September 2008 Investor Letter

Third Quarter Market Conditions

After a very successful 2nd Quarter of 2008, our investment results in the 3rd Quarter were disappointing. We understand and incorporate into our thinking that markets advance and retrench, but such rapid, violent retrenchments as we have seen during this quarter surprised even us. We at Kanos want to thank you for your patience, confidence and trust in us as we try and navigate your portfolio through the "shoals" of the investment markets.

Energy prices peaked early in mid-summer due to a number of factors (discussed below in the 'Energy' section) and then dropped throughout most of the quarter as high prices were judged to caused demand to drop. Concern about high energy prices cutting down worldwide growth also led to falling prices of metals and other commodities (discussed more below).

The Security and Exchange Commission's surprise mid-July prohibition of shorting shares in nineteen financial companies caught us off-guard, but in a way only tangential to the government's intentions. The limitation of shorting those nineteen financial companies, coupled with fears of short sellers that they might be forced to "cover" (or buy back) other short positions caused a massive rally in highly-shorted stocks (most of which are companies in trouble due to poor management decisions and deteriorating fundamentals, like banks, brokers, retailers, and some technology companies). The momentum generated by the short covering rally led traders and computer-program traders to add to the momentum, and sell sectors with flagging momentum – the energy and natural resource stocks that had enjoyed such gains in the first half of the year and had started to re-trace. The violence of the upward rally in previously-shorted stocks led to the violence of the rally of the sell-off in energy and natural resource stocks, hurting our positions because of "sector rotation" into groups with "favorable momentum". That is, of course, just financial firm mumbo-jumbo for selling holdings that had done well to look for the group that will have the next big upward movement. Earlier in the spring/summer, many hedge funds and mutual funds had reached some of the conclusions that Kanos had, namely that continued growth around the world was taxing energy resources, leading to higher prices. Hedge funds had even "paired the trades", buying energy/metals, and short selling a like amount of financial stocks. These funds sold their energy and resource stocks as their financial short positions moved against them. Meanwhile, problems in financial companies brought on by historic amounts of mortgage

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loans and excessive leverage throughout the financial community led governments to intervene in markets and restricting trading in various ways. Investor losses from the abovementioned hedge/mutual fund sell-off, coupled with fears of further financial damage after the rescue/takeovers of Fannie Mae, Freddie Mac and American International Group by the US Government, along with the collapse of Lehman Brothers, led to new market perception of slowing world economic growth and thus the accelerated selling of commodities and commodity stocks, in the belief that the rise in prices was mostly a demand-driven phenomenon, and if demand growth dropped from recent levels, commodity supplies would balloon and prices collapse. This perception was not backed by much statistical evidence and we at Kanos are skeptical about how big and how lengthy a drop in worldwide demand will be.

Finally, the Federal Reserve (in concert with the US Treasury) continued to implement new and expanded credit facilities not only to US financial institutions but to world central banks as well. Perceptions that slowing global growth centered on Europe, where housing/financial woes in Britain, Spain, Greece, Ireland led to financial institution bailouts by governments, led to growing worries about the Euro, leading to a massive sell-off in the European currency. The prime beneficiary of this sell-off was the US Dollar. The dollar rose versus the Euro and other currencies like the Australian and New Zealand dollars (but not versus the Japanese Yen) as the US was judged to be "farther along in solving its financial and economic problems" than the Europeans, Australians, etc., although we at Kanos are not sure other economies were as levered to debt as that of the United States. The US dollar also benefitted from the "deleveraging" of the financial system, where traders who had borrowed dollars (using low US interest rates) and had invested the proceeds in other countries and currencies (in investments denominated in the Euro and other currencies that paid higher interest rates like Australian, New Zealand and Canadian dollars) had to sell those investments, and pay back their US dollar loans. This led to massive (but temporary) demand for US dollars as traders "unwound" their leveraged bets pushed the US dollar up more than 10% in three months, further hurting commodity producers (since most commodities are priced worldwide in US dollars, a rising dollar makes commodities more expensive around the world, hurting demand). While unwinding dollar bets had happened twice in the past three years, they were nothing compared to the scale of this unwind, and our positions suffered from this turbulence.

Review of Third Quarter Markets

Energy

Two major causes of crude oil's mid-summer peak were: 1) increased demand for diesel / distillates for use in power generation (especially in China), and 2) derivative book problems caused in part by the large energy company SemGroup. This spring's Chinese earthquake caused power shortages (due to hydroelectric problems in the affected areas) and caused Chinese authorities to use diesel generation to try to satisfy stretched power needs throughout central China. Throw in increased heating oil demand for heating in Europe due to lingering winter conditions, and diesel demand spiked in late spring. The pause in Chinese demand due to shutbacks in the month before the Olympic Games (in order to lessen pollution problems), coupled with the onset of summer in Europe led to market perception of demand dropping significantly, leading to drops in diesel / heating oil / gasoil prices around the world. We will see how temporary this flagging of demand turns out to be (more on that below).

