

Fall 2002

However distinctive was this period in other respects, from the speculator's standpoint it would justify applying to Wall Street the old French maxim that "the more it changes, the more it's the same thing." That enormous profits should have turned into still more colossal losses, that new theories should have been developed and later discredited, that unlimited optimism should have been succeeded by the deepest despair are all in strict accord with age-old tradition. That out of the very intensity of the debacle there will arise new opportunities...

—Security Analysis, Benjamin Graham and David L. Dodd
Commenting on the U.S. stock market of 1927-1933.

Published 1934

The turbulent financial markets of the past two and one-half years have witnessed a collapse in interest rates and stock prices that have been both a blessing and a curse. Gleeful U.S. homebuyers and homeowners now have the golden opportunity to purchase a home or refinance an existing mortgage by taking advantage of interest rates that have not been this low since Dwight Eisenhower was President. Homeowners have been refinancing with the zeal of frenzied groupies at a rock concert, and car buyers are driving SUVs off of the lots with precious little money down and zero percent financing. Yet while borrowers are benefiting from low cost money, the savers providing much of the fuel for lending must feel like chickens in a barnyard pecking around for extra crumbs.

The pickin's are mighty slim. The yields on money market funds, C.D.s, U.S. Treasury bills and other short-term, fixed income investments are well under two percent. Two-, five-, and ten-year Treasury bonds were recently yielding 1.8%, 2.8%, and 3.8%, respectively.

Yet despite these paltry yields, investors have socked away trillions of dollars in short-term investments and bond funds in the face of the worst bear market since the Great Depression. In July, \$52 billion in redemptions hit equity mutual funds. The Financial Research Corporation, which tracks mutual funds, points out that in August alone, \$849 million exited stock funds while bond funds had a net inflow of \$15.5 billion. Bond funds made up nine of

the top ten “hottest” categories for fund investors. Clearly, many investors are confused and frightened. The primary reasons have been well chronicled.

After several years of excess investment, especially in technology and telecommunications, equity markets around the world witnessed the culmination of a speculative bubble in the early part of 2000. Between 1995 and 2000, the Dow Jones Industrial Average almost tripled in value to its zenith of 11,722. The Nasdaq catapulted more than 500% during the same period. Business executives and Dot.comers were the toast of Wall Street. “This time it’s different” became the mantra of the day.

As all investors are so painfully aware, the bubble has burst. As the excesses have been unwound and corporate profits have declined dramatically, the pendulum has swung from greed to fear. In the first few days of the fourth quarter of 2002, the Dow Jones hovers around 7500, down almost 40% from its peak. The Nasdaq has plummeted 80% from its giddy zenith. Over 40% of the Nasdaq 100 stocks now trade at prices below \$10 a share. With a growing legion of doomsayers predicting no end in sight for the downward economic and market spiral, the markets have undergone a rolling capitulation that has ravaged one industry group after another. Corporate malfeasance and fraud, with yesterday’s “geniuses” led away in handcuffs, have undermined the willingness of investors to look to the future. The War on Terrorism and the targeting of Saddam Hussein have accentuated fears engendered by the depression experienced by the technology and telecom sectors. Many predict the worst, even saying that the U.S. is headed for a Japanese style, protracted recession with deflation eroding corporate profits. Hopes for a strong recovery have been delayed and large numbers of

investors, benumbed by the decline of their stock portfolios, now flee to the “safety” of bonds as a growing chorus screams out again, “This time it’s different.”

Looking back at the recent bubble years, it is clear that the claims of a “New Era of Investing” were wishful thinking. True, there was one major difference, but it was in the magnitude of the speculation, not in the almost immutable laws of basic economics and return on investment. The rationalizations at the peak of the bull market that tried to explain away why stocks could levitate at stratospheric valuation levels finally yielded to stock prices that reflected more historical norms of reality.

Markets rarely stay fairly valued. They can reach extreme levels of overvaluation and undervaluation. Certainly, the year of 2000 registered a high watermark of overvaluation. Are we now in a period when the equity markets will keep sliding downward to absurd levels of undervaluation because the old rules no longer apply? Is the recent upturn simply just another bear market rally? We believe the tide is turning, and both the balance of the evidence and the dynamics of potential returns have shifted in favor of stocks. Conversely, those who are buying longer dated U.S. Treasuries are making a rather large, and possibly risky bet.

