

Spring 2004

You don't need a weatherman to know which way the wind blows.

— ROBERT ZIMMERMAN, A.K.A. BOB DYLAN
“SUBTERRANEAN HOMESICK BLUES,” 1965

If... history... teaches us anything, it is that man, in his quest for knowledge and progress, is determined and cannot be deterred.

— PRESIDENT JOHN F. KENNEDY
ADDRESS AT RICE UNIVERSITY, HOUSTON, 1962

The Wizard has spoken. Chairman Alan Greenspan bid adieu to deflationary fears and intoned on Capitol Hill that the U.S. economy is in a “vigorous expansion,” and “the federal funds rate must rise at some point to prevent pressures on price inflation from eventually emerging.” Greenspan’s follow-on observations were less threatening: “The protracted period of monetary accommodation has not fostered an environment in which broad-based inflation pressures appear to be building.” However, investors who initially took solace at the Maestro’s subsequent comments that the expansion has not yet produced “broad-based” inflation were quickly signaled by fellow Fed Board member Robert Parry that the Fed will indeed have to raise its target interest rate “significantly at some point” to head off inflation.

During Greenspan’s recent testimony, his minions at the Federal Reserve were probably huddled around the water cooler gathering greenbacks for the office pool to see which lucky stiff would guess exactly when the official increase in interest rates would be decreed by the Fed. Upon first hearing Sir Alan’s nuanced warnings, investors, who had already wagered much larger bets, ran for the exit of a very small door. The stock market suffered its worst drubbing in seven months and bonds tanked. Although the markets recovered somewhat from

their initial swoon, the end game became clear. The halcyon days of interest rates that had reached their lowest levels in 46 years would, at some point, be over.

What is surprising about the markets’ knee-jerk, negative reaction is that investors seemed surprised that the Fed is setting the stage to take the proverbial punch bowl from the party. Most observers of the Federal Reserve maintain that the Fed follows interest rates, it does not lead them. The futures market has been anticipating a rise in the Federal funds rate for several weeks, with the expectation of at least one increase if not two before the November elections. Central bankers must concern themselves with price stability. When prices move higher, they start tapping the brakes on liquidity. Anyone who has bothered to check the price of everything from latte to lumber would have realized that prices have stopped going down and are inching higher. And we will not even talk about the indigestion caused by a visit to the gas pump.

No one, including Mr. Greenspan, knows exactly when or by how much the Fed will raise rates. The economic tea leaves will tell the Fed when it is time to move. It may or may not be in 2004, but it will definitely occur by 2005. *But rise they will!* What should investors do in view of the Fed’s apparent

new course? Should they run with the lemmings for the nearest exit? Should they dump their bonds? Is it time to buy gold and real estate? Should they plunge into commodities? Are stocks going to decline dramatically? We believe it is best to relax and take a deep breath. Above all, do not let the talking heads, doom-sayers, and myopic denizens of Wall Street cause you to cut and run.

In the investment world there is one constant: something is always lurking around the corner that could negatively impact investment portfolios. Investor psychology vacillates between extremes of greed and fear as the perceived impact on portfolios of current and possible future developments motivates investors to act upon their emotions. In recent weeks, fear and greed have taken turns exerting their influence on the financial markets.

One could make a long list of the concerns weighing on investors' minds. In addition to worrying about interest rates, a few minutes reflecting on what else could go wrong will have investors reaching for their Prozac. Will the situation stabilize in Iraq? How do we deal with worldwide terrorism that seems to be spreading like kudzu? Will federal, state, and local governments continue to spend money like drunken sailors? Will an aging population have enough savings, given spiraling healthcare costs and Social Security and Medicare systems that look like Ponzi schemes? Will taxes be raised or cut? Is our education system causing the U.S. to fall behind in science and math? Are regulations and an octopus-like government burdening businesses with mandated and wasteful costs? Are we going to be faced with an energy crisis? Are pharmaceutical investments at risk if the government allows the reimportation of drugs? And this year, we can worry about whether John Kerry or George Bush will be President in 2005. Ad nauseam. Is this enough to make you cry?

Well, cheer up. How would you like to buy a dollar for fifty cents? You may have to wait a few years to get a payoff, but the odds are very good that if you are patient, you can make a good return on your investment. Just where would that be? The bond market? Guess



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again. Commodities? Not likely, and certainly not over the near term.

