September 2009 Investor Letter

Third Quarter Market Conditions

The third quarter of 2009 was characterized by the ongoing rally in the stock market (that started in early March) which continued throughout much of the quarter. Many market participants (we at Kanos included) expected a pullback in the market during July, but after a bearish "head and shoulders" technical pattern emerged and then was broken, the US stock markets took off to the upside and ended up having the second best performance during the 3rd quarter in 70+ years. The market was driven by improving (but still dismal) unemployment news, improving (but still low) housing starts and sales and improving international economies (especially in Asia). Earnings for the second quarter were considered "less bad", and the lack of a new dose of bad news also added to the bullish enthusiasm. As you can tell from our commentary, "less bad" was the new "good", but that was enough for stock market bulls in an easy money environment. The US Federal Reserve (or The Fed) has continued to keep short interest rates at virtually 0%, while trying to keep the value of the US dollar steady. Toward the end of the quarter, both the US Treasury (the official "keeper" of US dollar policy) and the Fed (who carries out monetary policy and thus impacts daily the value of the US dollar through supply and demand) failed to convince investors that the US was as good an investment venue as in the past, and financial participants sold dollars in earnest in September, sending the dollar down to yearly lows.

The other major news impacting financial markets during the quarter was the purported end to the recession. The National Bureau of Economic Research, a non-profit organization that is "charged" with analyzing and stating the beginning and ending of recessions (in arrears, so it is a much easier job than we who focus on the market have to do) told us in 2009 that the latest recession started in December 2007/January 2008. A number of market observers / researchers declared that the recession ended in June/July 2009 as marked by a "spike" down in weekly jobless claims, "improving" economic conditions as depicted by the upturn in economic indicators and the estimated resumption of growth in the gross domestic product. As research and news stories of this event propagated around the markets, traders and investors were emboldened to increase their positions in equities. However, there is one huge aspect of this news that most research and news stories conveniently left out: the "end of the recession" means that the economy is no longer judged to be shrinking; however **<u>the recovery is the most important part of the end of recessions for long-term investors.</u>** The recovery will almost certainly

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end up being tepid, due to the substantial debt load and forced deleveraging of the US consumer and much of the financial system, both of which will steer capital to repay debt instead of for consumption and investment. Thus, we are glad the recession "had ended", but we are afraid the recovery is going to look a lot like the latter days of the recession, and that US economic growth (and European growth too, for that matter) will not return to its long-term trend for a long time (and much longer than many people think).

Stock markets during the quarter were driven higher by rising stocks in consumer discretionary companies (like retail companies, whose stocks did incredibly well during the quarter – far outpacing the fundamentals in our opinion), consumer durables (housing companies, for example) and technology (which had led the way out of the March lows with the financials, but tech continued to shoot to new highs during the 3rd quarter, again outstripping fundamentals in our opinion). While many would consider us too conservative, we have the nagging feeling that these tech earnings are fleeting, due to the fact that inventory liquidations of last fall/winter led to shortages of parts when demand turned up during the spring/summer, leading to tech firms over-ordering components and parts to try to overcome shortages. This is a regular cyclical occurrence in "tech land", and double-ordering looks like economic growth until shortages are alleviated and a number of orders are cancelled. The same seems to be true in the retail and consumer discretionary segments – stock market participants believe re-stocking of inventories and pent-up demand will drive a surge in sales and profits that will justify higher stock prices.

Precious Metals

Precious metals, after underperforming in the second quarter, broke out in September as financial market participants soured on the prospects for the US dollar (and other paper currencies). Rising budget deficits, continued Fed easing (available liquidity from the Fed started to rise again during the third quarter) and deteriorating market technicals led to a dive in the value of the US dollar, accelerating to the downside in September. Precious metals responded, with gold exceeding $1,000/oz for much of September and silver exceeding $17.50/oz before closing the quarter at $16.67/oz. Copper, platinum and palladium also had good quarterly performances, although none are near their all-time highs. The new highs in gold (with the all-time high from March 2008, $1,030/oz, surpassed in early October) led to a large amount of interest and (unsurprisingly) negative press, saying that gold exceeding $1,000/oz was a "bubble" and it was "speculative buying which could not be sustained for long" that had buoyed the gold price. As you our investors know, gold prices have reacted to the deterioration of the once mighty US dollar and benefitted from the mounting uncertainty, both economic and political, of the actions of the US government (unfortunately, Republican and Democrat alike) and US monetary authorities, dictated by the Fed. Rising supplies of US dollars and unbridled US fiscal policies have led to rising gold prices, and we have successfully protected the value of your capital and the future purchasing power of your wealth by parking it in gold, silver and precious metals-related companies and investments. We give more detail in the commentary below why we think we will see more of the same, at least in the near future.