Second, we find out in retrospect that SemGroup, a large US pipeline and gathering company, which buys crude oil, transports, stores and eventually sells the oil for a large number of customers in the US Midwest, had a large futures loss that disrupted the company and a lot of its counterparties. Since the company buys large amounts of crude oil and doesn't immediately sell it, they typically hedge their purchases in the futures market on the New York Mercantile Exchange (Nymex), buying back their futures when they sell their physical crude oil. SemGroup in June ended up not being able to cover margin calls on their large short crude oil futures position, as the price ran up (the futures market "marks" all positions to market each day, and those with losing positions must put in cash to satisfy any temporary losses [the cash goes to the day's "winners" – futures markets are a zero-sum equations where there is a winner for each lost dollar on a daily basis]). When SemGroup finally declared bankruptcy and gave up its futures position, pressure on the crude oil market abated (after reaching the high $140s per barrel) and the price corrected some of its fast, furious rise. We saw the energy futures prices drop significantly over the months of July and August, but surprising to us was that the companies that produce these hydrocarbons, which had shown much smaller rises than the underlying commodity prices, fell as fast or faster than actual commodity prices! One reason this happened is discussed below in the short sales paragraph, but another reason is that a number of large natural gas companies (Chesapeake Energy, XTO Energy, and others) bought other companies or large acreage positions in natural gas shale plays (the Barnett Shale, the Haynesville Shale, the Bakken Shale, etc.) and the banks financing some of these purchases required the companies to hedge this future production, leading to pressure on natural gas prices (due to increased producer selling) and lower share prices as investors worried about the purchase prices of the acquisitions, mid-summer natgas fundamentals, continued predictions of lower gas prices (due to the anticipation of rising daily production volumes) and "sector rotation" out of sectors that had done well in the last quarter.

Thus, energy prices fell precipitously as: 1) upside momentum in prices crested as Chinese stockpiling pre-Olympics waned, 2) US government intervention/shoring up of US financial companies led to the "unwind" of the crowded long energy-short financials trade, putting downward pressure on futures prices, 3) growing speculation that slowing US and European economic activity would slow worldwide growth more so than previously thought, and 4) short-term increases in energy availability brought on by $125+/bbl crude oil prices and $10+/MMBtu natural gas prices throughout the late spring/early summer. Downward momentum then built on itself (just as upward momentum propelled prices in the $100-125 range to the $140+ range twice). Finally, markets tend to correct further than most people believe they will, so when energy prices started dropping, they dropped farther and more quickly than on other recent corrections.

The table below shows some shockingly poor investment performances by a number of hedge funds for the month of September and year-to-date (2008 through the end of September). These are large, well-run hedge funds, many of whom were bearish of the markets or long-short (in which the fund holds long stock positions offset with roughly equal amounts of short stock positions of companies you think will do poorly in the future. Investors dismay with hedge fund performance caused $43 billion of withdrawals in September alone (a record by more than $30 billion), as reported by TrimTabs Research, and hedge funds under management dropped by $210 billion during the third quarter, according to Hedge Fund Research. There is no doubt that withdrawals will climb as longer term "lock-ups" of capital by hedge funds are satisfied and hedge fund investors see how poorly funds have done in October during it heightened financial turmoil.

Hedge Fund	**September**	**Year-to-date (through 9/30)**
Maverick Capital	-19.5%	-21.2%
TCI	-15%	-26.4%
Greenlight Capital	-12.8%	-16.4%
Lone Cypress	-14.7%	-26.5%
Third Point	-11.0%	-18.4%
Atticus European	-15.8%	-43.5%
Tontine Partners	-59	-66.7%
TCS	n/a	-44.6%

[Note: as we go to press in mid-October, a number of energy company CEOs, most notably Aubrey McClendon of Chesapeake Energy and Bob Simpson of XTO Energy, have had to sell a large portion of their equity holdings in their own companies to meet margin calls due to the dropping price of the stocks – thus these stocks have had even more selling pressure as the company's own executives are forced to dump stock onto the market to pay off their debt. This shows it was not just hedge funds that had levered energy equity positions that had to be sold in "forced sale" conditions]