The sizable increase in commodity prices may have already peaked. There is a lot of production that can be brought on line to satiate demand for raw materials. Part of the rise in commodities in recent months has been due to speculative buying in China, shipping bottlenecks, and a falling U.S. dollar. Recent negative price action in copper and aluminum is signaling that the cyclical boom in China has run into some hurdles. Speculators are disgorging their positions in a number of industrial commodities as the buying frenzy has resulted in excess supply chasing slowing demand. Shipping prices, a good indicator of the demand for commodities, have also softened in tandem with the corresponding falloff in commodity demand. Only six months ago, most pundits had talked of a dollar that would decline for the better part of 2004. Now they are talking about a stronger dollar and a weaker euro in the face of an improving American economy. The prospect of a rise in interest rates changes the dynamics of commodity investing.

As interest rates begin to rise, the dollar will strengthen. A stronger dollar makes the currency more attractive vis-à-vis most other currencies. Consequently, it costs more to finance bond and commodity trading while also making commodities denominated in dollars less attractive, especially to foreign investors.

Is real estate a great investment? Higher interest rates will cast a pall over real estate for a while. Unless the cash flow is strong and growing, and the odds of appreciation are favorable, real estate will have a difficult time providing above average returns in future quarters. If you are thinking about refinancing a mortgage or buying a house, you had better get on the Internet and lock up a loan soon.

So, outside of the usual alternatives and some exotics like art, rare coins, antiques, and your brother-in-law's latest fantasy, that leaves cash and stocks as two of the more logical options for investment. The return on cash may begin creeping up before the year is over, but it will still be very low. And if inflation is factored into the equation, the real return on cash is negative.

From a tax standpoint, stocks have notable benefits. Capital gains and qualified dividends are taxed at a maximum rate of 15%, down dramatically from previous levels. While the tax rates could change in the future, they will be at this level through at least 2008. As companies' earnings grow, they usually raise their dividends, thus adding to their total return over time. In contrast, when was the last time anyone called up bondholders to tell them they were going to receive an increase in the interest rate on their bond holdings?

But aside from the tax considerations, stocks are a proxy on the growth of the economy. Unfortunately, a myriad of fears will prevent many investors from taking advantage of this growth. The list of potential negatives that weigh on stocks today is similar in many respects to the same types of problems that investors have faced ever since brokers met under a buttonwood tree in 1792 on what is now Wall Street and agreed to sell stocks. Look back to find a period in which it was the perfect time to

invest, when there were no problems and all was right with the world. It does not exist. Sure, there have been periods when investing in stocks proved more propitious than others. And there have been long periods when investors wandered in the wilderness as stock prices languished or declined. Today, despite a robust equity rally in 2003, most investors are still licking their wounds from what many would consider to be one of the worst bear markets in history—the agony of 2000 through the first quarter of 2003. And many of them are fearful of seeing some of their recent gains eroded.

It would be comforting if we could show all of the reasons why things will work out fine and the stars will align perfectly to produce a wonderful outcome for investors. But it cannot be done. Murphy's Law will emerge from time to time to dash the expectations of investors. Circumstances will change and events will occur which will have unpredictable consequences for stocks. Some will be good and some will be bad. Unfortunately, it is typical for most major market surprises to be negative in nature. Yet, in our mind, agonizing over the implications of potentially negative developments will immobilize investors and keep them from capitalizing on favorable risk/reward opportunities for the long term. Stop and ask yourself if most successful investors have created a great deal of wealth by listening to the endless and often cautionary advice of others. Or, have you seen anyone who is highly successful who is always waiting for the optimum moment to take a risk?

Pull out a chart of the performance of stocks over the past two centuries. All successful investors know one very basic fact. To wit: although there are periods marked by significant declines, the long-term trend of stock prices has tracked the long-term growth of the economy. True enough, there have been and will continue to be periods when it pays to be bearish. And one should always be very cognizant of the risk/reward dynamics of each and every investment. But it does not pay to be a permanent bear. Numerous studies have demonstrated that investors and money managers with a positive bias are more successful over time than those who have a negative outlook on the future. Optimism does not have to be

blind. Above all, it should be leavened with a realism based on an awareness of the major trend of economic growth and the factors that affect this growth and corporate profitability, knowledge of the historical rates of return on various asset classes, and an understanding of the corrosive effects of inflation.