Energy

Oil prices continued to improve during the 3rd quarter, but were confined to a trading range between $55–75/barrel, in spite of what some market observers considered high inventories (too much supply) while demand also returned (mitigating short-term supply concerns). Demand for domestic gasoline actually equaled last year year-to-date although demand for diesel fuel was far lower than 2008. Natural gas suffered from a cool late summer/early fall (with no hurricanes), and prices dropped as far as the low-$2.00s per MMBtu in mid-September as US storage fields were filled early. Prices have rebounded, and as we go to send out this letter in late October, crude oil has broken out to the upside, trading $80/barrel and natgas has traded above $5 in the futures market. Like the precious metals above, the falling US dollar, coupled with increasing demand from growing Asian and South American economies, is starting to push up prices with a dwindling worldwide surplus of crude oil deliverability to satisfy this demand.

We at Kanos continue to believe that protecting your wealth though investments in US dollar alternatives trumps the rewards from mainstream stock market investments that carry lots of risk due to rising valuation levels but only marginally improving company results. In our minds, “less bad” is not a reason to devote a large amount of capital to broad market investments, without seeing progress toward fixing the fiscal, monetary and regulatory policies which are at the heart of the angst surrounding the United States right now.

Commentary

“Real Recovery, Double-Dip or Something Worse”

As we confront the investment landscape at Kanos, we are struck by the incredible “gulf” of opinions with respect to the future of the investment markets, the US economy, the world economy, US politics and even the future of capitalism and US democracy as they exist today.

I am presenting two recent articles that help frame some of the questions and worries surrounding the future mentioned above. I think they do a good job of framing some of the future debates we will see occurring.

The first is a daily “musing” by Richard Russell, an octogenarian market watcher who writes “Dow Theory Letters” and who lived through the Great Depression (as a boy), World War II (as a young man and aviator) and started writing and managing money in the 1950s. He has a lot of investment experience and has truly seen a number of investment eras, so his thoughts on the subject are worthy of our attention. His October 13, 2009 letter included the following thoughts:

> “There are two ways to view the stock market's advance from the March lows. One way is to assume that the stock market, despite an awful lot of negative news, is discounting better times ahead. This is the usual way of viewing a steady stock market advance, and it is undoubtedly the way most bulls are thinking.
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> The other way to view the advance from the March low is that this is the normal and expected recovery following a semi-crash in the stock market. I consider the 2007 to 2009 collapse a semi-crash. The automatic recovery following a crash is the **single surest action** in the market. Normally following a crash, the market will recoup one-third to two-thirds of the territory lost during the crash. The Dow would have to advance to the 10300 area to recover just half its 2007 to 2009 loses.
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> Meanwhile, we are facing an extraordinary situation in US finances. Wall Street, or I should say, the Federal Reserve, has bailed out Wall Street banks and entities that were considered "too big to fail." The actual and potential costs of the financial bailout put US taxpayers on the hook for $17.8 trillion (that's trillion), which is more than the entire annual gross domestic product of the US.
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> In 1990 the 20 largest companies in the nation controlled 12% of US financial assets. Today the 20 largest companies control more than 70% of US financial assets. Many of these include corporations that have been deemed "too big to fail." The Russell comment is "if they're too big to fail, then they're too big to exist." In a true capitalist (not socialist) economy, if you fail, you fail and you're bankrupt. You just haven't made the "grade." If any business is so reckless and so ignorant of risk that it goes broke, then damn it -- let it go under. And let its CEO and board be accountable. But that's hardly what's happening in the US today.
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> While the run of Americans are struggling with their economic lives, the big bankers are back to “business as usual," paying out billions of dollars in bonuses and making profits on the backs of the taxpayers who bailed out these incompetents. And ironically, these same blundering bankers are now throwing road blocks in front of meaningful regulatory reform.
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> Even worse, the Congressional Budget Office estimates that the 2009 budget deficit will be almost $1.4 trillion, which is about 10% of GDP. As of September, 2009, the interest on the national debt was $383 billion or

more than one billion dollars for every day of the year! By 2020 the national debt will be $20 trillion, and the US will be borrowing to pay just the interest on its out-of-control debt.

I prefer to keep it simple and basic. I look at the whole picture from a Dow Theory standpoint. A basic principle of Dow Theory is that the primary trend of the market and the economy cannot be manipulated. The primary trend, one way or another, will run its course to conclusion, despite the wishes or efforts of any government or congress or president or central bank.