We at Kanos were aware of the risks, but didn't fully gauge the sequence of events very well that could cause such a massacre in energy equities. We are constantly on watch for overvaluations in our portfolios, and what we found during the June and early July peaking of energy prices was the fact that our companies only partially followed prices when they got above $130/bbl and $12/MMBtu, and that they were still valuing crude and gas as if they were $100+/bbl and ~$10/MMBtu. Thus, we were not surprised to find energy prices falling from their peaks, but we were surprised to find the equity prices of energy producers fall as much or more than the commodity prices! It seems as though those who were long of energy in the futures market also owned the equities, and when they sold futures, they also sold stocks. While anything can happen in markets, especially in the short run, this does not make sense in the long-run unless earnings are thought to collapse or another large reason for disappointment surfaces. But energy earnings are supposed to hold up – in fact, they are the star performing sector for the 3Q2008, according to Thomson-Reuters, much better performer than any other sector:

3Q2008 Earnings Growth Expectations (from Thomson-Reuters)

Sector	9/30/08	7/1/08
Financials	-67%	-4%
Consumer Discretionary	-9%	+15%
Industrials	+3%	+6%
Materials	+5%	+11%
Technology	+7%	+12%
Energy	**+53%**	**+58%**

The financial world believes that demand for energy will be far less than was thought just three months ago, and that falling demand in the face of rising supply spells disaster for energy prices. We believe the world energy position is much closer to balanced, and that the interaction of supply, demand, politics and costs are a recipe for higher prices in the future.

Demand has fallen in the US for gasoline and diesel as high fuel prices crimped consumers' and business' driving activities. However, the industry, fearing past history, has drawn down crude oil, gasoline and heating oil/diesel fuel to a point below where we have seen inventories for many years. With a smaller cushion of inventories, supply shocks or increases in demand (without sufficient inventories to take up some of the balancing needed) could lead to sharp prices increases. Hurricane developments (the disruption in energy production, falloff in refinery operations, pipelines underutilized due to product supply disruptions) have caused demand statistics to reflect larger decreases than forecast for early autumn, but Hurricanes Gustav and Ike may have distorted utilization statistics so that they appear lower than on a going-forward basis. Economic activity around the world has dropped from its formerly torrid pace, but most analysts see China still growing its economy in the 8-11% range, down from 10-15% of the last couple of years. While slowing growth in the developing world hurts the growth in energy demand, energy demand is still forecast to grow by the International Energy Agency, the developed world's Paris-based energy analysis agency. The crux of the matter is that energy demand in aggregate around the world is still growing, and that growth may have to bid for energy as supplies become more of a concern. China, after more than a year of reining-in growth, reduced interest rates and bank reserve requirements in mid-September in a bid to re-ignite growth after the Olympics. Meanwhile, spot shortages still appear often: Nashville and Atlanta experienced extreme gasoline shortages after Hurricane Ike due to supply shortages in pipelines feeding the area; Canada has experienced diesel shortages in late September/early October due to refinery snags; North Dakota has seen gasoline shortages for much of the past summer; etc. It is not at all obvious that demand is falling as much as some analysts think while we have trouble supplying different regions of North America.

In addition, the credit crunch in the US and Europe has seen large amounts of stimulus (i.e. liquidity) thrown by the US Federal Reserve to banks in the US and through the European Central Bank to banks in Europe. The central banks think these large amounts of new monies are needed to rebuild capital in the banking system and restore confidence so that bankers will start lending among themselves and keep credit flowing to businesses around the world. As US dollars flow forth in ever larger torrents, we believe the deflationary aspects of the credit crunch will be stemmed, and inflationary forces will again be felt in the world's economies.

We at Kanos continue to believe that the energy markets are not focused enough on the supply challenges faced in a number of different regions. We have written for a number of quarters how non-OPEC supplies have not grown due to depletion of existing fields and the delays of large new projects due to their cost, complexity and generally remote locations. Supplies got a boost this quarter (on the crude oil side) from 500,000 barrels/day from the only new Saudi oil field scheduled to come on line in the near future. On the natural gas side, high prices (as high as $13+/MMBtu) caused by doubt that there might be enough gas for filling winter storage, led producers to accelerate drilling in the large shale plays around the country (the largest being the Barnett Shale, but also the Haynesville Shale and others) which produced large amounts of new deliverability due to high initial production rates of these types of wells. Higher deliverability occurred just as higher prices caused US and European energy conservation and a decrease in demand growth by Asian countries as increased spring/summer demands dropped back to more seasonal levels.

Lower prices and the spread of the credit crunch will start to affect development. After natgas prices fell below $8/MMBtu, companies started to cut back on their drilling plans because "all-in" costs for shale gas is thought to be approximately $8/MMtu. This will almost certainly lead to drop off in overall US deliverability as shale wells' initial high rates drop off and fewer new wells are being drilled to maintain that deliverability.

