

Spring 2003

“(B)elievers (should) not... hinder the forces of liberation, and (should) help bring this war against the tyrant to a successful end for the Iraqi people.... Our people need freedom more than air [to breath]. Iraq has suffered, and it deserves better government.”

—Ayatollah Ali Mohammed Sistani

“We shall never forget what the coalition has done for our people.... A free Iraq shall be a living monument to our people’s friendship with its liberators.”

—Hojat al-Islam Abdel Majid al-Khoi

Ayatollah Sistani, the 75-year-old spiritual leader of Arab Shiites (who comprise 60% of Iraq’s population), uttered his unequivocal views of the coalition action in Iraq by issuing the first pro-U.S. fatwa, or religious edict, in modern political history. His pronouncement came after being freed by U.S. Marines from house arrest in Najaf for the first time since 1988. Khoi, viewed as Sistani’s right-hand man, was the son of the late grand Ayatollah Khoi, who was Iraq’s supreme religious ruler for almost 40 years.

The statements of Sistani and Khoi and the signs of joy on the faces of newly liberated Iraqis are poignant testimony to the real plight of the Iraqi people under Saddam and their aspirations for a new freedom. These expressions of gratitude belie and peel away the hypocrisy and self-serving rationalizations of many world leaders, critics, and media pundits who failed the Iraqi people by their inaction or complicity. With each passing day, as new revelations of the brutality and evil of the Saddam regime emerge, the coalition action takes on greater stature around the world.

The TV shots of the falling statues and crushed mosaics of Saddam Hussein are reminiscent of the

fall of the Berlin Wall in 1989. In the 1980s, an American “cowboy,” often ridiculed by many world leaders and the liberal media, leaned against conventional thinking in his quest to defeat the “evil empire” of the U.S.S.R and Eastern Europe. President Reagan attained this outcome not through force of military action, but through building an overwhelming military arsenal and the threat thereof with which the Soviet Union and its bankrupt economy could no longer keep pace. His efforts were vindicated by the fall of the Berlin Wall and the collapse of communist governments throughout Eastern Europe and the U.S.S.R. shortly after his term of office. He, too, was aided by a Prime Minister from the United Kingdom—the Iron Lady, Margaret Thatcher. The ending of the Cold War and the era of the threat of mutually assured destruction, coupled with the introduction of the Reagan tax cuts, were important elements underlying the 18-year bull market in equities that began in 1982.

Today, another “cowboy” from the West is equally, if not even more, vilified by the world’s bureaucratic and media elite in his quest to rid the world of the menace of terrorism. Ironically, in addition to the indefatigable support of the U.K. Prime Minister, Tony Blair, President Bush finds much of his

support coming from the nations of Eastern Europe that grasped their post-WW II freedom from the U.S.S.R. in the wake of the fall of the Berlin Wall and the Iron Curtain. As but one example of the new world that is now reflected on the geopolitical stage was the assistance in the Iraqi conflict provided by such groups as the Polish GROM commandos, while the toothless, old-guard socialists of “Old Europe” hid behind the facade of a feckless United Nations and piously fretted about American “imperialism.”

It will undoubtedly take some time to completely eradicate all the vestiges of Saddam and his legion of ruthless thugs. While the action in Iraq is but one piece of the war on terror, it is a major and historic step in addressing one of the core sources of terrorism in the Middle East and the world. The nation of Iraq is being liberated from a quarter century of diabolical despotism. We are witnessing an earthquake that will send shudders throughout the halls of other state sponsors of terrorism in the Middle East and North Korea.

