THE DECISION MAKER

KING

Summer 2003

Many shall be restored that now have fallen and many shall fall that now are in honor.

— Homer

Looking at the current environment and assuming that it will persist indefinitely in the future has rarely worked when investing. This was true nine months ago when many investors feared that things would never get better again in the equity markets, as evidenced by the mass exodus of funds from stocks into both bonds and cash instruments. That statement also applies to the environment today, where we have witnessed a 25%-plus rally off the market's lows. While our outlook for the equity market remains positive, we believe that the recent rally in equities will not persist at this pace, nor will things continue to be as rosy for bond investors.

The second quarter equity market rally was one in which it was very difficult for an active money manager to keep pace. For example, in the small-cap arena, the Russell 2000 rose an impressive 36% from the March 12th lows through June 4th. However, much of these spectacular gains were provided by micro-caps (companies with a market cap under $50 million), as this group rose by 96% over the same period. Most of this price appreciation was provided by $1 and $2 stocks, high-risk companies which saw their price double or triple as fears of bankruptcy began to subside. Interestingly, at the time of the most recent market bottom on March 12th, 44% of the Russell 2000 possessed a share price below $10 per share, and 45% of the Russell 2000 Technology constituents possessed a stock price under $5 per share. These statistics provide harsh reminders of the destruction of stock prices over the last several years.

Many things have changed for the better over the course of the last year. Companies with financial leverage, particularly those that suffered mightily in 2002 due to a powerful feedback loop that developed between credit, options, and the stock market, have made a remarkable comeback. Last October, analysis showed that 43 large-cap, investment grade companies were on the cusp of a financial crisis. Now, very few (if any) of these 43 companies are at risk of tipping over into an abyss. Banks are becoming more accommodative, the economy is showing some signs of life, geopolitical concerns are subsiding for now, and corporate profits are improving. Other factors are also encouraging. For example, the term structure of interest rates is actually very steep right now, a classic sign of an impending increase in economic growth.

The equity market has made a bottom three times in the past year— July 2002, October 2002, and March 2003. If we assume the relevant starting

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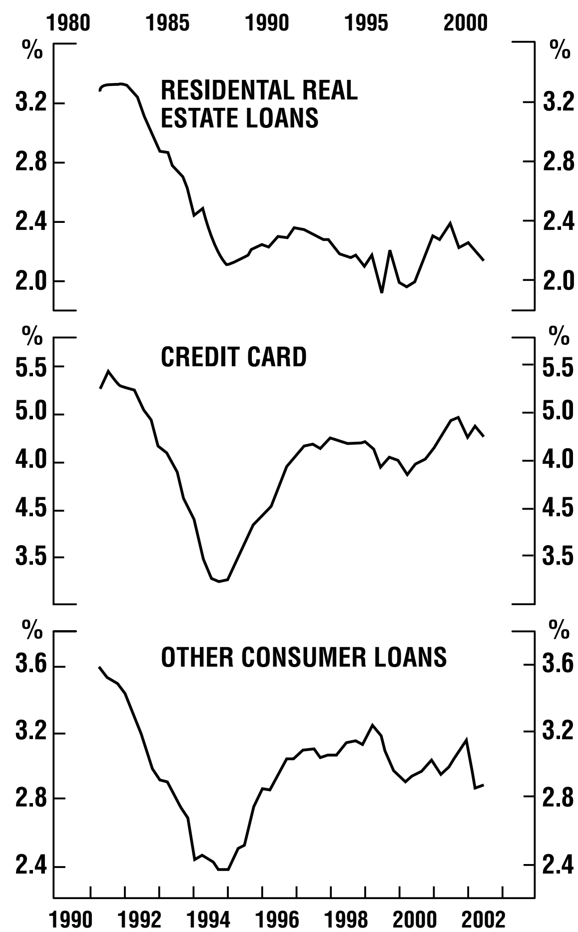
point on the S&P 500 is the most recent of the three dips to the 800 area (March 12, 2003), then the current rally has been one of the most rapid in post-war history. After 14 weeks, the S&P rose 25% from its closing low. The only other rally where the S&P closed up significantly higher after its first 14 weeks was the rally following the Russian debt default and the collapse of Long-Term Capital Management in October of 1998. This suggests that we could be due for a pause in the strong upward momentum that we have seen over the last several months.

