sony, Microsoft), as are semiconductor companies that make memory and control chips for games systems, cameras, appliances, etc. (Texas Instruments, SanDisk, Analog Devices, etc.). More mainstream tech companies have continued to add manufacturing capacity in the last few years in expectations of continuing demand growth; however, anemic capital spending from the US, EU and Japan and only moderate non-OECD international demand growth will hurt profitability of tech companies due to high fixed costs of overcapacity. Valuation ratios for tech stocks have been high compared to the general market because many investors believe that tech stocks will grow quickly and have pricing power; when the market re-discovers that tech stocks are cyclicals that rarely have pricing power (absent a monopoly or proprietary technologies) and will not grow as fast as is currently forecast, we expect large tech companies to drop in price and valuation.

Energy

So, what about our commodity exposures? Let's start with oil – we believe the trends that brought us to this point are not yet finished. As we write in late April, prompt month crude oil futures have almost reached $120/barrel due to a combination of: supply disruptions (increased Nigerian violence and lower volumes, North Sea interruptions, continued loss of Mexican production, and flat multi-month production from Russia), continuing demand increases in spite of US economic weakness (Chinese GDP up 11% in Q1 2008 and demand for petroleum up 7%, Indian GDP up nearly 10%, US gasoline consumption flat over the traditionally weak March-April period, US distillate (from diesel demand) using up stockpiles that generally build in the spring) and increasing resource nationalism (Russia threatening BP's BP-TNK joint venture, Kazakhstan's continued interference in the development of the Kashagan field, even Alaska's recent revoking of Exxon's development of the Point Thomson gas field). We believe the stakes continue to go up as governments start to recognize that their commodities are national assets to be more carefully managed. We have seen one possible outcome in April as rising rice prices and increasingly hard-to-find rice supplies have led a number of governments to PROHIBIT RICE EXPORTS. This has led to rioting in rice-poor countries like the Philippines and Pakistan. This could be a future scenario for energy supplies. We believe that the increasing tenuous supply-demand balance will lead to higher crude oil prices, as the inelasticity of world demand overcomes the demand drop-off that is bound to occur in the US in the next few months. Colder weather in the northern hemisphere during this winter and spring have eaten away at what many considered a surplus in storage last fall – a hot summer and/or a cold winter next winter could further strengthen energy prices – crude, petroleum products and natgas.

However, there is risk to the downside – booming Asian, Latin American and Middle Eastern economies could slow, and with the US economy in slowdown and Europe thought to follow, we could see demand slacken to the point where futures move back below $100/barrel. A number of forecasters believe this is the path that is sure to follow, and the stock market has been up during April, thought by many to be forecasting a recovery from recent economic malaise and including lower energy prices. We are skeptical on how long "lower" prices would be in force, because lower prices would encourage the return to habits that use more energy, thus pushing demand back up with price soon to follow. So we believe we will probably see wide variation in oil and gas prices during "shoulder" months, but summer (and we believe winter) seasons will highlight still high worldwide demand and keep average 2008 prices over $100/barrel. We have seen this before post-Katrina and in January 2007, and each time, energy prices resumed their climb each time as demand trumped supply.

Precious Metals

What about precious metals prices? As mentioned above, gold prices passed $1,000/oz in March 2008. Why? There were a number of factors: 1) most importantly, the US dollar dropping against many other currencies led to increased interest in holding gold as a store of value (replacing the dollar in some investor portfolios), 2) pessimism over the state of the US credit markets (and to a lesser extent the whole US financial system) due to increasing bank write-offs and capital raising led people to invest in gold as a safe haven, and 3) power interruptions in South Africa (formerly the #1 gold producing country in the world but now #2 behind China) led to fears of shortages of gold production. Now, as we write in mid-April, financial markets are forecasting few or no new Federal Reserve easings (meaning no new downward pressure on the US dollar), that the US financial system (and in particular the large US commercial and investment banks) have seen their lows, and that the power situation in South Africa is "manageable". However, the forces that have caused a lower dollar will eventually re-assert themselves in the next few months: large US deficits, weak US economy, poor housing markets continuing their price weakness and an accommodative government and Fed trying to restart the US economy plus weakness in the European Union and Canada (both central banks are also becoming more accommodative).