In their effort to halt or reverse the primary bear trend, Bernanke and Geithner have virtually bankrupted the US. Their frantic efforts to "pump up" the US economy with an ocean of Fed-created junk money and zero interest rates have failed to inspire America's consumers to go back to their high-spending ways. For the retail stores and chains, the "back-to-school" session has been a dud. Leading retail experts are already warning of a "slow to disastrous Christmas season." The age of **thrift** has descended on America. And all the wild Fed and Treasury spending has only served to frighten US consumers into (can you believe?) saving.

Now the fright has moved into anger. Americans see that the Wall Street banks and Goldman have been saved. But what about the man on the street? Politicians respond to only two things -- money and votes, and the pols are currently quaking at the thought of the next elections.

As far as Bernanke is concerned, there is only one path to follow -- keep doing what you've been doing. More liquidity, keep the rate at zero, continue blabbing about "green shoots," issue more propaganda about "the economy improving."

Ironically, the talk has now turned to an "exit strategy" for the Fed's program. This would mean raising interest rates and cutting back on government spending. Bernanke knows that at this point reversing the Fed's stance would be disastrous. It could throw the nation into a deep recession or depression.

The exploding deficits and skyrocketing debt of the US are not lost in real money -- gold. As the world's central banks create new currencies in order to stem any rise in the dollar, all fiat currencies weaken. ***[Editor's note: a "fiat" currency is one that is defined in value by a government without linkage to other valuation, such as a defined amount of gold or silver; hence fiat currencies (like the US dollar, Euro, Japanese yen, etc.) are open to manipulation through increasing money***

supply. Russell also refers to fiat currencies being manipulated as "junk" currencies. – KS] It now requires an increasing amount of junk currencies to buy an ounce of gold. Thus, against the time-honored standard, gold, fiat monies around the world are losing value or purchasing power. When it takes more of a currency to purchase a hamburger or a bicycle or an ounce of gold, you're talking about inflation."

The second is a blog posting from The Oil Drum on October 12, 2009 by blogger Jerome a Paris. The Oil Drum is a website (www.theoildrum.com) devoted to energy issues and Peak Oil, and Jerome's mid-October posting represented a cogent "diatribe" on how so many issues of the crises of the past couple of years do not seem to have been "solved". While we don't agree with a number of his points or his socialist leanings, his points reflect the thinking of a large number of people (worldwide) who feel like they were victims of the recent boom rather than participants:

"One (or two) years on - they have learned nothing"

Posted by Jerome a Paris on October 12, 2009 in The Oil Drum: Europe
Topic: Economics/Finance

Just over one year after it became impossible to deny that the financial crisis that had started in 2006/2007 was a major, systemic event, it is rather depressing to see that nothing has really changed and, to the contrary, if anything has, it is for the worse.

The most striking item, of course, is the continued dominance of politicians by bankers. Banks are universally seen - including by bankers - as being at the heart of the problem, and having created the crisis through reckless behavior and worse. And yet, after having being bailed out at a staggering cost, in a highly asymmetrical way (the losses were socialised, but not the banks), not only have they managed to eliminate the likelihood of any meaningful regulatory change, but more importantly they have managed to maintain the fiction that finance was the reason for earlier prosperity and should thus be protected as a source of *future* prosperity. The crash has not made anyone question the quality (or reality) of the previous boom, but rather made them wistful for these times. Thus, the dominance of the finance sector on the economy and the airwaves has not changed one bit: we still worry about the stock market, it's still financial analysts and economists that drive the public debate, we're still talking about "reforms" of entitlements or the labor market as if these were the main problem today, and public policy largely avoids the big looming issues of resource depletion and climate change.

To extend on this a bit, here are a few items worth noting:

- there's very little discussion of the fact that this is an *income* crisis namely, stagnation/lack of income, which was dissimulated for a long time by increased access to debt. All the endless debating about replacing private debt by public debt and whether that's a good thing or a sustainable one ignore the underlying problem: middle and lower class wages & incomes have been squeezed and need to be supported. Instead, we get savage budget cuts in social spending, i.e. in the very programmes that supplement or complement most people's incomes, and yet more talk about making the labor market more "flexible" (which only ever means pushing wages down). Public spending in collective infrastructure that would support living standards (including energy-saving plans such as support to home efficiency, or public transport), backed by real income (i.e. taxes on those who do not spend all their wages) is not seen as something necessary like the bank bailouts were;