While the rally in equities has been encouraging, several clouds linger on the horizon. Investors remain concerned about the high levels of consumer debt, deflation, unemployment, the declining U.S. dollar, and a potential stall in the recovery of the economy, to name a few. While our outlook is positive, many of these concerns are certainly valid, and we thought we would spend a few moments addressing some of these issues as well as pointing out several factors that have made us more constructive about where we are today.

A frequent concern voiced by investors is the current high level of consumer debt. The ratio of debt-to-income has been rising throughout most of the post-WWII period, yet consumer loan delinquency rates are currently far below previous peaks. The Federal Reserve's survey of consumer finances shows that most debt is owed by those individuals with higher incomes— the group that can most easily afford the servicing payments. It is critical to note that mortgages account for approximately 70% of household debt, and these loans are well collateralized. A shift from renting to owning a home has clearly played a role in boosting mortgage debt, but this may be a bullish rather than a bearish sign for consumer finances. With interest rates at current levels, mortgage payments may well be less than rent payments (increasing spending power), and home ownership leads to forced savings (via repayments of mortgage principal). Thus while a rise in household debt is worth watching, it is also important to look at the components and the implications of the debt that has been incurred.

A second major concern has been the potential development of deflation. After two and one-half decades of trying to contain inflation, the world's leading central banks are now officially trying to stop inflation from falling any further. The new goal of "pre-empting deflation"

Bank Loan Delinquency Rates



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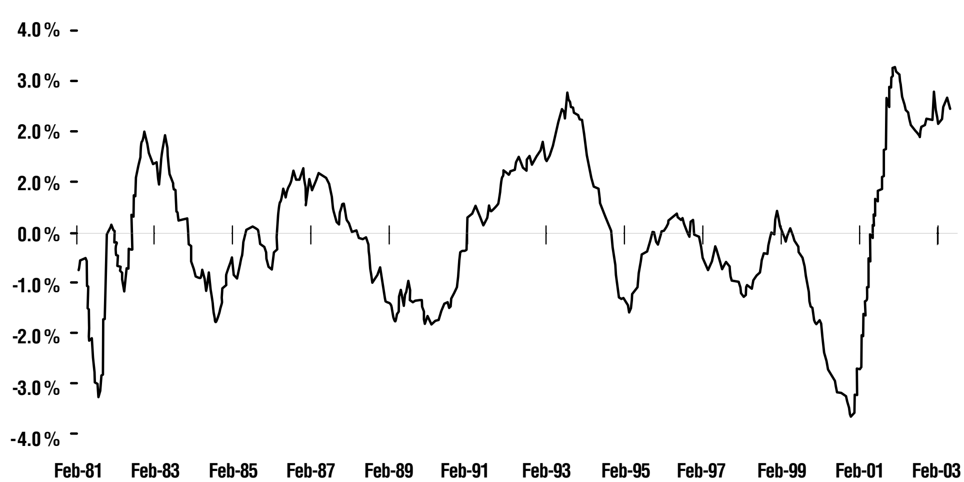
implies a promise to maintain abnormally low real rates at the short end of the curve until demand and resource utilization recover strongly enough to virtually guarantee that inflation will stop falling, or even rise a bit from current levels. For this new strategy to succeed over the next few years, at least two conditions must be satisfied: 1) the cost of credit to the private sector needs to decline further and 2) real yields must decline further down the curve, thus lowering discount rates on future cash flows and profits. In other words, credit spreads must narrow, yields of riskier corporate bonds must fall, and equity market multiples must rise. These would be positive developments for equity investors.

Federal Reserve Chairman Alan Greenspan has also indicated that the Fed would do whatever is necessary to resuscitate the economy and avoid prolonged deflation. Greenspan recently told a joint Congressional Economics Committee that "in the current environment, the cost of taking out insurance against deflation is so low that we can aggressively attack some of the underlying forces, which are essentially weak demand." This implies that Greenspan will keep rates relatively low until we see a material pickup in inflation. The Fed can fight deflation not only through the lowering of rates to stimulate demand, but also by increasing the money supply. Recent data from the St. Louis Fed shows an uptick in money supply growth that is two times the nominal GDP growth rate. Some have been concerned that we may be entering a period where we are pushing on a string, much like the situation that exists today in Japan where lower rates are having no real impact on the economy. However, things are structurally much different today in the United States versus the situation Japan faced when it entered its troubling period. On a positive note, the Fed only lowered interest rates by 25 basis points at its most recent meeting rather than the expected 50 basis points. This indicates that either the Fed may be seeing some positive signs in the economy or that if a pick-up does not materialize, the Fed has extra cannon fodder for a later date to combat any prolonged weakness. Although U.S. interest rates are extremely low, current Japanese interest rates are significantly lower than ours. In addition, interest rates in the 1930s, in the late 1940s, and in the early 1950s were much lower than today. Several disruptive occurrences were ongoing in each of the aforementioned periods. For example, in the 1930s the U.S. had a fixed price of gold and experienced massive tax increases. These circumstances do not exist today.