Today, the big picture, which is so often blurred by the endless noise spewed out by the doom and gloomers and equivocating, modern-day Hamlets, is a very positive one. Why are we so sanguine about the outlook for well-selected stocks? It is not particularly important to cite reams of statistics as to why the future looks so promising. But there is one economic barometer that is extremely powerful, and it is strong evidence of the long-term upward bias of economic growth in the U.S.—namely, corporate profits.

The Bureau of Economic Analysis of the Department of Commerce compiles the National Income and Product Accounts (NIPA) reports on corporate profits. The data is based on actual tax returns from the IRS and not GAAP accounting. Since corporations have no reason to overstate their taxable income, these figures are a very good measure of actual profits. The latest reports for 2003 reveal some mind-boggling numbers. Full-year 2003 U.S. corporate earnings were \$1.1 trillion, 18% above 2002, the previous record, and they were running at an annualized rate of \$1.2 trillion in the fourth quarter. Corporate profits are the highest they have been in history and the highest they have been as a percentage of GDP—8.5%—since this data has been recorded! As shown in the chart, NIPA profits declined in the late 1990s, in sharp contrast to the bubble in corporate profits that were overstated by GAAP accounting.

The U.S., NIPA-based corporate earnings have grown at roughly double the rate of the increase in world dollar GDP, which also reached a record high in 2003. World dollar GDP grew nearly 12% in 2003 to \$33 trillion and is estimated to grow 12% in 2004 to reach \$37 trillion. The explosive growth in U.S. corporate profits is, in our opinion, unappreciated by the media, politicians, and a large number of investors. And just as important as the

strong profit recovery that is rushing onto the quarterly reports of corporations is the likelihood that profits will continue to grow and stay robust for some time. This has major implications for the outlook for equities and bonds as well.

The significant improvements in productivity that have been made in corporate America have gone a long way toward enhancing the profitability of businesses. For several years the globalization of the world economy has forced managers to be vigilant in their constant battle to maintain efficiency and productivity in order to remain competitive. In the face of the slowdown in profits that marked the last recession, their efforts to stay competitive intensified. As a result, companies have been reaping a payoff for several quarters; in the first quarter of 2004, earnings shifted into high gear. Not surprisingly, analysts, ever fearful of sticking their necks out less they deviate from consensus, have been left agape at the strength of profit growth. U.S. companies will surpass consensus earnings expectations by the largest margin in at least a decade. Profits for companies in the S&P 500 are on track to register a 24% gain for the first quarter, up from analyst's forecasts of 13% at the beginning of the year. And they are projected to increase 20% for the April to June quarter.

Certainly corporate profit growth will not continue at such a torrid pace. But in both the intermediate and long term, the prospects for strong economic and profit growth are quite promising. Higher corporate profits will lead to debt repayment, stock buybacks, dividend growth, greater merger and acquisition activity, and importantly, business investment, and job growth. They will also result in greater tax revenues and contribute to a stronger dollar.

The recovery in profits and the fact that they are at such a high percentage of GDP is even more impressive when one considers the economic environment of the last few years. We have gone through one of the worst declines in asset values since the 1970s. The economy entered a recession toward the end of the Clinton presidency and was still weak when it was hit with 9/11. The U.S. has

been engaged in military conflict in Afghanistan and Iraq, with the latter causing a sizable fiscal drain. The federal budget, in the face of a slowdown in the economy and sizable spending increases, has gone from surplus to ballooning deficits. As the economy spiraled downward, job losses mounted and unemployment increased. Yet, despite these and other hurdles faced by the economy, a recovery began several quarters ago and it has gained significant momentum over the last few months. It was given impetus by lower taxes on income, capital gains, and dividends, along with an extremely accommodative Federal Reserve. Given all of the obstacles with which the U.S. has been confronted since 2000, the strength manifested by consumers and businesses, accompanied by record corporate profits, is truly remarkable.

Given the fact that corporate profitability has been as robust as it has over the past few quarters, it would seem that the potential for an even higher level of profits is in store as the recovery gathers momentum. With significant room for improvement in employment and capacity utilization, it is obvious that the resources of the nation are still operating below optimum levels. Businesses are investing in more capital projects, and spending on technology and research, but there is still a great deal of unused capacity. Capacity utilization stands at 76.5%, far below what is considered a level of strong business activity. Job growth is accelerating, but it is not yet booming. The U.S. is in the early- to mid-stages of a strong economic and profits recovery. As the economy continues its upward march toward greater business spending and higher capacity utilization, along with greater growth in employment, corporations should record growing profits. As profits increase, the price of stocks should increase as well, despite the inevitable rise in interest rates. Rising interest rates will be a sign of greater economic activity. The initial concerns about higher interest rates will yield to a growing recognition that the U.S. economy and corporate profits, having weathered a very difficult period, should move to even higher historical levels.