- there's been very little talk of the profound underlying responsibility of the financial world in that drive to reduce the cost of labour. This is usually presented as an inevitable consequence of globalisation, when in fact it's been a clear *policy choice* to focus policy priorities on improving returns on capital (at the expense of everybody else), and to take decisions that justified these choices. For instance, the permanent push to make pensions market-based rather than government-run: this creates new markets for the finance industry and, at the same time, helps justify return on capital requirements as something good for everybody's pensions; stock market performance and short term returns of investment managers then become key numbers for everybody and further drive the focus on short term profitability;

- the massive call upon public resources, and the apparent "success" of bailout/stimulus plans (i.e. governments succeeded where the private market failed), as touted by the markets and politicians, has not lead to a real change of mood about government being a solution rather than a problem. Consistency is not the hallmark of our times. Already the talk is about too-invasive regulation, and unhealthy public debt burdens, as if these had been caused by reckless civil servants. The most obvious point is that higher taxes to pay for government saving the day are still seen everywhere as inconceivable or inacceptable. Just like the War on Terror did not apparently require any financial effort, the Big Bank Bailout cannot be allowed to touch upon taxpayers - or banks, which are too-big-to-fail*er* than before.

- the oil price increases prior to the crash are now dismissed as aberrations caused by speculators and not a signal of anything deeper happening; similarly climate change worries are often dismissed by Serious People as a "luxury" in today's tough times. As a result, we're doing even less than we could on these problems - and so much less than we should. Oh sure, there's a nice bit of spending on green technologies in the various stimulus plans, but it's still dwarfed by help to traditional sectors of the economy (i.e. it's not really a game changer yet) and it's nothing compared to what we know *can* be done. More importantly, it's still seen as a sideshow, and more of a necessary PR exercise than actual policy; more generally, the focus on short term needs eclipses any long term thinking and planning; the past blanket discredit thrown upon government prevents it from fulfilling that natural role (and brings about a slow decay of infrastructure, generally);

- in that context, the impact of deregulation on energy markets, which encourages investment by private sector (at private sector cost of capital) rather than by the public sector (at discount rates close to long term sovereign debt cost) is never discussed. That means that energy spending is focusing, structurally, on investment-light but fuel-rich technologies, as it is easier to keep such investment profitable in the face of volatile prices even if it's not the cheapest technology. Thus we stay on our oil (and gas)-dependent trajectory through investment that can tie us in for decades. Additionally, private decisions on infrastructure generally lead to boom-and-bust cycles as supply reacts in exaggerated fashion to short term demand and price signals. But the financial world get to trade, hedge and finance to its heart, and apparently this is all that matters;

- throughout, progressive ideas and parties have been discredited - either by having Serious People call the bailout of the financial world and other current regressive policies "socialism," blaming the continuing crisis on Big Government while preventing actual public intervention where it would matter (public investment, increased transfers to the poor and unemployed, better and/or more universal public health care, etc) - followed by the knockout blow: claiming very loudly that the crisis somehow discredits alternatives to unfettered markets;

- behind all this, of course, is the agenda of large corporations - old industry incumbents, financial behemoths, not to mention the healthcare insurance juggernaut in the US - and their shareholders, and the twin overriding imperatives of return on equity and "competitive" management pay. They lobby, they run the debate and they outright buy off politicians. The grip of money over politics and policy has, if anything, tightened. But it's not seen as related to the crisis in any way - at least not by the Serious People (i.e. those that buy Serious People or are bought by them)

We need policies that actively promote (i) increasing incomes for the lower and middle classes, (ii) public investment (in particular on energy and healthcare) paid for by increased taxes, (iii) cutting down corporates (in particular, banks) to size. We obviously won't get any of these until the influence of money on politicians has been cut massively.

The past crisis was obviously not sufficient to shake the current system; if anything, the grip has been tightened. Pain for the masses does not matter if it has no impact on the political process; the past year suggests that the corporatists have been successful at defusing public anger and pointing it away from the real culprits; in many countries, the left is split between those that have been compromised too much within the system and those that are too seen as too shrill and neither can provide a credible alternative.

All this points, unfortunately, to a bigger crisis soon.

The reason we include Jerome's essay is that we believe the longer that government and financial interests continue to try to maintain the status quo after the reputed "end of the Great Recession", the more pressure to implement changes builds from those who were hurt during the bust and from those who didn't benefit at all.

