

Fall 2003

With money in your pocket, you are wise, you are handsome, and you sing well too.

— YIDDISH PROVERB

The first nine months of 2003 were refreshingly rewarding ones for equity investors who have suffered three years of wrenching losses as the major equity indices struggled to regain their footing in the aftermath of the technology frenzy. A powerful rally that began in the spring has propelled the broad S&P 500 Index to a 13% yearly gain through the month of September, while the Dow and the Nasdaq have risen 11% and 34%, respectively. Impressively, these gains have occurred in spite of endless skepticism regarding the staying power of an economic recovery and continued geopolitical uncertainty about the duration and cost of the U.S. military presence in Iraq. With the year entering its final quarter, the three-year streak of declines in the major equity indices will likely come to an end.

The current behavior of the equity market is decidedly different from the investing landscape that prevailed during the second half of 2002 and the first quarter of 2003. As the Dow was descending from a level of 10,000+ to a low of approximately 7,200 reached in October of 2002, investor psychology was terrible. Fear was rampant as the

market's bottom seemed nowhere in sight. The selling continued week after week, with intermittent rallies followed by lower lows. Each short-lived updraft was met by a wave of selling as pessimistic investors used any uptick to exit. According to the old Wall Street adage, "no one rings a bell at the bottom," and finally the market began to hold its gains in late March of this year despite continued investor skittishness.

During the past six months, market action has been the mirror image of the previous waves of selling. Stocks have been making higher highs as each decline has been met with renewed buying. Equity mutual funds saw strong net inflows during the month of August, a clear sign of rising confidence on the part of the retail investor. Fears of endless declines have been replaced by fears of missing out on the next bull run—some of the tremendous amount of cash on the sidelines has entered the market, making any pullback shallow and short in duration. This sentiment shift represents a powerful recipe for further healthy gains, albeit at a slower pace.

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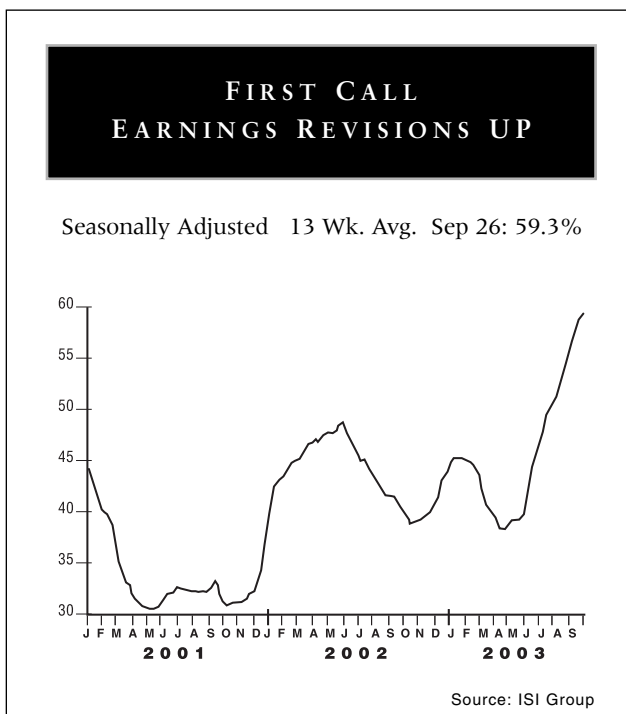
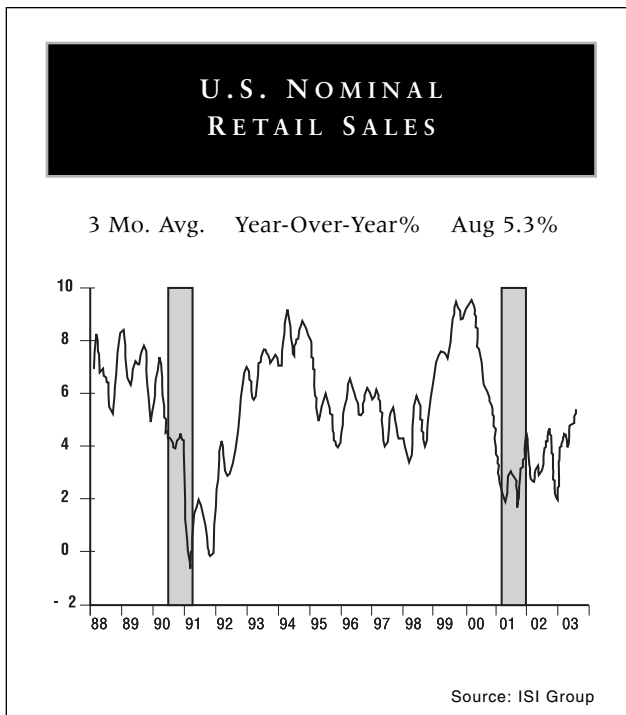
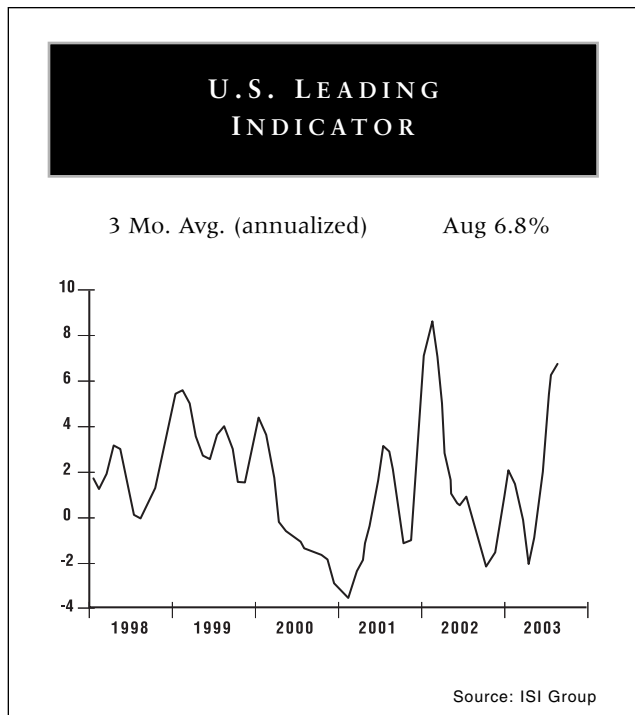
Obviously, a key factor in the sustainability of the market advance is a re-acceleration of growth in the economy and corporate profits. Numerous data points are encouragingly indicating that this re-acceleration has begun and should continue to strengthen. The index of leading economic indicators rose 0.4% in August, its fourth straight monthly increase. The national manufacturing indices have been signaling expansion for the past several months, and business investment has been reinvigorated. Earnings estimate revisions tracked by First Call have been trending higher. Recent declines in unemployment claims suggest that employers are slowing the pace of layoffs. Inflation remains low; prices paid in August for goods and services excluding food and energy showed the smallest 12-month gain since 1966. Oil and natural gas prices have fallen from their recent peaks and personal income tax reductions have been enacted.