The mad rush into bonds and cash equivalents and the continuing flight from stocks during a period of historically low interest rates and at a time when the DJIA and the S&P 500 have turned in their worst September performance since 1937 and the worst quarter since 1987 is quite possibly evidence of capitulation selling in stocks and a buying panic in bonds. A bear market that initially ravaged technology and telecom stocks has now mauled value oriented



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investments as well. The average large-cap value fund declined 19% during the third quarter and is now down 26% for the year. The purge has been widespread and thorough.

Of course it can get worse. But the economic background is hardly one that is as negative as that portrayed by the doomsayers. We do not underestimate the problems facing the U.S. and global economies, but there is never a time when the economic stars are in perfect alignment. And stocks have been pummeled because the problems that exist have been publicized for some time. That is why bear markets occur. Investors sell because they anticipate the downturn in economic activity and corporate profits. The economy has already undergone a two and one-half year correction of the technology bubble excesses, a record inventory liquidation, a record capital spending downturn, and a sluggish manufacturing sector since 1998. It would seem that the markets are already reflecting these negative developments; will they continue to drift lower?

This has been the worst bear market since 1929-1932, surpassing the previous record bear market of 1973-1974, yet the economic fundamentals today are far better than they were in these previous downturns. The negative performance of the market in the 1930s was exacerbated both by a Federal Reserve that was tightening at a time when it should have been highly accommodative and by major fiscal policy mistakes, including a fixation on the deficit and the Smoot-Hawley Act which crippled world trade. The U.S. banking system was in a precarious state. The 1973-1974 downturn was an outgrowth of the OPEC oil embargo in the aftermath of the guns and butter policies of the Vietnam War period, imposed at a time when energy efficiency was not widespread. It was also a period when American industry had become bloated and inefficient and had lost much of its competitive position vis-à-vis Germany and Japan.

Today, it would appear that the markets are already discounting almost any fundamental economic negative about which investors could worry. The economic glass that is half full and rising seems to be overlooked as investors' fears appear to be as much psychological as substantive.

Investors have typically anticipated economic upturns by buying stocks in advance of an actual recovery. By this logic, stocks should be dramatically higher already. The Federal Reserve has lowered interest rates to historically low levels and supplied liquidity to the system. It is poised to be even more proactive if the need arises. Increased federal government spending is also providing a significant boost to final demand. The economy is far from anemic. While it appears that on alternating weeks the economic statistics often indicate one step forward and two steps back, or two steps forward and one step back, these mixed signals are fairly typical at major

turning points in economic cycles. Approximately 94% of Americans who want to work are working. They are paying taxes and buying goods and services. There are signs that capital spending is beginning to turn up. Inventories, which have been drawn down for two and one-half years, will need to be replenished. An upturn in capital spending and inventory restocking will begin to lift the confidence levels of businessmen. As they ramp up production, employment growth should accelerate.



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In addition to the growing, albeit uneven signs of economic recovery, two other factors will play a critical role in future quarters. First, despite all of the publicity surrounding the bankruptcies of the Enrons and WorldComs of the corporate world, the U.S. banking system is in much better shape than in past economic downturns. Its ability to fund economic expansion is at a high

level. Second, U.S. corporations have been forced to control their costs in order to remain competitive. They are highly efficient, and productivity continues to remain at a healthy rate of growth. As economic activity picks up speed, greater top-line growth will result in expanding profit margins and greater profits. Ironically, the recovery in corporate profits is a stealth story that the markets are ignoring.