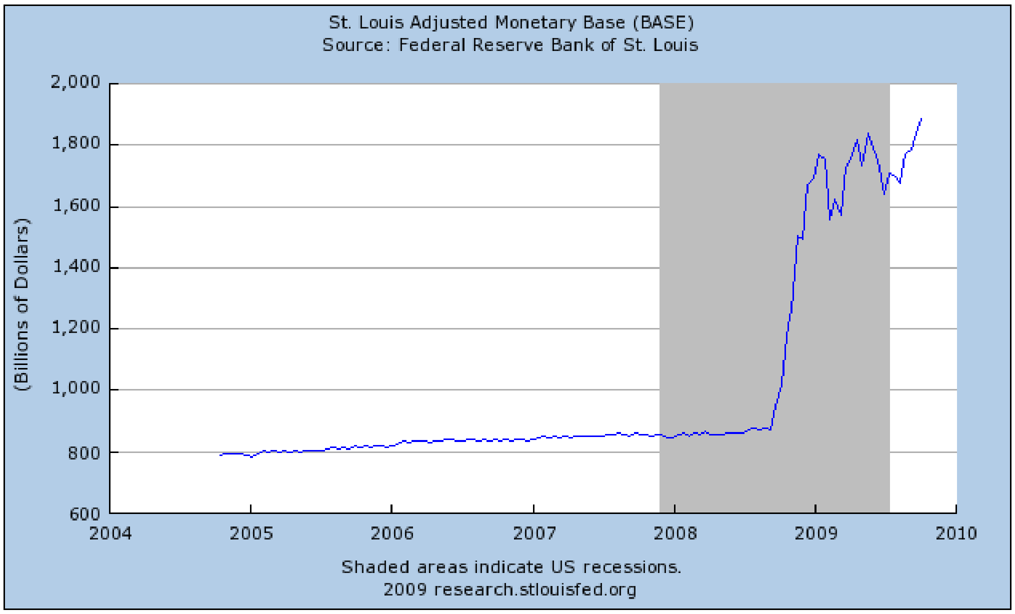
The major point of the two included articles is that governments around the world, especially the US government, have created huge amounts of public debt to try to protect the status quo of the developed worlds' businesses, and the monetary and fiscal stimuli appear to have most benefitted the world's large financial companies – whom many people blame for the crisis in the first place. Obviously, the crux of the matter is that the US really cannot afford to fund such stimuli, while at the same time fighting two foreign wars, continuing as the world's policeman and raising domestic spending, all the while contemplating raising taxes. The world's investors are very aware of this, and they have started to vote with their feet, liquidating US dollar holdings and moving capital to regions where economic growth, stable political situations, falling unemployment and other investment- friendly results are occurring, namely in Canada, Australia, China, Brazil, the countries of Southeast Asia and even India.

The Fed has tried to maintain its balancing act, keeping short-term interest rates at very low levels to keep expansionary forces at work during this time of still-rising unemployment, slack industrial capacity usage and the deleveraging, "hunkering-down" US consumer. Lately, as the US dollar has fallen in value against its international counterparts and gold, Chairman Ben Bernanke and the Fed Governors have been on the defensive, trying to reassure US dollar investors by intimating how they will be tightening monetary policy and raising interest rates when conditions permit. Since they are charged with trying to maintain stable prices (which they interpret as mild inflation) and to try to promote full employment, it seems that although we might have technically stopped the shrinking of the US economy, the Fed will need to continue to have an "easy money" policy (with very low short-term interest rates) for many months (if not years!) to try to reach their employment and price stability mandates.

Thoughts for the Future

So what does all this mean? We think it boils down to the following points:

- The Fed will continue with its easy money policy unless there is some kind of extreme reaction in the US dollar or bond markets where the dollar falls and/or longer term bonds fall in value (thus driving up the interest rates), forcing the Fed to raise short-term interest rates. Until that happens, the excess liquidity that the Fed has made available will continue to seep into the financial markets, driving up equity and commodity prices and leading to asset inflation, not wage inflation, which is the majority piece of the inflation measures monitored by economists and the Fed. The Fed and many economists will try to de-emphasize the asset inflation which is occurring and will grow by saying that wages are not growing much, so inflation is "in check". [An excellent representation of the amount of money the Fed has created that is available for banks is the Adjusted Monetary Base reported by the St. Louis Federal Reserve Bank which is the amount of money the banks have on account at the Fed + currency in circulation; it increased from $800 billion in August 2008 to about $1.7+ trillion in late 2008 and is now nearing $2 trillion in late 2009 (the shaded section depicts when the recession was occurring) – see graph below.]