The probability of achieving success in winning the hearts and minds of Iraqis and others in the Middle East will be dramatically enhanced if the U.S. addresses the decades long Israeli/Palestinian struggle. In addition to the war on terror, it must be a key initiative of U.S. foreign policy. Until there is a resolution of the Israeli/Palestinian issue, the Middle East will remain a quagmire for terrorism and a threat to U.S. national interests. It will not be an easy task. As Joshua Muravchik of the American Enterprise Institute points out in *The Weekly Standard*:

[T]he missing ingredient for peace between Israel and the Palestinians is... a decision by the Palestinians and the other Arabs to accept the existence of a Jewish state in their midst and to live in permanent peace with it. Despite all the Palestinians have suffered these two and a half years, public opinion polls show that a clear majority of them support continuing the intifada and suicide bombing and that about half say that the goal should be the “total liberation of Palestine,” in other words, the elimination of Israel.

The other half of the Palestinians say they want a two-state solution. When that half grows and becomes dominant, then and only then, will real peace be possible.

The war in Iraq has inflamed much of the Arab world, but it has also demonstrated that the U.S. is more willing to aggressively protect its interests and citizens by focusing on terrorist regimes. It will not be necessary to go to war with every rogue state. There are many ways to deal with state-sponsored terrorism. The mere demonstration of the commitment to deal effectively with Saddam will serve as an object lesson to those governments in the Middle East that have been supporting terrorism around the world. Already, in the immediate wake of the end of the major military battles in Iraq, the nations of Iran, Syria, and North Korea, while still concealing their more nefarious activities, are sending new conciliatory signals to the U.S. that would indicate a new level of concern on their part. In the case of Iran and Syria in particular, they will inevitably be forced to reassess their willingness to serve as guardians and sponsors of terrorists.

The resoluteness of the Reagan administration in combating the “evil empire” of the Soviet Union and the eventual blossoming of political freedom in the wake of that commitment was a galvanizing force in fostering a new era of economic growth, not only in the U.S., Russia, and Eastern Europe, but throughout the world as well. This newfound political freedom helped to hasten the movement toward globalization, greater world trade, and a higher standard of living for hundreds of millions of people. In other words, it bred hope, something that the Iraqis and many others have been lacking for decades.

It remains to be seen whether the presidency of George W. Bush will be marked as one in which the war on terror will precipitate a sea change in the dynamics of the Middle East and other areas of the world that have been destabilizing roadblocks on the path to both political and economic freedom. World events are unfolding rapidly. It would be naïve to make predictions about future political

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recent upsurge in
consumer confidence
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of better days ahead.

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and economic developments in areas marked by political instability engendered by ethnic and religious rivalries and hatreds that have their genesis decades or centuries ago. In particular, the transition to a new government in Iraq will be difficult and fraught with the risk of a backlash against the U.S. There is already evidence of the treacherous and difficult nature of the rebuilding process. Khoi was murdered in a mosque in Najaf as religious tensions flared between rival factions. More radical Muslims who contested Sistani's authority besieged him and demanded that he leave Iraq. In Afghanistan, the fledgling government is gasping for oxygen as tribal warlords and Al Qaeda remnants continue to attack its power.

Despite the almost certain risks that lay ahead, the overthrow of the Taliban and Hussein regimes and the liberation of Afghanistan and Iraq is already yielding tangible benefits. It would seem that the world is a safer place than it was before 9/11. There are signs that the Israeli/Palestinian impasse is less intractable. The risks and costs of aiding and abetting fanatical terrorists have risen dramatically since that day. Rogue states are less certain of their ability to conduct and foment terrorism with impunity. Terrorists will ultimately subject their hosts to severe economic or military sanctions. And amid the inevitable setbacks in the new war on terror in ancient lands, voices of moderation are emerging in the Middle East. President Hamid Karzai in Afghanistan,

secular voices in Iran, the fatwa of Sistani, and the gratitude expressed to the U.S. by millions of people in Afghanistan and Iraq are testament to a more positive chapter in world history.