Both of these developments put more money in the pockets of the consumer. The National Retail Federation expects sales to increase 5.7% in November and December versus the 2.2% gain registered during the holiday shopping season of 2002. Home sales unexpectedly rose during the month of August. Existing home sales rose 5.5%, while new home sales increased 3.4%. Both of these measures had been expected to decline due to increased mortgage rates. Though mortgage rates are no longer at all time lows, they are close to an eight-week low after the sharp mid-summer increase. During the second quarter of 2003, household net worth jumped \$1.7 trillion to \$41.2 trillion, the biggest quarterly increase in net worth in six quarters. Household net worth has now recovered 56% of the \$5.1 trillion decline from its peak in the first quarter of 2001 to its trough in the third quarter of 2002, hardly telegraphing a precipitous decline in the strength of the consumer that some economic bears are predicting.

Many economic naysayers have also pointed to the lethargic job market and lackluster or non-existent new hirings. These pundits are looking in their rear-view mirror as they forget that the job market is a lagging indicator—the unemployment rate today is a poor barometer of future economic health. Given the current weakness in the job market and tame inflation, equity investors should not worry about a near-term Fed hike in interest rates derailing the market rally. Alan Greenspan and the Federal Reserve Board are likely to keep short rates steady until the job market shows decisive and sustainable strength. Finally, aided by impressive gains in productivity, quarterly corporate profits set a new record of \$905 billion annualized in the second quarter of 2003 as measured by the National Income and Product Accounts (NIPA). This surpassed the

previous record set in the third quarter of 1997. Given the ubiquitous cost cutting that has taken

place as a result of the overcapacity and economic sluggishness of the past few years, NIPA profits are



poised to grow strongly in coming quarters as a larger part of strengthening sales falls to the bottom line.

“I know how it ends, I just don’t know when.”

— PORTFOLIO MANAGER

Though many investors may be feeling wise and handsome this year with more money in their pockets, those who have reaped significant gains in a certain segment of the market should remember recent painful lessons and not view themselves as infallible. From its October 2002 low of 1,109 through the end of the third quarter of 2003, the Nasdaq has rallied 61%. Over the same time period, the Dow and the S&P 500 have risen 29% and 30%, respectively. Many of the best performing stocks in the overall market over this time frame have been tech companies with little or no earnings—stocks that were the most beaten down in the wake of the bursting of the tech bubble. While it should not be a surprise to see a rally in stocks of companies that were in precarious financial positions, the magnitude of price appreciation in many cases has been startling and unwarranted.