- The financial markets will continue to rise due to the easy money policies described above as well as a number of timing-specific occurrences: 1) "underinvested" investment managers feel "career risk" (that they not miss any large rallies) and that they must keep up with the major indices gains – while economic malaise tends to merit caution in industries vulnerable to new weakness (e.g. financials, consumer durables, consumer discretionary, etc.); 2) investors who sold out during the V-shaped decline of January-early March who have been waiting for "the big pullback" to get in and see financial markets running away to the upside, leaving them with losses for the year and virtually no income/yield from cash investments to make up for their losses; and 3) US and foreign investors purchasing stocks as inflation hedges and to convert US dollars into holdings of something more concrete.

- Commodities will continue to benefit from the falling US dollar and economic growth of Asian and Latin American economies. Usage (and stockpiling) of commodities from crude oil to copper to rare earth elements have driven their prices up as investors (and countries such as China) look to keep their money in hard assets. Precious metals should continue to serve as an alternative currency and store of value; a falling US dollar and falling trust in currencies in general should benefit gold especially. Silver could benefit even more than gold if industrial demand for the "white metal" picks up. Energy prices will continue to be strong as industrial demand from emerging economies combines with stagnant crude oil supply growth to produce higher oil, gasoline and diesel prices. Natural gas prices will stay (on average) far below their Btu-equivalent price compared to oil due to abundant supplies in the US and from rising worldwide LNG supplies; cold weather during the winter however could cause natgas prices to spike locally as deliverability to consumers hit winter bottlenecks.

- The US economy will rebound during the rest of 2009 (and possibly early 2010), but after the "restocking" occurs (after inventories of so many items were cut "to the bone" last fall/winter), the US economy will grow only marginally as consumers spend at a fraction of their 2005-2007 rate and companies limit capital investments due to low industrial capacity usage.

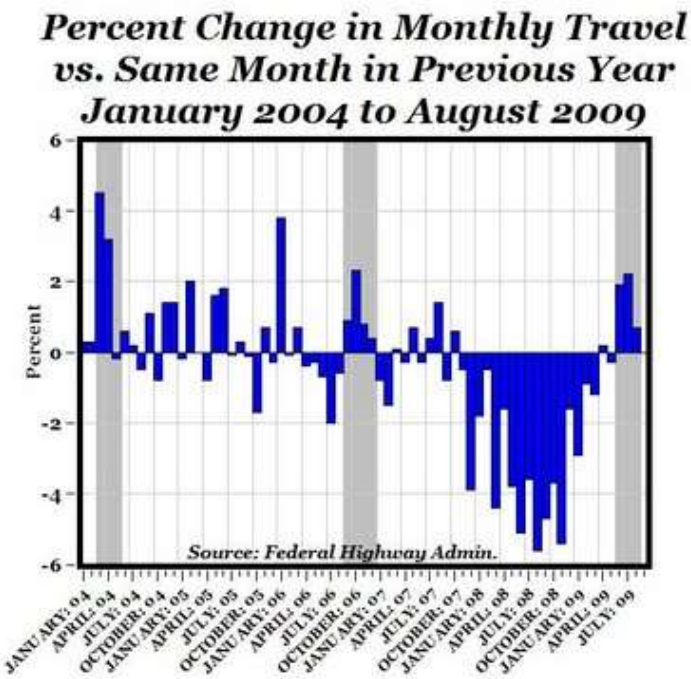
The wildcard will be what happens politically – will "Blue Dog" Democrats combine with Republicans to limit the socialization agenda of the Obama presidency and Pelosi/Reid congress? If not, the economy could be pushed into "double-dip" led by rising taxes (a virtual certainty), rising energy costs (cap-and-trade could still pass) and rising healthcare costs (Obama seemingly has staked his presidency on it).

We continue to invest your capital in commodity-oriented companies, some cheap stocks, some foreign currency holdings and keeping some cash as dry powder. It appears the market may have upside all the way into the holidays, but we believe that the stock market will find "tough sledding" in 2010 while commodities buck the trend and go up in price, as happened for much of 2007.

Some have inquired about "go go" sectors (such as technology) and what our investment thesis is surrounding the technology sector. We believe that, in general, technology companies are back to being cyclical manufacturing companies, striving to add innovations to their products while fighting against constant pricing pressure due to competition and improving manufacturing efficiency. Thus, we don't believe technology companies in general deserve premium valuations – the current 2009 estimated P/E ratio for the Standard & Poor 500 is 19.1x, while the Technology sector P/E is 21.0x, up from a 2008 P/E of 14.4x. Buying high P/E technology stocks seems like a poor risk, especially since we think their anticipated growth is suspect due to anticipated cautious corporate investment spending. We consistently monitor sectors and their risk/reward to gauge when it might be time to move capital to these sectors. We currently have our eye on pharmaceutical and telecommunications companies.

