KANOS CAPITAL MANAGEMENT, LLC

September 2005 Investor Letter

Market Overview and Portfolio Point of View

The third quarter of 2005 was eventful (to say the least), and Kanos clients enjoyed a successful quarter of investing. Sometimes life imitates art, but we don't think anyone could have written a believable story that involved two category-5 hurricanes like Katrina and Rita. However, our belief that materials and energy stocks would benefit in the pre-hurricane environment was correct, and our investments prospered during the first half of the quarter, while the twin hurricanes of the second half of the quarter expanded our gains slightly as investors realized the value of investments in industries with growing demand and barely sufficient supplies.

The general stock market indices enjoyed a slight rally during the quarter, as the Standard & Poor's 500 returning 3.66% and the Dow Jones Industrial Average returning 3.44%, with energy, utilities, consumer staples, and technology performing well during the quarter, while telecommunications, consumer discretionary (thing like autos and other large ticket items) and financial stocks performed poorly.

Commodity prices across the board continued to rise, with energy, copper, precious metals and other "hard" commodities reaching either all-time highs or multi-year highs. Companies that produce these products rose in value and companies that consume these commodities generally had their stock prices either flatten or fall in value during the quarter, especially after the impact of the hurricanes led to higher spot prices of a number of commodities due to storm-related shortages.

Economic Situation

We have been bearish the US dollar since last year due to low US interest rates (making the US less attractive to foreign savers), large US government trade and budget deficits (which could lead to inflation due to too many dollars chasing goods and services) and the high relative valuation of US equities (making foreign investors look at areas with more reasonable valuations). Since many important commodities are denominated in dollars (oil, copper, gold, etc.), weakness in the dollar means those commodities are cheaper to the rest of the world, which should stimulate demand (other things being equal).

However, the US Federal Reserve has raised short term interest rates steadily this year, making the dollar and dollar-denominated investments more attractive (relative to the Euro and Yen, for example), which has led to an appreciation of the dollar versus other currencies during 2005. In spite of these headwinds, global economic activity (led by a stronger-than-expected US economy) has led to increased demand for commodities

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and rising prices for them. Thus, during the 3rd quarter, we saw historic high (nominal) prices in the energy sector and multi-year or –decade high prices in copper, gold, iron ore and other metals and materials. These prices led to increasing stock prices in the energy and materials companies where the majority of Kanos investment positions are concentrated.

The risk is that high prices caused by this secular demand growth results in lower future demand and a resulting fall in commodity prices (and thus stock prices of the companies that produce these products). As the 4th quarter of 2005 opens, we have seen some stock price weakness as investors anticipate falling energy demand due to high prices.

Investments

So where does that leave us? While we are constantly on the lookout for attractive ideas and investment themes, we have found few lately that we like as much as our commodity producers. We believe these companies remain so attractive for two main reasons: 1) valuation of equities with respect to their anticipated growth prospects and 2) anticipation of lackluster demand by both business and consumer buyers for present products, with lack of "killer applications" that helped drive so many investment themes in the 1990s. Our investment focus consequently will continue to concentrate on natural resource and materials companies while looking for investments in interesting companies in other industries.

For example, in the technology arena, we have bought Advanced Micro Devices which has developed two new microprocessors that are more powerful and efficient than Intel's best microchips, leading to AMD taking market share from Intel this year. AMD also has a memory chip division that has increased in value lately and AMD is looking to monetize this increased value through a sale of the unit. As you can see from our investment premise, this is not a "new demand" story; it is a "taking market share" theme. The products that use these chips are PCs, laptop/notebook computers and servers – mature products with modest current growth prospects. Big technology companies like Dell, Microsoft, Intel, Cisco and IBM – all are fighting for market share in traditional products with low expected growth rates. In our humble opinion, technology shares will have a hard time rising in price without some catalyst for business and/or consumer growth. Absent something like this, we believe most large technology shares will remain uninteresting or even unattractive.

In healthcare, we have bought the European pharmaceutical company Sanofi-Aventis due to its stable of current products that have potential for continued strong growth: Allegra (allergies), Ambien (sleep), and a number of hypertension, oncology and other pharmaceuticals; its vaccine business (SNY owns the only vaccine plant on US soil) and SNY's participation in the developing vaccine efforts against avian flu; and the promise of a potential blockbuster in development – Accomplia, an anti-obesity drug in late stage development. We like the mix of businesses that SNY has, but other large pharmaceutical companies are less attractive: Merck (and Pfizer, to a lesser extent) still face patent expirations on blockbuster products while struggling to introduce new products. Similar situations facing many of the large "pharma" companies have led to shrinking P/E multiples and lower prices for the group. We would like own more pharmaceutical companies and will look to new product "pipelines" and company valuations to see if we can add more companies to our portfolio. Valuations have priced us out of many other healthcare sectors as multiples seem high for the growth prospects of many companies in the elderly care and medical device segments.

We believe telecommunication are an important part of the world economy, but the competition among the companies in the business and the continued overhang of networks built in the developed world in the late 1990s/early 2000s means that companies have little pricing power. Thus, profitability has been fleeting, and we have not found investments yet that convince us to enter the space. The Baby Bells pay a handsome dividend, but they have been hitting new lows as investors believe they face diminishing futures.