How high is high? The earnings for the popularly followed Dow Jones Industrial Average were \$462 in

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2003. Guesstimates for 2004 have been racing upward as company reports reveal stronger economic activity. Reflecting recent changes in the Dow, the estimates for Dow earnings for 2004 are \$606, a 24% increase over 2003. As investors begin to look forward to 2005 and 2006, estimates of earnings could range as high as \$680 and \$790, respectively. The normal discounting process of looking ahead could result in investors placing a P/E in the high teens on forward earnings. The Dow could easily flirt with a level of 15,000 versus 10,358 at the end of the first quarter, for an annualized appreciation of 24% by the end of 2005. A pipe dream? We think not.

Much could go wrong between now and the next eighteen to twenty-four months. The what-if, bearish commentaries are familiar to most investors. Skepticism in itself can often be healthy, as too much optimism may signal that potential investors may have already used all of their buying power. But regardless of the gloomsters' admonitions, the economic growth of the past few quarters will not be easily reversed, and, in fact, may accelerate as the virtuous cycle of profits, business investment, and job growth leads to greater revenues and even higher profits. The excess capacity of capital and labor in the world will do much to keep inflation from increasing too rapidly.

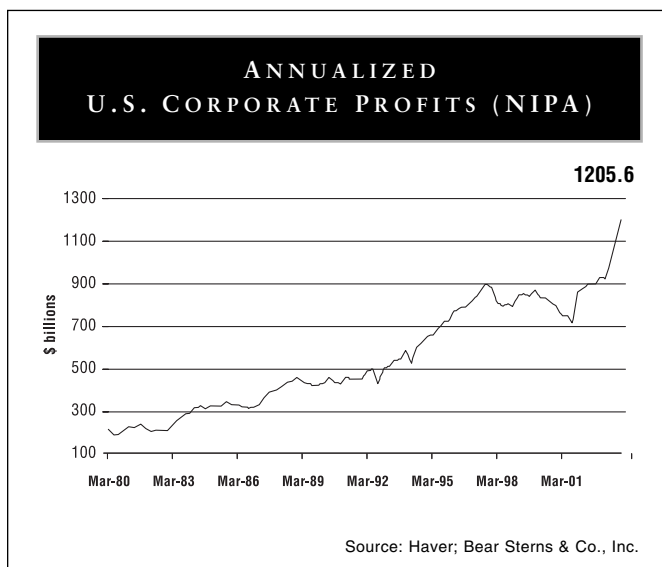
Importantly, the factors that will lead to a global economic recovery may well last for many years. The entry of countries from eastern Europe and the former members of the Soviet Republic, along with China and India, into greater participation in the world economy has tremendously positive implications for long-term economic growth that transcend misplaced concerns about such issues as outsourcing and greater demands on global resources. The outcries generated by such pressures as dislocations in the American labor force, immigration, and the imbalance in foreign trade, while addressing some very real issues, too easily ignore the potentially positive dynamics of the changing world. As but one example, China and India have populations of 1.3 and 1.1 billion, respectively, compared to the 291 million who live in the U.S. While China and India are becoming growing factors in world production, they are also building a growing base of businesses and consumers who will demand a growing share of the world's production. The economic disruption experienced by America is also being offset by a greater ability to compete internationally as currencies adjust and U.S. corporations maintain a high level of productivity. Not only will these new entrants to a larger global economy become greater producers, they will also become important and growing consumers of the products and services that well-managed companies in the U.S. can provide. Far from being dismayed by the dark

side of the coin that the xenophobes and protectionists present to us, the obverse of the picture for long-term domestic and global growth is shiny indeed. For American corporations and workers, the geopolitical transformation occurring spells not only challenges but a long period of prosperity as well. For equity investors, the economic growth arising from domestic and international developments will provide, if not always the smoothest of rides, a very rewarding journey. Beyond the current cancer of terrorism, a global super-boom may well be in store for the world.