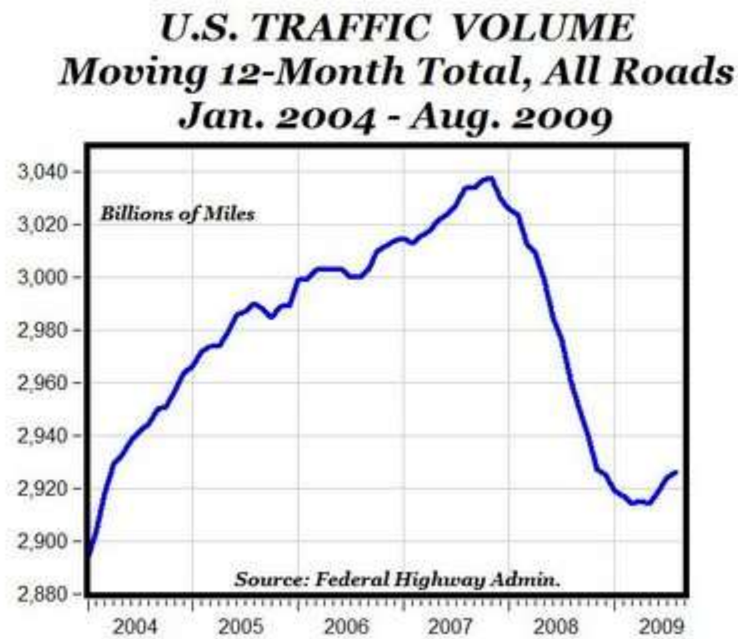
Energy

The investment community tends to focus on demand as the short-term driver for energy prices. The following graphs and commentary, from the blog of Professor Mark Perry of the University of Michigan business school (http://mjperry.blogspot.com/) shows how US gasoline (and presumably diesel fuel) demand has recently picked back up:



"The chart above shows the percent change in U.S. traffic volume through August (from the same month in the previous year), in a report released today by the Federal Highway Administration (data and report here). After falling for 17 consecutive months starting in November 2007, traffic volume has increased in 4 out of the last 5 months. The 0.7% August increase follows increases of 2.2% in July and 1.9% in June, and is the first time since late 2006 of 3 consecutive monthly increases in traffic volume, and the largest 3-month increase since early 2004 (see shaded areas in chart above).

The chart below displays traffic volume as a moving 12-month total, showing a similar pattern to the percentage monthly increase above. After falling for 16 straight months going back to December 2007, the moving 12-month total has now increased 3 months in a row, and in 4 out of the last 5 months, and marks the largest 3-month increase in traffic volume (12-month total) since the spring of 2006, more than three years ago."



This second graph also illustrates how US road travel, while lower, only fell (peak-to-trough) by approximately 4% during the recession. As recovery occurs, we believe demand will cause energy prices to continue to be much higher than the investment community currently anticipates.

Precious Metals

We had the chance to hear John Paulson, the hedge fund manager who personally made billions of dollars shorting subprime debt over the past few years, at the *Grant's* conference in New York, express his investment thesis for gold: he believes the Fed will continue to print large amounts of dollars to help the government stimulate the US economy, and monetary stimulus of this magnitude ALWAYS leads to significant inflation, according to his studies. Thus, he has bought gold via the large gold ETF, the SPDR Gold Trust (ticker GLD), and is the largest shareholder of a large South African gold company, AngloGold Ashanti (ticker AU).

Another of the smartest (and long-lived) hedge fund managers, Paul Tudor Jones, explained his rationale for owning gold in his recently-released Third Quarter Letter. We thought it might be interesting for Kanos investors to hear what another investment professional's explanation for owning gold is:

> "I have never been a gold bug. It is just an asset that, like everything else in life, has its time and place. *And now is that time.* The economic and political comparisons to the late 1970s are too numerous to ignore. And as such, gold is at the center of our thinking as a store of value during a period of potentially large and persistent global portfolio shifts. The temptation to directly, or indirectly, monetize rising fiscal deficits globally means gold could have a bid for the foreseeable future."
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> "In our opinion, the scope for increased investment demand over the coming years is much stronger than the potential from new supply. As a result, incremental new demand must buy from current holders. With a macro backdrop that suggests gold is undervalued, we doubt the transfer of gold from current holders to its new owners will occur at, or near, current prices."

We feel that our investment approach is further validated by having additional sophisticated investors joining us in feeling the need to protect capital via investments in precious metals.