Much of the media has focused on the disasters in technology, telecom, merchant energy, the airlines, and many other high profile victims of the boom-bust aftermath. Yet behind the headlines of executives in court and large layoffs, corporate profits have been staging a recovery. In a recent study, Laffer Associates, a supply side think tank, highlights this very bullish, yet largely unappreciated development. They point out that the Commerce Department tracks U.S. corporate profits under the National Income and Product Accounts (NIPA). These are taxable profits, not accounting puffery and pro forma hype. As corporations attempt to report as little taxable income as possible, they are a very good measure of what profits are and what their trend may be. The Laffer study compared stock prices to NIPA profits and ten-year Treasury yields over many years and market cycles. While it may be surprising to some, taxable corporate profits have begun a major turnaround. In both the first and second quarters of 2002, U.S. corporate profits have risen in healthy fashion. Even more promising, net cash flow, a reasonably good precursor of future earnings, is up 10.5% over 2001 and is 219% of after-tax profits. The U.S. markets suffered a major downturn during the second half of 1987, yet net cash flow in the NIPA reports released during the market crash was 237% of after-tax profits. There followed a boom in corporate profits that the markets, after ignoring the NIPA figures, eventually recognized as a new bull phase

ARE EXTRAORDINARY GAINS IN STORE?

S&P 500 ANNUAL TOTAL RETURNS

Year	Total Returns
1929	-8.4%
1930	-24.9%
1931	-43.3%
1932	8.1%
1933	53.9%

Year	Total Returns
1939	-0.4%
1940	-9.8%
1941	-11.6%
1942	20.3%

Year	Total Returns
1973	-14.7%
1974	-26.5%
1975	37.2%

Year	Total Returns
2000	-9.1%
2001	-11.9%
2002*	-28.2%
2003	?

*2002 total return YTD through September

ISI: International Strategy and Investment

began. Based on NIPA figures, current interest rates, and historical patterns of profit and market cycles, Laffer Associates concluded that equity prices could rise dramatically before returning to historically normal levels.

Well, if the economy is recovering, and real, taxable profits are chugging ahead, why have stocks been bouncing in the cellar? Bubbles take time to unwind. Just as greed propelled stock prices to inordinate heights, fear and uncertainty have moved investors from irrational exuberance to irrational fear. Many attractively priced stocks of very sound companies are yielding 3% to 6% in dividends, greater than many Treasury bonds, and have excellent prospects of increasing

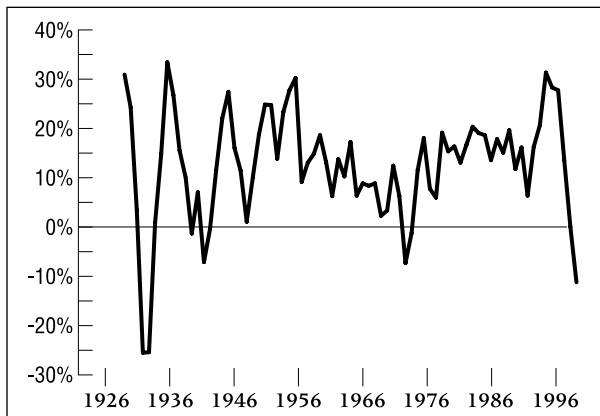
dividends over time. The earnings yield (earnings divided by price) of stocks today is 7% and is much higher on a large number of individual issues, while a ten-year U.S. Treasury yields 3.6%. It is also important to note that a growing corporation can easily increase its dividend so that an investor's yield on original cost can grow dramatically over time. By way of contrast, no borrower will ever call a bondholder and tell him that they are going to raise the interest rate being paid. Most importantly, if interest rates

go up in future years, the prices of most long-term bonds will go down, resulting in some cases in a negative total return. We think that bonds are a far more risky investment than a very large universe of stocks. Many stocks are selling at price/earnings ratios that are in single digits and at prices below their liquidation value. In short, the plums available to investors look increasingly tasty. Yet investors are treating stocks like they are the forbidden fruit touched by the Devil.

