KANOS CAPITAL MANAGEMENT, LLC

March 2006 Investor Letter

Market Overview and Portfolio Point of View

The first quarter of 2006 was schizophrenic, with great environments for our positions during January and March, and poor performance during February. We ended up with a positive quarter, and we believe firmly that we are set up to be in position for further gains during the rest of 2006.

Economic Situation

While economic activity in the United States hit a swoon in the fourth quarter of 2005 after the Gulf Coast hurricanes, economic activity appeared to be quite strong during the 1st quarter of 2006, and prices of most things reflected that strength.

Oil prices moved from under $60/barrel at the end of 2005 to nearly $68 at the end of January, but then fell back under $60 in February before going over $66 by the end of March 2006. Gasoline and distillates (diesel fuel & heating oil) however rose faster in March as more refineries shut down for maintenance, and refiners / wholesalers sold off inventory in anticipation of using ethanol-enhanced gasoline and cleaner diesel exclusively by May. Energy companies made their highs in late January (and were negative for the year by February) before recovering to post gains by the end of March. This is during one of the warmest winters in history! January was the warmest in 130 years of recorded temperatures; natural gas prices plunged from a peak of $15/MMBtu in early December 2005 to $11/MMBtu at the beginning of 2006 to under $7/MMBtu on March 1, 2006. In spite of the short-term supply glut created by lack of heating load for the winter, our energy investments continued to rise in price as oil prices stayed high and the market looked forward to the 2006 hurricane season and next winter.

Materials companies did better than energy during the first quarter, as metals markets rose most of the quarter, with a small swoon in February. Leading the way were base metals (and the stocks of companies that produce them) with copper rising from just over $200/pound to nearly $250 by the end of March. Zinc, nickel and other base metals did as well or better than copper. Precious metals also moved up smartly, with gold moving from around $515/oz at the end of 2005 to nearly $590/oz at the end of March, while silver went from under $9/oz to approximately $11.50/oz, as the introduction of an ETF for silver drove up the price in anticipation of tight physical silver supplies. Stock prices of producers of precious metals lagged the performance of the physical metals, as investors were concerned about rising production prices (especially impacted by high energy prices) and the ability for companies to find more gold and silver mines. Supply

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and demand concerns continue to point to higher prices for both physical metals and the equities of the companies that produce them.

Our other positions, performed modestly well, as industrial stocks, tech stocks and pharmaceutical stocks were up slightly during the quarter. Our pharmaceutical company positions are generally chosen to try to benefit from any progress that might be made against worldwide flu concern. We continue to look for good companies with intriguing financial characteristics, but we have been selective due to the concerns expressed in other parts of this letter.

As mentioned above, the US economy showed a rebound from the reduced economic activity of the fourth quarter of 2005, and industrial companies led the way, with booming production for equipment for material extraction and construction, while home builders and financials (banks, credit card companies) were laggards. Employment statistics showed more and more Americans going to work, at the same time as the Federal Reserve continued to create money at a nearly double-digit rate. Supply and demand concerns for energy and materials, coupled with rising wage pressures and increased money supply, point to accelerating inflation in the future. A cooling of housing demand is a concern, but otherwise the US economy continues to hum along. Our concerns about the increasing current account deficit and trade deficit, coupled with the out-of-control spending in Washington (as evidenced by the government's growing budget deficit) lead us to think that the US dollar is vulnerable, and if it starts to go down, interest rates will rise, dollar-denominated commodities (like energy and precious metals) will become more expensive for the US and could lead to a slowdown in US economic activity.

Finally, the broader market staged a decent rally, with the Standard & Poor's 500 Index rising 4.21%, as investors bet on continued strength in the economy. The Dow Jones Industrial Average was up 4.25% this quarter as the largest companies finally outperformed the broader market, although small cap stocks outperformed their larger brethren again this quarter. The bond market, which appears vulnerable to us due to the concerns written about above, was down slightly on the quarter, as longer term rates moved up slowly. However, a large contingent of bond buyers believe that the main drivers of inflation (which is most of the time measured without factoring in food and energy prices – as if no one eats or drives their car or heats/cools their house!) are considered under control. We believe this confidence in the Federal Reserve is misplaced and that inflation will accelerate in the future.

Thoughts for the Future

While we are looking for bright spots in the business community to invest your capital, we reluctantly find ourselves concerned about the future. The world, while always a complicated place, appears to be slowly getting less "capitalist friendly", and the benefits to the United States (and the rest of the developed world) of globalization may be eroding. Commodity markets, whether energy, base metals, lumber, precious metals, etc. have continued to rally as worldwide demand continues to grow, while the long cycle supply replacement has failed to keep up with demand. The result: much higher prices than just a few years ago, coupled with growing resentment from many lesser-developed producing countries that they are not getting their fair share of commodity price appreciation. This resentment, best seen in the machinations and rhetoric of Venezuela's president Hugo Chavez, is also starting to appear in other ways: Bolivia's recent nationalization of its natural gas industry, a number of strikes in Mexico's very large coal and silver mining businesses, Chad's insistence on increased royalty payments for its oil production and sporadic demonstrations at Indonesia's mines, most notably the Grasberg mine in New Guinea. These are all symptoms of nationalism that we think will lead to less productive commodity replacement (in energy, metals mining, agriculture, etc.), and we think there will be an increasing value in commodities from "safe" locations like the US and Canada.

We also believe that the abovementioned demand growth, mostly driven by Asia's rising standards of living and America's refusal to curtail its voracious consumption, will continue to drive all commodity prices higher, although there will be violent downturns in prices on the way to new highs. We also believe that supply will also become more of a problem as commodities become harder to find, more expensive to extract, more expensive and time-consuming to bring online and harder to get access to in the developing world.

Meanwhile, US consumption of consumer goods (including luxury goods) seems to continue to grow. The US as a country and individual Americans appear to continue to live at the edge of their means as evidenced by our negative savings rate and our building trade (and current account) deficits. Thus, demand for goods by the US (and increasingly the rest of the world) is leading to accelerating inflationary pressures. In our mind, this drives us toward investments that will hold their value in inflationary environments (usually stocks, commodities, real estate, collectibles, etc.) while we are shying away from over-extended areas – real estate and stocks, which are both trading at historically very high multiples.

Thus, in spite of a multi-year increase in demand and prices for energy and materials, we currently plan to stay invested in these sectors due to their attractive fundamentals (demand still growing, supply still shrinking) and value preservation (worldwide inflation erodes value of paper assets and overextended asset classes like real estate). The bull market in commodities will not be without some violent interludes, and we believe that staying with our positions until fundamentals or macroeconomic variables shift against this strategy.

Meanwhile, we will be looking for selective investments in the broader US stock market, but we believe that better opportunities will probably be found in international markets, where equities have better growth characteristics, lower valuations and less (or no) US dollar exposure.

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The Managers of Kanos Capital Management