To be sure, the Nasdaq contains technology companies with strong balance sheets that are generating significant cash flow and are not trading at stratospheric multiples. Microsoft and Dell are two that come to mind. The Nasdaq is also made up of many more companies that are trading at far higher multiples with far weaker financial positions relative to the two technology bellwethers just mentioned. Thus, it is hard to make the case that these stocks will continue their strong performance. The leaders of previous bull markets are rarely the same stocks that lead the next

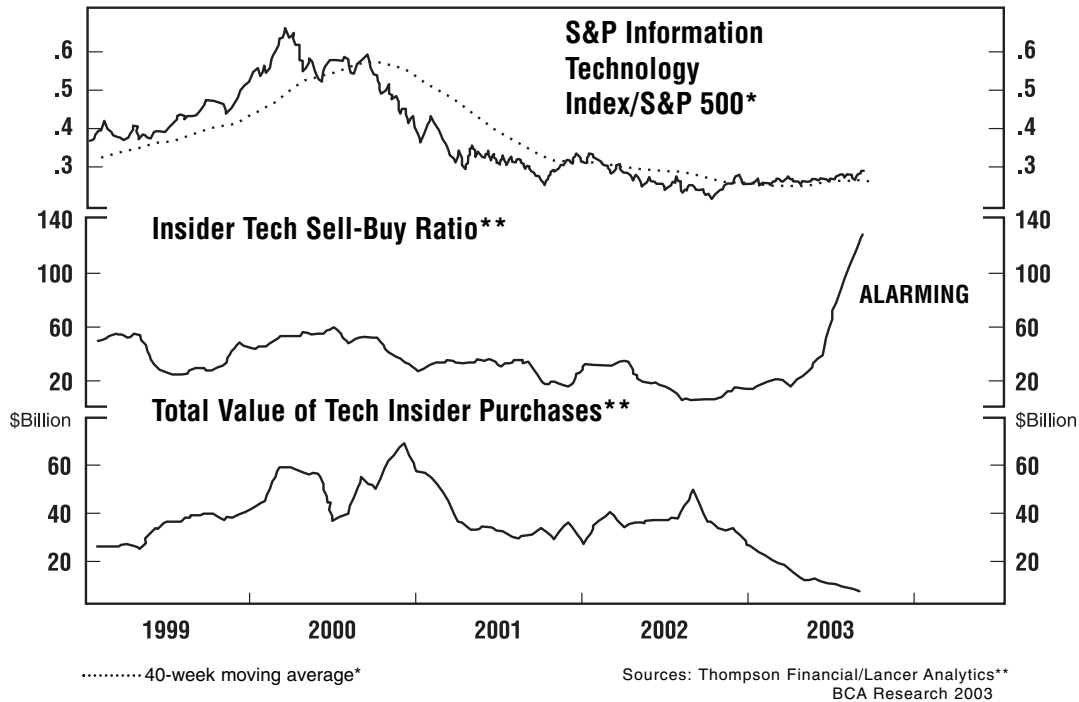
WHERE DO WE GO
FROM HERE?

	9/30 PRICE	'03E P/E
Priceline.com	\$29.04	59X
Monster Worldwide	25.22	66X
EMC	12.63	79X
Apple Computer	20.72	92X
Amazon Computer	48.43	93X
Lam Research	22.23	97X
Juniper Networks	15.00	144X
Applied Materials	18.13	151X
Corning	9.42	157X
Novellus Systems	33.60	198X

sustained upward move. Most of the Nifty Fifty high-fliers of 1973 didn’t approach their former highs for at least ten years.

In the words of Merrill Lynch chief technology strategist Steve Milunovich, we are currently going through an “echo bubble.” In terms of scale, this bubble is certainly a shadow of the one that drove the Nasdaq north of 5,000, but the speculation in many issues without regard to valuation does bear a resemblance to the run-up of the late 1990s. Significant price appreciation has occurred in many names without any great change in the underlying fundamentals of the companies. Another cautionary development has been the insider selling in the technology area. Tech insiders have been selling their shares at an accelerating pace

TECH INSIDERS CASHING OUT



relative to their buying, with the insider sell/buy ratio for technology companies ominously hitting a new high recently. Investors would do well to remember that just because a stock may be trading at 60% of its all time high does not necessarily mean it is “cheap.”

“You have to do what you can to retain good people.”

— H. CARL MCCALL, FORMER NEW YORK STOCK
EXCHANGE (NYSE) BOARD MEMBER AND
FORMER HEAD OF THE COMPENSATION COMMITTEE

After witnessing numerous investigations into corporate malfeasance, several “perp walks” on national

television, and legislation enacted to improve corporate accountability, the average investor may have been thinking that the state of corporate governance has greatly improved and corporate excesses have been curbed. Richard Grasso and the NYSE, ostensibly the role models and watchdogs of corporate governance, have provided evidence to the contrary.