More importantly we believe are the relentless decline in mature fields that are the backbone to the world's oil infrastructure. Mexico, with its aging Cantarell field (once the 3rd largest field in the world) saw its oil production fall 9.2 percent in the first eight months of 2008, but more disconcerting to the US, its exports fell 14 percent as local needs use a large percentage of declining oil production (Pemex). Russia, the largest oil producer and exporter in the world (yes, slightly larger than Saudi Arabia) continues to underinvest in its oil fields, and production is expected to be down nearly 1% this year to 9.82 million barrels/day (Bloomberg). The North Sea, both the British and Norwegian sides, continues to show oil production decreases. In the starkest contrast of depletion, Indonesia, formerly a member of OPEC, is now a net energy importer, as domestic consumption has grown to the point that Indonesia imports more finished products than the crude oil and liquefied natural gas the country exports to Japan and Korea.

Politics, as mentioned briefly above, still exerts a large negative influence on energy production. Most prominently, the United States has prohibited drilling along most of its coastline for decades until this year, when the ban was allowed to lapse, and Congress is still debating how to allow energy companies to proceed, further delaying new production. Mexico has a constitutional ban on allowing any foreign companies from receiving Mexican energy production, which has hamstrung the Mexican national oil company, Pemex, which needs foreign drilling expertise to try to find more of its deepwater offshore resources. Venezuela, with huge energy resources, has scared off most of its major oil company partners as last year's partial appropriation of a number of heavy oil joint ventures has discouraged large oil companies from expanding any business with Pdvsa, Venezuela's national oil company. President Hugo Chavez' populist politics, along with his running off of much of Pdvsa's professional staff, has led to falling production volumes and extreme underinvestment in Venezuela's oil fields. Russia has also continued to use energy as a policy initiative, with Prime Minister Putin and President Medvedev steering new projects toward partially government owned companies Rosneft and Gazprom. BP's Russian joint venture, TNK-BP, has had a lot of interference from the Russian government and its Russian part owners, restricting its activity. Kazakhstan, frustrated with the slow development of some of its large discoveries, has moved to restrict further access to new concessions and demanded higher shares of current development projects. Nigeria's refusal to share significant amounts of its oil revenues with the Bayelsa state (where most of Nigeria's oil is produced and living conditions and pollution are horrible) has incited groups to wage war on the government and oil company facilities. The best organized group, MEND (Movement for the Emancipation of the Niger Delta) has actually used speedboats to attack oil platforms 80 miles offshore. This has deterred further developments by many oil companies and has caused more than 1 million barrels per day to be shut in semi-permanently. Other African countries, including Chad, have demanded renegotiation of production sharing agreements as prices have risen over more historic price levels. Renegotiation possibilities may deter companies from further investment due to uncertainty of returns. OPEC also exerts an influence on price as well as volume; the cartel voted at their September 10th meeting to cut production over next few weeks by 500,000 barrels, and there was October talk of a possible emergency meeting with an additional production cut to occur within a month. In spite of Saudi Arabia's mid-summer production increase, Reuters reported in late September that Saudi Arabian sales dropped 5 percent for September and October.

How market participants buy and sell their products on the futures markets and store their products can sometimes give us a hint about direction of the market. At the end of the third quarter, petroleum inventories, including crude oil and other raw materials plus products like gasoline, diesel fuel, heating oil, etc., were under the lower range of the five-year average of inventories. Especially low were inventories of gasoline and distillates, the two main products from crude oil. This tells us a couple of things: that there is very little margin for error if demand is to spike for any reason, or to pick back up from its recent slump. It also tells us that energy companies fear high-priced inventory and are keeping them low so that they don't get caught with high-priced products in storage during the "shoulder months" of September/October when demand is seasonally lower. The other indicator we can look at is what is called the "shape of the futures curve" which is formed by plotting prices of each month's crude oil futures on a graph of time vs. maturity of the future. When the graph has an upward sloping line, this is called "contango" and signifies that current demand is weaker than expected future demand, so the lowest price is the closest future price, with longer-dated prices higher. If the closest future price is higher than the next future price which is higher than the next future price, the situation is known as "backwardation" and signifies current strength of demand, since the closest price is high compared to the next future which is lower. After all that explanation, the crude oil futures curve at the end of the third quarter was backwardated for the first few months, signifying strength in demand for the fall of 2008, then in contango from mid-2009 through 2016 showing that prices are expected to rise in the future. <u>Both the inventory situation and the shape of the futures curve show a bullish stance for crude oil after its precipitous drop from $147 to $90 and back to ~$100/bbl at the end of September</u>.

Precious Metals

Gold had reached a point just under $1,000 per ounce in mid-summer as worries about financial institutions led investors around the world to invest capital in a safer store of value rather than leave cash in potentially shaky financial institutions.