George W. Bush has staked his Presidency on two key initiatives. The war on terror, with its corollary tenet of preemptive action, is his major foreign policy directive. Bush's major domestic agenda is the push for economic growth through structural reform aimed at lowering personal and corporate income tax rates and instituting investor-friendly incentives to encourage savings through various retirement and savings plans. A key part of this reform is the demand for the elimination of the double taxation of corporate dividends. Other domestic initiatives including healthcare reform, social security reform, less regulatory pressure on businesses and consumers, greater energy independence, and a more conservative judiciary are subordinate to these two overriding goals.

It is doubtful that Bush would be reelected if there were major setbacks in the war on terror or on other international fronts. But even if he is able to achieve an enviable record in the war on terror and the international arena, his Achilles' heel remains the economy. If the economy does not resume a healthy rate of growth with lower unemployment rates, his tenure would be at risk. However, if President Bush succeeds to a significant degree on these two major fronts it would almost insure his reelection and would positively shape the future of economic growth and the investment environment for years to come. The initial progress in Iraq looks more promising for Bush than does the full implementation of his proposals for tax relief, but the battle on this issue is still being waged.

The war in Iraq and a successful transition to Iraqi self-government should prove to be a major coup for the Bush administration. As the real story of the brutality and pursuit of weapons of mass destruction is pried out of the annals and caves of the Baath party and Saddam's garish palaces, there should be no small level of vindication

for the actions of the American government and its coalition partners. However, channeling the expanded political capital of President Bush derived from success in Iraq into the achievement of his domestic goals will be a challenge indeed.

The significance of the Bush tax proposals is that they are aimed at long-term structural reform. A key part of the suggested measures, the more liberal tax treatment of personal retirement plans, should foster greater personal savings. But the acceleration of already legislated tax cuts and especially the elimination of the double taxation of dividends are the crux of the Bush tax proposals.

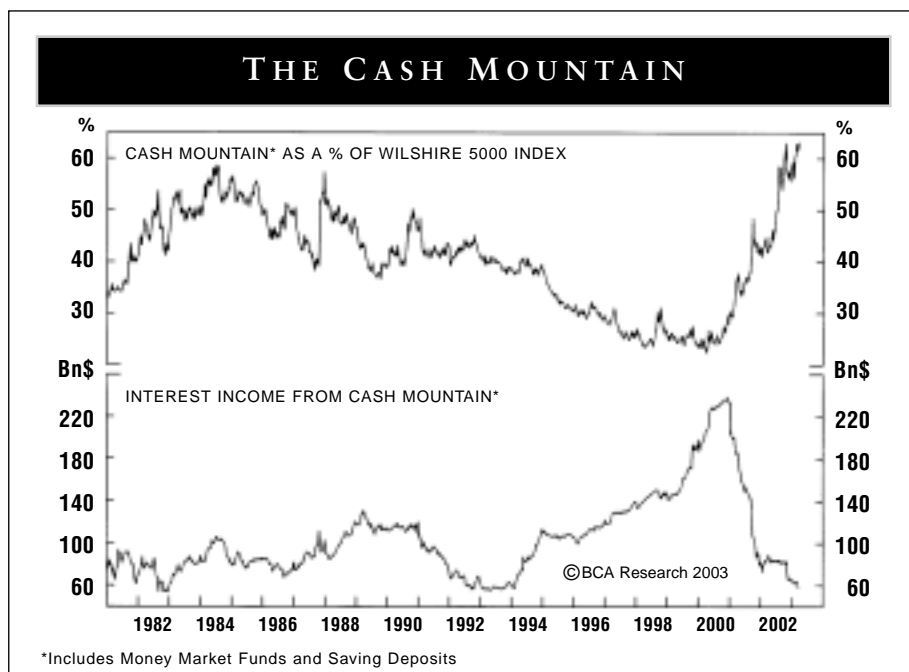
In recent days, the U.S. Senate has emasculated the heart of Bush's dividend tax relief program. And although Bush has signaled that he intends to fight for the eventual passage of the bulk of his proposal for new tax relief, unless the Senate develops newfound fear in the face of his restored political heft, he may have to settle for far less than was requested.