As mentioned, another valuable tool for the Fed is providing excess liquidity to the system as a way of fighting deflation. Excess liquidity measures have been very high over the last two and one-half years. While this has played

Excess Liquidity Measure



Source: Datastream, CSFB Estimates

an important role in supporting consumer spending, it seems that up to now, high liquidity has had only a relatively limited impact on the corporate sector. But that seems to have changed in the last six months, and for the first time since the start of the recession, the corporate sector is starting to see the benefits of excess liquidity.

Inflation could continue to fall a bit further both in the U.S. and in Europe, not so much because of an acceleration in core goods price deflation, which has already happened, but as a result of the lagged effect of the post-bubble downturn and jobless recovery from it. Also, if deflation were truly a threat, gold prices, which tend to be a good indicator of inflation, would not have remained relatively stable in 2003. In addition, spot commodity prices have risen substantially, reflecting the recovery of the economy.

A third concern plaguing the markets is the declining U.S. dollar. The U.S. administration has made it clear that it is no longer pursuing a strong dollar policy. Comments by Treasury Secretary Snow led to a steep sell-off in stock and bond prices a few weeks ago. There are both positives and negatives to a weaker U.S. currency. First, a softer dollar would prove to be positive since it spreads the burden of excess capacity across other economies. It also makes U.S. exports more attractive and foreign imports more expensive (on a relative basis). It is estimated that a 10% decline in the U.S. dollar over the course of the year would boost S&P 500 earnings by approximately 2.8%. However, the current situation could prove to be negative should the decline in our currency be too severe or prolonged. It is important to remember that a softer dollar would be a positive only as long as it does not frighten foreign investors. A significant drawback of the declining dollar is that U.S. equities become less appealing to foreign investors.

Another apprehension on the part of the market has been the lack of a rebound in employment. Importantly, the unemployment rate probably will not return to the unsustainable lows experienced in the late 1990s. A primary reason is the manufacturing jobs the U.S. and other countries have lost to China. There is certainly a very tight correlation between the 22.3% increase in China's exports last year and the growing number of industrial workers losing their jobs. There is also a cause-effect relationship between the closing of U.S. factories and the resulting loss of local real estate tax revenue as more and more plants are abandoned. This is a big part of the budget shortfalls that plague America today. Further evidence of the weakness that continues to persist has been reflected in the relative performance of the employment services group to the S&P 1500, which historically has been an excellent leading indicator of things to come in the labor market. The underperformance of this index in recent months argues that labor market conditions are still in for a tough ride. Many of these job losses are likely to be permanent and we believe this is a situation that is worth watching closely.

Since we have witnessed four distinct rallies of 18% or better over the past three years, some doubt may exist

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in many investors' minds as to whether this will be the rally upon which others will emerge. We believe there are several reasons why this rally is sustainable. First, the profit picture of many companies has thus far been better than many analysts had expected. During the first quarter of 2003, 63% of the companies in the S&P 500 actually beat expectations (albeit, many of which had been previously lowered). This indicates that things are not continuing to deteriorate. There is little doubt that expectations were beaten down, but even after stripping out the effect of energy and the decline in the value of the U.S. dollar, first quarter 2003 profits were impressive in a quarter in which GDP growth was 1.6%. Perhaps even more important, the quality of earnings is improving— the difference between operating and GAAP earnings has narrowed considerably. For example, during the fourth quarter of 2002, the difference between reported and operating earnings was $9 per share. In the first quarter of 2003, the difference was a mere 30 cents.