The earthly devils that are obviously haunting investors and creating continuing uncertainty are Saddam Hussein and Osama bin Laden (or his ghost) and their minions of evil. The anxiety that surrounds the whole issue of terrorism and Iraq

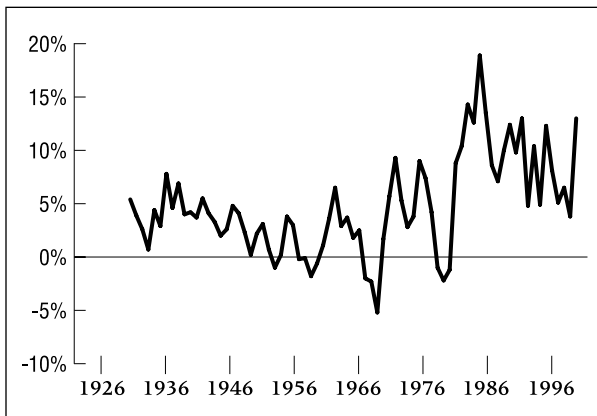
S&P 500 TOTAL RETURN

3-YEAR MOVING AVERAGE
-11% AS OF 9/30/02



IBBOTSON* BOND TOTAL RETURN

3-YEAR MOVING AVERAGE
+13% AS OF 9/30/02



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has cast a pall over investors. True, consumers have continued to energize the economy, especially with automobile purchases and new housing



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activity, but their spending is not as robust as it would probably be in the absence of the geopolitical turmoil that exists. And businesses, due to excess capacity and sluggish demand outside of autos and housing, are not yet ready to gin up production or engage in major capital expenditures until demand expands and appears sustainable. They too are seemingly mesmerized while awaiting a resolution of the Iraqi issue in particular.

Certainly, the issues of Iraq and terrorism are intertwined and do pose a unique set of problems for the country. Yet, along with a recession, corporate fraud, and major credit problems, we suspect that the anticipation of conflict in Iraq and further manhunts for the Al Qaeda may have already been discounted to some significant degree by both the equity and fixed income markets. History has shown that the markets have had a difficult time prior to military conflict but have staged meaningful recoveries in the

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period following signs of a positive resolution. While recognizing the multi-faceted emotions and opinions that military conflicts present, it is quite likely that, from a pure economic and market standpoint, the initiation of military action against Iraq would lead to a positive response in the markets, particularly if an allied coalition is successful within a fairly short period of time.

After a disappointing start to the year, we restructured our client portfolios with many companies which are less leveraged and are of a higher overall quality. This action was due not to a change in our investment philosophy but to the fact that so many higher quality companies declined in price to the point that they became attractive and met our buy criteria. We have been patient in looking for what we believe to be the best opportunities in some very attractively priced companies offering compelling value. The gut-wrenching thirty-one month decline in stock prices has resulted in attractive current valuations. Low multiples coupled with improving but seemingly ignored corporate profits provide an investment environment populated by numerous companies offering the potential for healthy double-digit rates of return. Recent purchases

have included healthcare names, financials, select consumer cyclicals, and a few energy companies. We have confidence in the Business Valuation Approach and are optimistic about the prospect for rewarding returns. Through capitalizing on the fear so rampant in the markets today, the future should be much brighter indeed.

We want to assure our readers that we recognize how frustrating it has been to witness the seemingly endless declines in the equity markets. The recent period has been one of the most difficult times for investors in decades. Though down over the past quarter, our portfolios performed much better than the broader market. We are confident that this outperformance is a harbinger of things to come.

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ABOUT KING INVESTMENT ADVISORS, INC.

KING is in its twenty-second year of operation. Our professional staff includes investment managers, security analysts, and other specialists qualified to meet the needs of our individual and institutional clients. We are committed to creating wealth for our clients in the long term.

Over the past twenty-one years, we have successfully navigated through both good and challenging markets by adhering to a discipline of value investing geared to evaluating ever-changing data and markets.

Our philosophy focuses on the valuation of businesses and their economic worth as measured through cash flow and not accounting artifice. Our work in equity and balanced accounts, which includes fixed income instruments, helps each type of account. Many excellent fixed income opportunities develop as a result of our research in equities, and vice versa.

We eschew “market timing” as theoretical nonsense divorced from the real world of investment decision-making and investing. Cash will accumulate in client portfolios when we do not find stocks that meet our selective criteria.

We are confident that the knowledge, experience, and dedication of our investment team, and the application of a disciplined process which has worked successfully over long periods of time, will continue to reward our clients in the years to come.

Other contributors to this issue:
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Sources: Barrington Research Associates; Bloomberg; ISI: International Strategy and Investment; Laffer Associates