While we had previously been somewhat sanguine about passage of the dividend tax relief toward the higher end of the Bush proposal, failure to enact it, while a setback, should not prevent the economy from hastening its recovery. There are a large number of positives at work whose growing impact will stimulate economic growth and induce a more positive equity market outlook. Some of the more obvious factors include: 1) low inflation; 2) an accommodative monetary policy; 3) the positive impact of tax cuts already enacted into law; 4) an aggressive fiscal policy aimed at growth; 5) strong productivity growth; 6) a declining dollar that will make the U.S. more competitive; 7) the unappealing potential

returns available on alternative investments; and 8) valuations on stocks that, while not cheap on a trailing earnings basis, underestimate what may well be a future period of sustained corporate profit growth. Add to these positives the over \$7.0 trillion parked in money market funds and cash equivalents earning less than 1.0%.

Now that the most feared part of the conflict in Iraq is history, the current catalysts that already exist for an improving economy will lead to a more rewarding future for stock investors and a more problematic one for fixed income investors. We believe the recent upsurge in consumer confidence is a harbinger of better days ahead. What, then, might be a reasonable expectation for the potential returns for equities and bonds based upon a conservative set of assumptions regarding future economic growth, normalized price-to-earnings ratios, and present interest rates?

Long-term operating earnings growth for the S&P 500 has historically been approximately 7%. Operating earnings were \$46 in 2002. Consensus estimates for 2003 and 2004 are \$51 and \$56, respectively, well below trend line growth of 7% that would place S&P earnings for 2004 at



\$63. Using a baseline, conservative estimate for 2003 S&P 500 earnings of \$50, a below trend line growth rate of 6%, a dividend payout ratio of 40%, and a normalized P/E ratio of 18X at a terminal point 30 years in the future, the projected annual compound return for the S&P, including dividends and capital appreciation, would be a little over 8%. This is a figure that appears very reasonable, as the historical annualized total return for the S&P dating back to 1900 is 9.6%.

When compared to current interest rates on either short-term or long-term fixed income securities, the potential for an 8%+ return is particularly salivating. At current interest rate levels for 30-year Treasury bonds, the S&P 500 should outpace Treasury bonds by approximately 3.3% per year. To illustrate, invest \$100,000 in Treasuries today and it will grow to \$420,000 in thirty years. Look beyond the never-ending wall of worry that always besets investors and consider that the same \$100,000 invested in the S&P 500 and compounded at 8% a year will reach \$1,060,000!

Obviously, taxes and inflation will lower these numbers. But these twin devils take a bite out of both apples. And inflation's bite can be especially painful for fixed income investments. When interest rates and inflation ascend, bond issuers (with TIPS being the notable exception) will not magnanimously raise their coupon rate. On the other hand, stocks can provide a growing dividend stream as the earnings of corporations increase over time, thus ameliorating the pernicious effects of inflation. The enactment of more favorable tax treatment for corporate stock dividends would be icing on the cake for dividend paying stocks.

At present, most dividend discount models that take into account corporate earnings and interest rates on 10-year Treasury bonds show that the S&P 500 is undervalued by 40% to 55%. Even the lower of these figures calls for an objective look at the risk/reward equation for stocks and bonds today. Today, taking inflation and taxes into account, the effective after-tax real returns on the trillions

of dollars invested in money market funds is negative. More importantly, it is quite possible that the 8% expected return on equities may turn out to be somewhat conservative given the present levels of stock market prices and the optimum earnings power of corporate America and the S&P 500.