We have already discussed above why we think housing prices and contracting credit are not going to be good for growth in the US economy in the near future. Thus, we believe there will be more disappointments in the future, although they may not be as momentous as the loss revelations seen during mid-to-late 2007 and in early 2008. But the US government is still running large deficits, the US still has a very large current account deficit (and attendant trade deficit) with the rest of the world, we are still involved with two very expensive wars and sovereign wealth funds are trying to make investments around the world, using their depreciated US dollars before they fall further in value. Thus, we think that precious metals are digesting their large recent gains (as they have many years during the late spring) and that they will resume price advances as investors

around the world realize that less has changed since Q1 2008 than many had thought. As we see with oil, we believe we will see large swings in the prices of precious metals as investor schizophrenia over whether the US economic situation is getting better or worse for the next few months pushes sentiment and prices back and forth, but heading upward in fits and starts. We still see gold prices rising above $1,000/oz for much of 2008 and expect to see silver prices rise over $20/oz by end of 2008. We base these beliefs on the continuing efforts of monetary authorities throughout the developed world to stimulate economies through large increases in borrowing programs that over time will dampen demand for all paper-backed currencies, the US dollar, the Euro and the Yen, in favor of more tangible objects like precious metals.

Food prices are going to be in the headlines for a long time in our opinion. The advance in diets in Asia especially has led to large increases in demand for feed for animals at the same time that biofuels were using the excess grain supplies that could be used for human or animal feed. Now that some upset has occurred in some grain-growing regions around the world and propelled food prices to double (and in some cases, triple) digit price increases in just the last year, we see governments getting involved to try to provide more proactively in the future toward feeding their populations. We believe this will help stop the huge spikes in the cost of foodstuffs, but it will also serve to keep prices at averages far above where they have been in past years. Also, government needing to provide food for populations will lead to a cry for more arable land, threatening more of the earth's forests and increasingly pitting governments against environmentalists. This tension will lead to increases in prices of most commodities, including timber, industrial metals, foodstuffs, energy, etc. as governments and environmentalists make it harder to build new mines, facilities, smelters, sawmills, etc.

We mentioned in the title of this quarter's narrative a "Crazy Ivan". This is a term popularized in Tom Clancy's first novel, The Hunt for Red October, which described how captains of Soviet/Russian submarines occasionally pull a wild maneuver, deviating off-course in order to see if there is a submarine following them. It is such a wild, unexpected maneuver that US Navy submarine crews christened this phenomenon a "Crazy Ivan", and the term has since become a phrase which describes any sudden unexpected deviation from the expected course. We believe that the financial markets' sell-off of commodities and commodity companies while buying financial and housing companies are a "Crazy Ivan", and that financials and economically sensitive stocks will face turbulence in the near future. We believe these "Crazy Ivans" will continue to occur over the next few months and possibly years as financial market participants adjust to new price levels. Financial companies are borrowing more money from the government to "get them through the crisis", but increased liquidity through increased short-term government loans is not going to lead to large new profits that propelled banks and investment banks to new heights during the mid-2000's like mortgage bonds, private equity debt financings and stock/bond financings of the late 1990s and mid-200s provided.

Conclusions

Thus, we see continued inflation, in spite of governments' efforts to try to "legislate inflation away." Steady prices will only come when prices reach levels that truly cut demand, and demand for food and energy is not seen to be easily quelled – as the BRIC countries have shown us in the rise of oil prices from the $20s/bbl to the $120s/bbl and doubling of prices of wheat, corn, soybeans and rice in the past few years.

Thus, we will continue to lean toward investments that will preserve our wealth versus the US dollar, while trying to capture good value in more mainstream investments as they become attractive.

The Managers of Kanos Capital Management

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