However, government moves to shore up financial institutions in mid-July (as mentioned above) led to a reversal in the price of gold due to a number of factors. The US government's July 13th guarantee of Fannie Mae and Freddie Mac and the prohibition on short-sales of 19 financial institutions led to a short-covering rally in financial companies. Traders who had shorted US dollar-denominated stocks and bonds US dollars to buy back their positions. Many traders who had owned gold (or other commodities) as part of a trade which also included short positions in financials then reversed that trade. The rise in beaten down financials and the profit-taking in up-to-then profitably commodity trades led to a vicious momentum-induced sell-off of commodities. Why? Investors judged that European economic activity was slowing faster than in the US, and that European short-term interest rates, at the time over 2% higher than US rates, would have to drop. This led to selling of the Euro currency for the US dollar, which traders considered stronger since the US was judged to have "already taken its medicine" and was thus stronger economically. Since gold often trades opposite to the US dollar (oftentimes people sell dollars to buy gold since gold is mostly traded in dollars around the world), when the euro dropped, the dollar rose and gold traders sold off gold in response to the rise of the US dollar. The unwinding of a large amount of trades that were financed by borrowing dollars (cheaply) and invested in higher-paying investments (or those rising in value, like gold) fed on itself, further boosting the US dollar as these "carry trades" [where traders borrow cheaply in weaker currencies and invest in higher paying investments in stronger currencies] were taken off.

Gold dropped under $740 per ounce at its weakest in early September, but the looming threat of so many dollars being created and governmental actions being either too little or too late emerged, driving investment demand back to gold. Credit markets deteriorated in September and gold rallied back from its extreme oversold situation and traded up to $920/oz in late September. But the looming government rescue as proposed by Congress, creating the $700 billion TARP government bailout plan, drove gold down to the mid-$800s by the end of the quarter as investors started to feel that the crisis would be over.

We at Kanos are still very bullish of gold in spite of some of its weaknesses for investors: 1) the gold market is a thinly-traded market (compared to much larger markets like foreign exchange, bonds, stocks and even crude oil) and 2) it can be subject to periodic price weakness due to government selling. But we like it because it continues to be the asset that is a viable alternative store of value compared to depreciating paper currencies like the US dollar and the Euro. The crisis in financial companies in the US and Europe especially has forced governments and central banks to make available far more liquidity (they are basically "printing new money") to recapitalize banks and other financial institutions (like the world's largest insurance company American International Group and the hugely-levered now-insolvent mortgage giants Fannie Mae and Freddie Mac). The US Fed's efforts to stave off financial turmoil started with the Fed's exchanging poorer-quality bonds from investment banks for Treasuries, then led to large borrowing facilities made available (like the Term Auction Facility where the Fed auctions blocks of money for 3 month loans – recently expanded to <u>$900 billion</u>) that allowed financial companies to have the liquidity that they needed to lend. The government also guaranteed money-market fund investments for pre-September 19th balances after a large money fund lost enough money (the Reserve funds) that it closed at least two funds and returned less than $1 for the money invested). Then the $700 billion TARP legislation was passed by Congress in early October. All of these efforts by the Fed (and augmented by its huge loans to the European Central Bank (ECB) for loans to Europe's financial institutions) appear to have made available more than <u>$3 trillion</u> to the world's financial companies (banks and other finance companies) to overcome their bad loans and to shore them up so that they can continue lending.

This type of increasing government activity to try to "staunch the bleeding" of the financials should have continued long-term bullish effects for gold as government money goes to fight the deflationary aspects of a collapse of the credit bubble, maybe as quickly as by the end of 2008. While we believe that the world financial system could collapse without government activity to shore up banks, we also believe that governments' responses will continue to be active until the financial system has demonstrably healed, which will be too late to avoid the inflation that all this net new money will cause. As a caveat, central banks seem to favor at least some inflation at all times so that deflation does not become a problem, so the Fed and even the ECB are likely to keep money "easy" longer than in a more stable situation in order to be sure that financial institutions maintain their future health.