A second reason the rally may have legs is that the technical health of the equity market is the most positive it has been in three years. Impressively, the S&P 500 has broken decisively through its 200-day moving average while the moving average itself has turned higher— a classically bullish sign. In addition, the 50-day moving average just crossed the 200-day moving average, the first time this has occurred decisively since November 1998. The equity market has built a nice base over the past nine months, which could pave the way for further market advances. Several other technical indicators suggest that the deterioration in equity prices experienced in the recent past was more than overdone. For example, one indicator termed the Secular Oversold Conditions Indicator (SOCI) generated a buy signal as long ago as July 2002, only the eighth buy signal in 150 years— an illustration of the severity of the sell-off. Also, taking the five worst bear markets in the 150-year history of the U.S. equity market, bottoms have typically been formed approximately 2½ years from the peak. Whether this was purely coincidental or whether human beings react in a fundamentally similar way to major financial crises is uncertain. Another bullish sign is that a surprising degree of caution still exists on the part of investors. Despite the significant rally during the second quarter, short interest on the New York Stock Exchange actually rose 2.5% in June from May. Usually, rising short interest is viewed positively as it represents potential stock purchasers as those investors who borrowed stock to sell short must eventually purchase stock in order to close out their short positions.

Lastly, the decline in corporate credit spreads and anecdotal evidence that banks are actively attempting to build their corporate loan portfolios lies in sharp contrast to what we have seen over the last three years. This activity should go a long way toward repairing corporate balance sheets and providing the basis for an improvement in the economy.

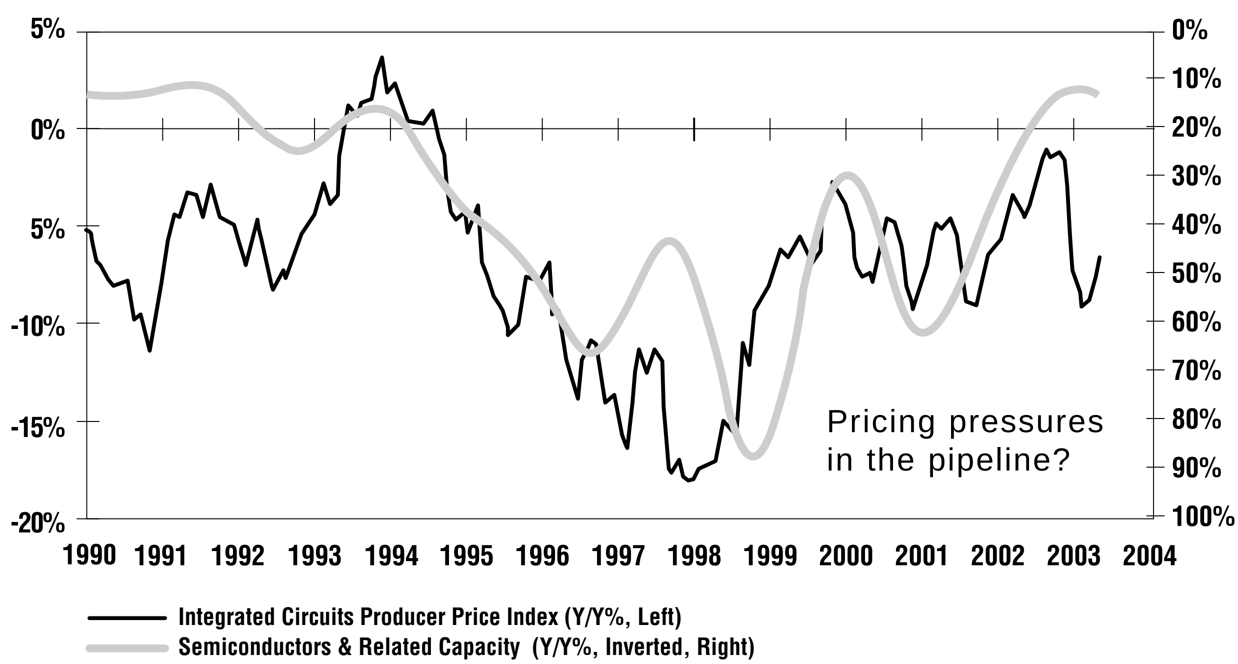
The equity rally thus far has not been driven by an actual increase in earnings, however. In fact, earnings estimates for the S&P 500 for the second quarter have been revised down 0.6% since the market bottomed in March 2003. The fuel for the recovery in stocks has had more to do with low interest rates, expectations for improved corporate profits, and the perceived stimulus to be provided by the tax cut package. The pace of the advance in equities will likely slow once interest rates find a footing, and we may well be near an inflection point. Looking forward, concepts such as earnings, dividends, and valuations will probably come back into focus. Importantly, a stabilization in interest rates does not imply the end of the equity market rally, but rather the end of the easy money period and the beginning of a more challenging phase where individual stock selection becomes even more important.