Investors can always find something about which to worry. Now that the major military battles in Iraq are over, we can worry about the transition of power and the reconstruction of Iraq. How will we deal with the "Axis of Losers," France, Germany and Russia, who will seek to stymie the U.S. again in the U.N.? Now we will be forced to deal with the other members of the "Axis of Evil," Iran, North Korea, and now, Syria. Investors will turn their attention again to an economy that has failed to deliver strong corporate earnings growth. Is the housing boom going to turn into a bust? Will SARS be the death knell for many airlines and travel related industries, bringing sizable losses to their creditors in the process? What if Bush fails in his bid to salvage his dividend tax relief, as seems a likely prospect? Make your own list; there is always something that can keep one awake at night and thus frozen from acting while waiting for the perfect moment of certainty and mental comfort. Those who are so mesmerized might take a cue from how success is achieved in America's favorite pastime, whose echoes of "play ball" have once again gleefully heralded another spring.

A baseball player who waits for the perfect pitch will, more often than not, be called out on strikes, as opposed to the batter who adjusts and learns to swing at the deliveries in the strike zone. The last professional big leaguer to hit over .400 during a full season was Ted Williams in 1941. Looked at from a negative perspective, one could say that Williams, the greatest pure hitter in the history of baseball, failed sixty percent of the time in his best year. But far from being a failure, he epitomized the ultimate in perfection in his profession because he capitalized on the pitches that were thrown to him instead of waiting for what he wished them to be.

Just as in baseball, investors are seldom thrown a whole lot of “fat” pitches over the middle of the plate. But there are times in the game when some balls look a great deal juicier than others. Today, trying to hit a “bond ball” is like trying to hit a golf ball fired at you from 60 feet away by Roger Clemens. Even if you could see the missile, you will be swinging the bat at a whiff of air. On the other hand, there are a lot more appealing pitches among the stocks being hurled at investors by “Mr. Market.” “Mr. Market” looks like a corpulent, sluggish old bear on the mound, huffing and puffing in the late innings of the ball game, out of gas. Many of his offerings appear to be the size of a bowling ball drifting toward the plate in slow motion. Investors should be grabbing their bats; “Mr. Market’s” three-year no-hitter is over.

One does not have to swing for the fences to do well in the investing world. While it may be a long time before the equity markets enter a sustained multi-year bull market, the geopolitical hazards that have so roiled the equity markets have de-escalated by a significant degree in recent days. Economic freedom and political freedom are intertwined. The gale that swept over Iraq in March and April could well sweep across the globe and advance both of these freedoms around the world. The impact on global economic growth would be energizing and long-lasting. Beyond the almost inevitable post-war rally, the events of the past few weeks and those in the months to come may provide the catalysts that augur for a healthy, if less frenetic period of economic growth bubbling up from the wellsprings of the political freedom that may spread to other parts of the world. In chronicling the road of political freedom from Berlin to Baghdad, Daniel Henniger, Deputy Editorial Editor of *The Wall Street Journal*, correctly points out that the journey traveled by Eastern Europe after the fall of the Berlin Wall was not an easy one, nor will it be for Iraq. But the road to freedom was traversed by many brave souls, thousands of whom spilled their blood. There will be many naysayers who argue that the effort to bring political freedom and some form of democracy to Iraq and other areas of the Middle East will fail. But the success achieved in

liberating Eastern Europe from communist slavery, despite considerable difficulties at nearly every step of the way, should not be forgotten. As Henniger notes, his message:

...is not an attempt to play Pollyanna in thrall to stirring images of freedom. It is an attempt to be hopeful. The last big year of political hope for the world was 1989. It didn’t work out in Tiananmen Square in June. The statue then, of liberty, was made of papier-mâché; state power won and smashed the statue. The year got better for the cause of individual freedom, reaching its apotheosis with the fall in November of the wall across Berlin.

Was it grandiose for Donald Rumsfeld... to liken the toppling of Saddam’s giant statue to that famous, enduring leap forward for freedom? Maybe someone should find that big fellow who was swinging the hammer at Saddam’s pedestal. Ask him.