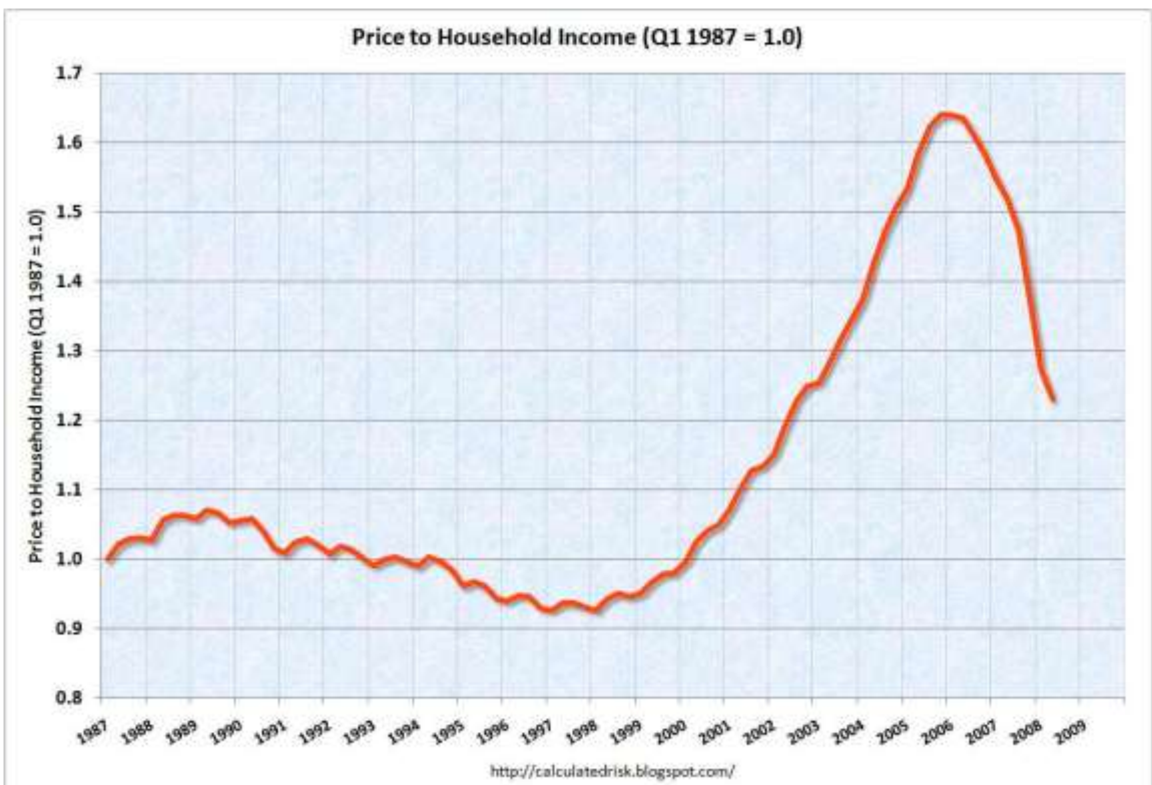
Finally, we believe that the over-leverage and the large derivative books still inside the developed world's banks / insurance companies / mortgage companies will drive more people to own gold as a hedge against the reappearance of financial trouble. Inflation, when its reappearance becomes more obvious as purchasing power continues to erode in the economy, will cause people to look for stores of value other than their falling-in-value US dollars, and we think that gold is the obvious choice as an investment that fits the abovementioned criteria. We also believe that many gold mining stocks will outperform the price appreciation of the metal in the future as companies prove their operational competence and show their financial wherewithal as gold production around the world drops due to lower yields, higher costs, and difficulty of commissioning new mines due to the difficult geography, politics and regulatory hindrances associated with metals mines. For example, gold production in South Africa, for decades the largest gold producer but now #2 after China, fell 10.4% in the second quarter of 2008 (compared to 2Q2007) due to South Africa's deteriorating electrical infrastructure, according to the Associated Press. South Africa failed to maintain and expand its electric grid, leading to electricity shortages that have caused rolling blackouts during much of 2008, limiting electricity to businesses such as mines and crippling their operations through sporadic interruptions. Other mines continue to have mechanical failures (BHP's largest copper mine in Chile will have output curtailed by at least 10% for the next twelve months due to electrical equipment failures, according to Bloomberg) and political problems (two Central American mines have had workers blocking mines to get further wage concessions, causing mining to be postponed in both instances) that will impact world supplies and prices over the long-term.

Thoughts for the Future

"More Government Is On Its Way"

We are having a harder time trying to figure out where the credit and investment markets are going now that the governments and central banks are as involved as they are. One would expect that the market might try to get back to "normal", <u>but</u> one would also think the announcement of any withdrawal of government capital in the near future might spook people again and reignite a crisis. Financial companies are now separated into the "too big to fail" group and then the rest of the banks, with their status in limbo as the government tries to protect as many as possible, but not as explicitly as the "chosen" megabanks. Since these banks are backstopped by the government now in so many different ways, one would expect them to be pressured into lending, thus alleviating the credit crisis. However, we believe that a big reason behind the credit crisis was the inflating of a US housing bubble that has not resolved itself.