It was recently revealed that the former Chairman of the NYSE had accumulated \$140 million in a retirement pay package including pension benefits, deferred compensation and other perks, decent pay for a regulator. Soon after, another news release revealed that *oh by the way*, Mr. Grasso is entitled to \$48 million in additional compensation—after all, what’s another



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\$48 million among friends? In the midst of a push toward increasing transparency in the corporate world, the byzantine nature of Mr. Grasso's contract made it about as easy to decipher as an old Enron cash flow statement. The idea that a board made up of Wall Street power brokers who paid millions of dollars a year to a Chairman whose principal function was regulating their firms was conveniently never deemed unacceptable by either Mr. Grasso or the members of the board. Making the conflict of interest even more egregious, Mr. Grasso nominated the members of the committee that awarded him his compensation. Kenneth Langone, a founder of Home Depot and not coincidentally a close friend of Mr. Grasso's, chaired the NYSE compensation committee from 1999 until June of this year, while Mr. Grasso serves on the Home Depot board and its compensation committee.

One wonders what special treatment the board members and their firms received for lavishing such wealth on their boss. In justifying the vast sums paid to Mr. Grasso, members of the compensation

committee pointed out that they wanted to make his pay commensurate with that of the heads of Wall Street financial services firms. These financial wizards must have forgotten that the revenue and net income of the NYSE are a small fraction of the comparable figures at the Wall Street firms. What of Mr. McCall's claim of paying up to retain Mr. Grasso? Novelist and columnist Michael Lewis said it best—"You never know. At any moment Richard Grasso could have been offered \$250 million to ring the bell someplace else."

Fortunately, change is underway. John Reed, the former co-chief executive of Citigroup Inc., has been named the interim Chairman of the NYSE. Mr. McCall has resigned. Many other board members are probably on their way out the door. Reed has pronounced that he will "embrace and make appropriately transparent new governance procedures." He should also limit the power of Wall Street executives and facilitate increased representation of the average investor. Eight of the world's ten largest companies trade on the NYSE, and the

Exchange is the most visible symbol of American capitalism. Reforms need to be made swiftly in order to restore confidence in the Exchange, and by extension, in corporate practices of American businesses as a whole.

“Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.”

— MICHAEL B. STEELE

After witnessing the strong performance of the equity markets over the last year, many investors may be wondering if the gains will continue or give way to yet another painful retreat. Pessimism and skepticism about the permanence of the economic recovery and the market advance are widespread. We believe we are in the early stages of a period of accelerating economic growth and satisfying equity returns. We are confident that the equity market will continue to reward the patient, valuation-conscious investor. As the high beta rally in technology shares loses its strength, companies trading at reasonable levels generating predictable and growing cash flows should reassert themselves on the relative performance scale. Many of these companies have shown optimism about the strength of their businesses by increasing or initiating dividend payments in the wake of the dividend tax cut. Through mid-August of this year, 719 companies announced dividend increases compared to just 550 in the same period of 2002. Additionally, 134 non-dividend payers have announced they will pay a dividend this year.

While no one should expect sustained gains similar in magnitude to those we have recently experienced with the major indices bouncing off of multi-year

lows, the stage is set for stronger economic growth and healthy returns in the near future. The consumer has remained resilient, aided by a 9.4% annualized increase in disposable income over the last three months. Since consumer spending never significantly declined during the downturn, however, one should not expect a significant jump in consumer spending to be the catalyst for increased economic growth.

The next big economic driver must be increased spending and investment by businesses. The continued application of technological innovations to multiple facets of corporate America has led to an explosion in productivity growth. Productivity growth in the non-farm business sector rose by an astounding 6.8% annualized rate in the second quarter, and has increased by 4.5% annually over the last seven quarters, translating into strong corporate profit growth. Productivity has even been rising in the services sector, an area which many thought was incapable of efficiency gains. These productivity gains are an unambiguous, powerful stimulant to long-term economic growth. While temporarily depressing job growth, the productivity surge will inevitably lead to job creation as businesses, aided by lower tax rates and faster depreciation schedules in the wake of the recently signed tax bill, deploy their profits in the next round of capital goods investment, making them even more efficient. Increases in corporate profits and capital spending will lead to more robust economic growth. Higher stock prices will follow.

Ryan C. McCleary

ABOUT KING INVESTMENT ADVISORS, INC.

KING is in its twenty-third 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-two 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.

Sources: BCA Research; Bloomberg; Cantor Fitzgerald; International Strategy and Investment (ISI); *Wall Street Journal*