That leaves us with our natural resource companies. As mentioned above, world energy demand, led by strong growth in the US as well as emerging giants China and India, has elevated refined products demand (for gasoline, diesel fuel, jet fuel, and (in winter) heating oil). Higher demand has meant higher prices, with the prices of crude oil and natural gas rising throughout the quarter. The occurrence of hurricanes Katrina and Rita led to spikes in prices due to spot shortages, but elevated prices (and shut down plants) have also led to diminished demand during September. The question at this point is whether crude oil prices in the $60 range and gasoline and diesel fuel prices approaching (and over) $3.00/gallon will hurt demand enough to take prices down. We believe that prices will have an effect on demand, but that residual supply problems will also weigh in on the equation, and we believe that prices will average near where we find prices at the end of the quarter. Natural gas production has been strongly affected by the twin storms, and while we believe there is enough gas for all who want to burn it, price will be the means of rationing demand, and prices are going to stay high. Our society has arranged housing, lifestyle and routines around automobiles and burning fossil fuel for transportation and heating. We think that this "cheap fuel"-reliant scenario cannot be changed quickly and that high energy prices are here to stay. Thus, energy companies will continue to accrue value as they sell their products, and we believe that value will accrue to us as shareholders, hopefully through price appreciation, dividends or both.

Another factor that should help our energy equity investments is that Kanos is convinced that energy companies are "underowned" by the big money behind Wall Street. Many large financial institutions are convinced that energy prices "have had their run" and that prices will retreat to more historical levels ($30 crude oil, $2 gasoline). However, we believe that two factors will help push up energy equity prices, even if fuel prices don't rise from their current levels: 1) profitability and 2) indexing. Profitability of the energy companies in the Standard and Poor's 500 represent <u>**44.2%**</u> of the estimated 2005 profitability of the S&P 500 while they only represent <u>**10.5%**</u> of the market capitalization of the S&P 500 Index. This shows that the other segments of the broadest US index of equities are much less profitable, meaning these non-energy companies should be less attractive to investors. In addition, while estimated earnings of the S&P 500 companies increased approximately 18% in the 3rd quarter of 2005, without energy companies that growth would have only been 10%. Thus, in both overall earnings and incremental growth of those earnings, energy companies represent an inordinately large part of the main driver behind investors' buying decisions; earnings. The second reason for feeling that energy companies are underowned is that (as mentioned above) energy companies represent only **10.5%** of the S&P 500 Index but have represented a much larger percentage in the past: in 1977, before the second 1970's oil shock, energy companies in the S&P 500 represented **15%** of the Index. At the height of energy prices (and energy company stock prices), energy represented over **29%** of the S&P 500 Index! Thus, as investors realize that high energy prices will be part of our economy and that the earnings of energy companies will not drop off significantly, more money should move into energy equities and move prices up in the future. A large amount of money managed by Wall Street firms is in index funds or in portfolios that are designed to track the index on a performance basis (a practice called "shadow indexing" that is widespread on Wall Street). These index investors will supply increasing buying support as energy companies come to represent a larger percentage of the S&P 500.

Finally, last but not least, the materials and metals stocks we own did alright during the quarter, although since commodity prices have risen quite a bit over the past couple of years, equity investors are wary that we have seen peak earnings (we haven't – our opinion), so stock prices have not moved as far as we expect them to do. While the price of gold set recently set 18 year highs, our investments in the gold mining sector had mixed results, some moving up nicely and some moving only stubbornly and modestly higher. Silver stocks acted similarly to gold stocks. Industrials metals (including uranium) did better, and those equities responded with nice gains during the quarter. Out thoughts for the future are included at the end of this letter.

Thoughts for the Future

While we are fully aware of the implications of the recent run-up that has occurred in the prices of energy products, precious metals, industrial metals, and other commodities, we still believe that we are in the middle of a multi-year bull market for the price of commodities.

Why? Many commodities, best illustrated by the supply situations in energy and metals, have not had adequate investments in new capacity until recently, and recent year increases in demand have made prices go up as the supply / demand situation adjusts prices upward. The current "solutions" to high energy and commodity prices will take months, if not years, to start to influence the supply situation – it is with the fluctuations in demand that prices will be determined. We believe that there is still a very good chance that energy and commodity prices stay high as Asian and North American demand continues to keep prices of oil, gas, copper, coal, iron ore, gold, silver, and others high. Holding equities that benefit from these high prices are a way to participate in these markets without the extreme volatility and transaction costs of futures trading. In addition, we believe that commodity producers will continue to deliver dividends and capital appreciation into the future.

We also believe that there are some other themes that support our investment interest: healthcare companies that have growth prospects but are reasonably valued, technology stocks with low P/E ratios but growing interest in their products, etc.

We are less enthusiastic about large-capitalization growth stocks where we think that the valuation multiples of the stocks are still too high for the growth prospects of the companies going forward. We also believe that the Fed raising short-term interest rates is bearish for financial companies, and the hurricanes may yet reveal problems in insurance companies in the months to come.

Thus, we anticipate the continuation of concentrated portfolios, with less diversification and a few themes represented in our investment decisions. Unfortunately, it appears we may be in for some short-term pain, as fall weather and high commodity prices tend to push down seasonal demand; however, for timing and tax purposes, we prefer to stay in what we consider attractive positions rather than sell and try to pick the best place to re-enter later.

Finally, we want to express our thanks to you for allowing us to serve as your investment managers. We try to give you good service and profitable investment ideas, but welcome your input on how we can serve you better.

The Managers of Kanos Capital Management