The graph below shows housing prices for the United States graphed against Household income, with 1987 indexed to 1 to simplify the graph. This is important because it illustrates how severely "out of whack" housing prices got compared to household income. The last recession that seriously involved the consumer was the 1990-1992 recession (that is barely noticeable on this graph) and after that weakness, the housing price/household income ratio continued to drop until the mid-1990s! If this graph is any guide (and we believe it is), then housing prices need to drop probably 20% further for buyers to be able to afford housing. Affordability is tantamount if the US is to absorb the historically high inventory of new and used homes for sale; we believe it will take a couple of years at least to absorb the housing stock. This has negative implications for financial institutions (and the governments and central banks!) that hold mortgages and mortgage securities, but it also has negative implications for consumer finance companies (less activity as housing continues to "clear" at lower prices, robbing people of value they thought they had in their homes) and consumer discretionary companies (consumers have less discretionary income) and homebuilders (below trend activity for many years as sales out of inventory dominate). We think retail, autos and recreational vehicles, travel and consumer finance/credit card companies will underperform as consumers repair their own personal balance sheet slowly. If our new president raises taxes, that will just make it that much more drawn out a process.



Energy

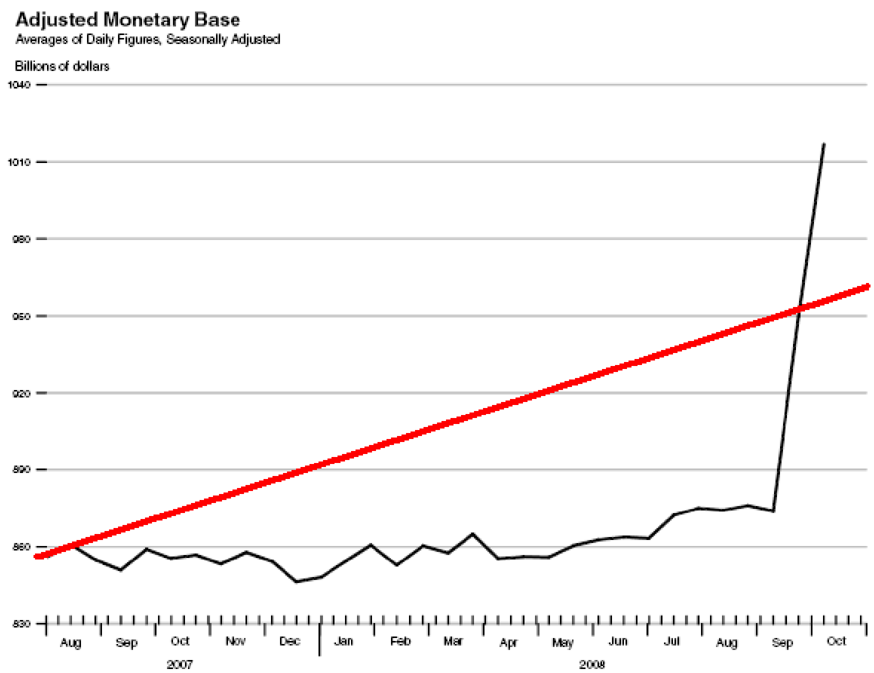
Global financial market turmoil got much worse in October which led to an extension of the third quarter trends of selling commodity-oriented companies of all kinds and running to the US dollar for temporary safety. October is a "shoulder month" for energy usage, between the peaks of usage in summer and winter, and traders continued to use any weakness in demand to sell energy products and equities, although the fundamentals of energy supply appear to have suffered along with demand. We think that supply problems will reappear during the winter, and falling prices will help spur demand.

The credit crisis will hurt supply as well as demand. Lack of access to credit hurts most exploration and production companies and MLPs. Uncertainty and/or lower prices and/or lower demand will put pressure on E&P company margins and expansion plans, lowering capital spending that will hurt future deliverability. However, October 2008's weakness in energy and energy equities prices appear to discount very poor conditions going forward, and for the reasons put forth above, we believe that downside risks are limited and the upside is not. Many energy bulls have overextended themselves (e.g. Boone Pickens and at least one of his BP Capital hedge funds is rumored to be down as much as 90% this year) while formerly bullish analysts have turned bearish (Goldman Sachs energy analysts predicting $200 crude and an average price for 2008 of $149 have now completely switched and say crude can fall to $50 and average $70 in 2009). There is obviously risk to the downside, but we are not "playing crude futures" in our portfolios, we own great companies with large [mostly] unhedged reserves in the ground in [mostly] politically secure areas. These companies continue to produce hydrocarbons and good profits, in spite of lower prices. Most importantly, our portfolio companies are capitalized in a manner that they will not be significantly affected directly by the credit crunch.

Finally, the sun has produced the least amount of sunspots and solar wind activity observed in at least 50 (and probably as much as 80) years. Generally, low sunspot activity has been associated with cold winters; thus, chances appear to be greater than normal that the northern hemisphere will have a cold winter, at a time when product inventories are very low for this time of year. Mild early October weather and economic weakness have helped out inventories recently, but there seems to be a chance of some much higher prices if weather produces unexpectedly strong winter demand.