The dividend tax cut should continue to be a positive for the equity markets. The decision to reduce the maximum rate of taxation on dividends to 15% from as high as 35% could add approximately $320 billion, or 3.5%, to U.S. stock market capitalization. Dividends also have an impact on the bond market via an opportunity cost effect. Nearly 20% of the S&P 500 constituents now have a dividend yield greater than the 10-year Treasury note. This compares with only 6% three years ago. For many income-oriented investors, this alone makes some large-cap equities more attractive than bonds. Dividend yields today are more than twice that of money market yields, a highly unusual occurrence. This is not insignificant given the fact that there is more than $2.5 trillion in money market funds (the stock market as a whole is worth approximately $9 trillion).

Many companies have initiated dividend payments over the last several months. Microsoft, Cendant, and Ralph Lauren are a few. Dividends should make many management teams more focused on cash flow growth and on returning value to the shareholder, both of which are positive and welcome developments.

After the recent rally in equity prices, many investors have asked us how we feel about taking some gains out of the equity market and moving into bonds. While we believe that we may be entering a period of consolidation for stock prices, we believe that the party is more or less over for bond investors and that interest rates will start moving up over the next six months or so. In early June 2003, the yield on the ten-year bond fell to a low of 3.19%— a 45-year low. At this point, we do not believe that interest rates will fall substantially from these levels, barring some major financial or geopolitical crisis. While bonds have handily outperformed stocks over the last several years, much risk exists in the credit

CAPACITY INCREASES WEIGH ON PRICING



Source: Bureau of Labor Statistics; Standard & Poor's; Bear, Stearns & Co. Inc.

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markets. A move into bonds by investors at this juncture could prove to be very risky as rising interest rates will adversely impact bond prices. In fact, the current shape of the yield curve could indicate that a bond bubble does indeed exist. As the economy continues to recover, we look for the yield curve to shift upwards and steepen.

There are numerous reasons to become more optimistic about the future for equities. Recent changes will alter the landscape for the U.S. equity markets for years to come. Many of these changes create opportunity for investors. For example, in the small-cap arena, a new trend could emerge where companies begin to go private. Increased regulatory scrutiny and costs coupled with Wall Street's research retrenchment (and subsequent declining coverage of small-cap companies) has many management teams of smaller-cap companies reconsidering the relative benefits of being public.

We continue to be cautious on the tech stocks. While tech has led the way during the recent rally, several concerns remain. For one, a key issue is the ongoing expansion in capacity at a time when there remains ample excess capacity from the previous cycle. Historically, a pickup in capacity growth has resulted in pricing pressures down the road. Though earnings estimates of many technology companies have been slashed during the post-bubble period, estimates are still declining today and are likely to be lowered further over the next several quarters— obviously not the greatest backdrop for stock price appreciation. Further, valuations of many tech companies were inflated even before the strong rally in the Nasdaq. If the complete aberration of the bubble period is ignored, current valuations of semiconductor stocks relative to the S&P 500 have only been higher in one previous year going back to 1988. Though technology stocks have been the relative outperformers in the high beta rally off of the October lows, it is hard to make the case that this outperformance will continue. Historically, the leaders of a new market upturn are very rarely the same stocks that led the previous bull run.

The economy is starting to recover. Corporate free cash flows have risen sharply over the last two and one-half years. Corporate profits are also starting to improve. These developments allow many companies to shift their attention from short-term survival to more medium-term profitability goals. The bottom line is that the combination of very easy liquidity conditions, equipment obsolescence, improving business confidence, and better profitability trends should lead to a progressive rebound in the level of corporate spending. Three positive quarters of increased equipment and software spending, a nascent inventory building cycle, and the recent surge in M&A activity are all evidence that the economy is healing and that confidence is returning. We believe that individual stock selection is key and that stock prices have room to rise, albeit at a slower pace.

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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.

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Sources: BCA Research; Bear, Stearns & Co., Inc.; Bureau of Labor Statistics; Credit Suisse First Boston (CSFB); Datastream; International Strategy & Investment (ISI); Laffer; Morgan Stanley; Oppenheimer & Co.; Standard & Poor's