Opinions of Investment Professionals

One last item: one of the information sources we follow is a financial website (produced by an ex-Barron's financial reporter named Kate Welling) called Welling@Weeden. She has been conducting interviews with people from the investment world for ten years at W@W, and to celebrate the anniversary in August 2009, she asked for commentary from all of her interview subjects. I thought there were a few worth reflecting on:

1) Martin Barnes: [on surprises over the last ten years, he was surprised by] "the ghastly performance of equities relative to bonds and cash [and] the speed at which everything unraveled in the past year". ***KS comment: these two comments were repeated in many of the respondents' answers; a lot of smart investment professionals thought equities would outperform in the 1999-2009 period [they actually underperformed by 26%] and were shocked by how quickly financial markets unraveled last year.***

2) Abraham Briloff: "Where were the auditors? When Bank of America took over Countrywide, where was the due diligence? When they took over Merrill Lynch, where were the auditors? When AIG – well before its derivatives blew up – when that half-billion of fake accounting for General Re was engineered on Hank Greenberg's watch, where were the auditors? What is stunning to me is that I'm still not hearing a hue and cry, demanding, 'Where were the auditors'?"

3) Tony Cilluffo: "The biggest surprise is that we let this fraud be gotten away with. If you look at the banks, they did all these structured whatever they call

them. Have you seen anybody go to jail? Have you seen anybody repay their ill-gotten gains? The fraud has become structural."

4) Mike Corasanti: "…you're going to re-equitize [the US economy] in one of two ways. Either by going through some kind of large debt forgiveness/bankruptcy cycle, where the debt gets burned down to a point where it's underneath the value of the asset and then, ergo, you're re-equitized. Or you're going to have a very, very, very, very high savings rate for a very, very, very long period of time, to the point where you can get yourself re-equitized."

5) Gail Dudack: "…I've been taken aback by how thoroughly the quants and momentum players dominate the market [in volume and activity], overwhelming value players and fundamentalists.

6) Harvey Eisen: "…what surprised me most over the last 10 years is how little things have changed in the markets, given the extraordinary events over this time."

7) Scott Frew: "I'd be a lot more sanguine about our current fiscal policy if the debt we were taking on were being used to create conditions in which entrepreneurship and productivity going forward could flourish; least in that case we'd be laying that groundwork for a recovery down the road. Instead we seem intent on recreating the world we inhabited in 2006…."

8) Lacy Hunt: "The thing that surprised me the most about the past decade was the string of serious policy mistakes… [including] the hubris that arose at the Fed as a result of presumed victories in the Long Term Capital Management [hedge fund bailout] affair in 1998 and with trivial deflation in 2003. The height of this hubris was evident in [now Chairman] Bernanke's paper on the great moderation in 2004, in which he argued that the Fed and other central banks had tamed the business cycle. This paper was released just as the total debt to GDP ratio was moving further into uncharted territory [thus, debt was being used to smooth out the usual boom-bust cycle, setting up for a much greater 'day of reckoning' in the future, some of which we experienced in 2008-2009]."

9) Michael Lewitt: "The President's [financial industry] reform plan completely ignores the credit rating agencies and does virtually nothing to address the fact that credit default swaps [have become] primarily instruments of speculation that can be used to destroy…companies. The decade to come will see more bubbles, more greed, more financial instability and more speculation – when what we need is greater stability and productivity and foresight among our business and political leaders."

10) Errol Rudman: "It would be good for the dollar to decline now, to stimulate exports and give us some kind of advantage in world trade, but so far that is not happening, but it's also clear that the Fed is committed to being accommodative. ***KS comment: this was written in mid-August; the dollar has declined significantly since the comment was made.***

This last comment was emblematic of a number of optimistic fund managers interviewed by Welling. The problem with Rudman's comment is that it reflects how a myopic investment professional thinks: lower the dollar to the point where domestically-produced products compete on price around the world, and have the Fed keep interest rates low so that we can grow our economy ad infinitum. This is only rational thinking in the context of trying to have your investment portfolio increase in price for a few months/years. But it is incredibly poor long-range monetary management – you cannot drive the dollar down without risking high future inflation and causing American standards of living to drop. You cannot keep rates low for a long time (as was just proved in the 2003 – 2009 housing bubble forming and bursting) without causing huge unintended consequences. A number of fund managers were bullish long-term, thinking that this past decade had produced the investment "pain" that was needed to then launch a new secular bull market. We at Kanos continue to think that the 2000s have been like the 1960s/early 1970s, and that the period we have entered will look a lot more like the mid-to-late 1970s, with sluggish economic growth and high inflation.

The Managers of Kanos Capital Management