Precious Metals

As described in detail above, governments and central banks are trying to preserve our financial system by recapitalizing and investing in financial institutions. They also say that they will be refinancing or renegotiating mortgages and generally fighting the bad parts of the deleveraging / capital destruction process. These actions are trying to overcome the deflationary feel of too much debt during a falling asset price environment. Thus, central banks and treasuries are pulling out all the stops by creating more and more money. Below shows the latest report of the Fed's (adjusted) Monetary Base which is the "money" produced by the US Federal Reserve (as reported weekly by the Federal Reserve Bank of St. Louis). The graph vividly shows the Fed "printing money" starting when the credit crunch worsened around the weakening and demise of Fannie Mae, Freddie Mac, Lehman Brothers and AIG. (The red line marks what 10% constant growth of the Monetary Base would look like).



This type of money creation will first be used as capital on bank balance sheets to start lending among banks and into the "lanes of commerce" around the world, especially in the US and Europe. However, we believe that this type of money creation will also lead to inflation growing again around the world as many trillions of dollars replace destroyed capital and then start to be applied to goods, pushing up nominal prices.

The natural beneficiary of these forces are precious metals, and in particular, gold. Silver and platinum, the other precious metals used as stores of value and inflation hedges by investors are also used industrially, so they have not held up as well since industrial activity that uses silver and the platinum group metals is assumed to have dropped starting in mid-summer. Platinum in particular is so critical in pollution control in vehicles that the extreme drop off in demand for larger cars, trucks and SUVs has halved the price of platinum while gold has move less than 25%. Silver has also fallen precipitously as investors fear that silver's usage in electronics and control instruments will be curtailed by reduced world economic activity and silver's use in photography, while is a far smaller use of silver than in the past, will also be affected by economic weakness. We believe platinum will be weak until car production picks up (probably in 2010 or even later), but we believe investors in search of inflation hedging will embrace silver in the next couple of years because it is much cheaper than gold. We are already seeing this in the extreme shortages of gold and silver coins that investors have been loading up on this year after gold prices weakened mid-summer. US government-issued gold coins have been discontinued due to shortages of physical gold, and silver coins are also very hard to find. This physical demand shows the underlying investment demand for gold and silver and should underpin any “relief rally” weakness we see in gold and silver prices this fall as stock market declines let up and traders sell their precious metals positions thinking they won’t “need” them anymore. We continue to believe differently for all the reasons espoused above.

We have invested in mining companies which we believe are highly undervalued (probably at least 30% when judged versus $850/oz gold) due to the value of their resources in the ground, their ability to extract it profitably and in a growing manner, and their ability to finance substantially all of their operations and expansions through cash flow or with reasonably priced capital that is not needed during the present credit crunch. Our precious metals mining equities unfortunately have underperformed most of this year, as investors looking for exposure to gold and silver have turned to investment in bullion ETFs rather than mining stocks. However, the silver lining (yes, the pun is on purpose) behind the drop in commodity prices is that mining companies’ costs should drop as energy price (a large cost component) and steel/equipment price declines improve profitability. These companies are at or near historical undervaluation, and we believe these well-run companies will prove to be excellent investments in the uncertain years to come.

One Final Note

One question we have been asked repeatedly is why we have not bought more positions during the early October “slow-motion crash” in which equities of all kinds fell precipitously over a number of days as credit markets nearly froze up. Our philosophy has been 1) to be invested with a meaningful exposure to those sectors we think will perform well, 2) to either be not invested in or short sectors that we think will perform poorly (or market indices, to protect ourselves from market weakness) 3) and to try to preserve some “dry powder” – have cash or buying power to establish attractive positions when conditions seem right. The October turmoil to us was a time of dislocations when so much traumatic selling led stocks to gyrate wildly, in a manner and with such volatility that has only been seen once or twice in the last hundred years. We felt that preserving cash resources to be used when the “smoke had cleared somewhat” was a better strategy than trying to pick out “the bottom”. We felt we had enough exposure after deploying cash in late July/early August and in late August/early September. While we still believe strongly in our positions (otherwise we would have sold some of them), generally markets exhibiting weakness reach an area you can later recognize as a bottom in prices, but usually after a rebound in prices go back down and test the “bottom” range. While the lows reached in mid-October may have been the bottom, we expect that markets will exhibit weakness in the future, and that we will have additional attractive periods to go bargain hunting. We also expect that our portfolios will outperform the general market during this time, and the bargains we will be trying to buy attractively will be in the sectors currently underrepresented in our portfolios.

We want to thank you again for all of your trust and confidence in our ability to manage your capital. We are constantly scanning the landscape and keeping tabs on investment opportunities while trying to conserve capital to deploy when great opportunities appear. Let us know if you have questions, comments or observations regarding our positioning of your portfolio in this treacherous market environment.

The Managers of Kanos Capital Management