We have all heard the philosophical query, “If a tree falls in the forest, with no one there to hear it, will it make a sound?” Iraq, a country roughly the size of California, had an entire forest full of figurative redwoods come crashing to earth in less than thirty days. Yet, like the three fabled chimpanzees, there are many people who have covered their ears, eyes, and mouths and refuse to hear, see, or speak of the thunderous reverberations resounding from the sands of Araby. We are witnessing history being writ large. Unfortunately, there will be many who are either unwilling or who fail to acknowledge and comprehend the magnitude of the truly earth-shattering events of the past few weeks and the freedom and hope that these events may eventually unleash. Along with those individuals who will not or cannot look beyond the immediate cacophony of turmoil and dissent, they may be handicapped by their inertia or dogma from participating in the political and economic fruits of these ongoing revolutionary developments.

Who would have dreamed in 1989 that countries such as the Czech Republic, Hungary, and Poland would eventually become members of NATO and among the supporters of the war to liberate Iraq? We believe that a few years

from now, we will look back and view the period of late 2001 through 2003 as one of those periods, like others of great historical moment, that will mark one of the greatest transformations of geopolitical freedom in history.

During these past few years it has often seemed that “Murphy’s Law”— “If anything can go wrong, it will”— was the order of the day for our nation and certainly for equity investors. Over the next few years we anticipate that the global political and economic forces that will be unleashed by the war in Iraq will swing the pendulum back in favor of investors who today are galvanized to take advantage of the opportunities that have been masked by the proverbial fog of war and its immediate aftermath.



It is a long way from Iraq to West Virginia, the home state of Pfc. Jessica Lynch. It was a joyous return to the U.S. for this brave, former POW. The long journey home for her military base roommate, Pfc. Lori Ann Piestewe, a Hopi Indian from Tuba, Arizona, was made only in spirit. A single mother, she was the first American female combat casualty since WWII and she leaves two young children behind. These two soldiers, like thousands of others in the all-volunteer, professional military services, put their lives on the line for all Americans— and millions of Iraqis too. Courageous individuals from the United Kingdom and others of our coalition partners joined them as well.

Sadly, many of these young men and women will not return. There are heavy hearts among the wives, children, mothers, fathers, brothers, sisters, and other loved ones who now can only hold a memory of their fallen heroes and heroines. In seeing the handsome, mostly so very young faces cross our TV screens as they are honored for their service, it is hard to hold back the emotions of sorrow and sadness at their loss. So many young lives snuffed out in their prime, their futures stolen from all of us.

Yet, despite our heartfelt sadness, one can also have a sense of great pride in the character and personal qualities exhibited by our military personnel, especially so evident and refreshingly wholesome among the young. They are disciplined, dedicated, responsible, articulate, humane, and almost idealistically naïve. Above all, they are patriotic and believe in the ideals that are the bedrock of the individual liberties of this country. They have given of themselves and made many sacrifices for their fellow citizens and country.

Despite the horrors of war, we have also witnessed what may seem like a minor miracle. Through the middle of April, coalition forces had lost fewer men and women in Gulf War II than in Gulf War I. That we did not lose more is a credit to their professionalism and training.

One of the sordid chapters of the past few years has been the greed, corruption, and venal behavior manifested by far too many in corporate America. Fortunately, many of the excesses of this recent past have been put behind us. Standing in beautiful contrast to the men of wealth and power who sold their souls for a mess of pottage are the men and women of our military services. One of the reasons we are hopeful for the future of this country is the character, spirit, and idealism displayed by these young patriots. Their qualities of character are worthy of emulation by all Americans.

In a few weeks, we will celebrate Memorial Day, and soon thereafter, Independence Day. Let us always remember our heroes of previous conflicts and the wonderful men and women who have given the best of themselves in recent months so that we and the citizens of Iraq can have so much. We salute them and will always be grateful for their courage and sacrifice.

Roger E. King, CFA
Chairman and President

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Sources: The Wall Street Journal; The Weekly Standard