As the long-term global boom unfolds, doubtless the perma-bears will conjure up new fears with which to scare investors. We think other events and voices herald a more realistic and promising example of the potential for the entrepreneurs of today and tomorrow.

In 1985, one year before Microsoft became public, it had revenues of \$140 million and profits of \$24 million. In 2004, it earned \$7.5 billion on sales of \$32.2 billion. In a recent interview with *Investor's Business Daily (IBD)*, its multi-billionaire Chairman, Bill Gates, who did not graduate from a university, spoke glowingly of the past and optimistically about the future of technology and its impact on our lives. "I've been amazed by... how quickly, after the first personal computer was launched in 1981, PC technology was adopted around the world. By how e-mail and instant messaging have become the primary means of communication for many people and businesses. By how fast the Web has become the richest source of information the world has ever seen... Now we're seeing wireless technology grow at an incredible rate."

Gates marveled at the almost limitless possibilities of the future, "If you invent a breakthrough in artificial intelligence so machines can learn, that is worth 10 Microsofts... Computing is fast moving to the center of the way we live and work. Hardware and software continue to become more powerful every day, and we're just starting to see the impact of fundamental technology advances... and an expanding range of new computing devices." Gates' rosy outlook is a refreshing antidote to those who do not yet recognize the new world that yet awaits us.



“I’ve always been optimistic about the potential of computers, but even I’m still surprised by how much they’re capable of today—and how fast their capability continues to grow... I’m confident that software breakthroughs will make computing vastly more powerful and intuitive in a few short years. My kids are part of a generation that won’t be able to remember what life was like without PCs and the Internet. I think that’s pretty exciting—this technology is like oxygen to them.”

Another recent example of the successful application of new technology and the benefits its can bring to consumers and entrepreneurs alike is provided by Google. Sergey Brin and Larry Page founded the hugely popular Internet search engine company only five years ago while still graduate students at Stanford University. Analysts estimate that Google is generating almost \$1.0 billion in revenues, with profits of approximately \$300 million. On the eve of a widely anticipated initial public offering that may raise \$2.0 billion and result in a market value of \$20 to \$25 billion, Brin and Page are about to become the world’s newest billionaires.

Perennially optimistic economist and commentator Larry Kudlow reminds us in *IBD* of the spirit of the late Austrian economist Joseph Schumpeter, whose “gales of creative destruction” were the inevitable consequence of rapid technological advances, invented and commercialized by risk-taking entrepreneurs. These technological outbursts drive economic prosperity to ever-higher levels. The capital formation fostered by lower marginal tax rates of income, capital gains, and dividends contributes to more technological advances, higher productivity, growing salaries and wages, and accelerating growth. Kudlow contends, “Rapid advances in biotech, nanotech and a myriad of wireless-communication networking equipment are poised to unleash phenomenal economic opportunities throughout every nook and cranny of American life.” He further maintains that growth is inherently counter-inflationary, as it tends to absorb excess money creation. Admonishing investors not to be overly fearful of a few small interest-rate increases, Kudlow states that they “are part and parcel of a normal prosperity cycle, one that can extend for another eight or ten years... So put any and

all of your interest-rate panic to rest. Disregard the Cassandras and the pessimists. They’ve always been wrong for this great country. Good times are coming. That’s what free economic opportunity brings.”

In our summer, 2002, issue of *The Decision Maker* we offered some comments that still seem appropriate today: “We have no way of knowing what the international scene may hold in future months. But over long periods of world and American history, it has never paid to assume... the worst will occur in the future... Certainly, there is risk in the markets today. There always is. Yet stock markets sometimes fall even if investors’ perceptions about the economy are wrong and fundamentals are clearly improving. The dark headlines on... the geopolitical front will eventually give way to more optimistic overtones. The [returns for] investors over the next few years should be rewarding ones indeed, even though they might not provide the pyrotechnics of the grossly speculative period of the late 1990s.”

Technological advances for the economy as a whole are a huge positive for productivity and economic growth. Ironically, as keen as we are on the benefits of these advances, in our opinion, technology is one sector of the market in which valuations are currently a bit stretched. Nevertheless, the opportunities created by the advancement of technology will open a wide array of profitable opportunities in many industries.

Investing is a tough, demanding business. It can be fascinating and exciting. It is intellectually stimulating and challenging. Sometimes it is gut-wrenching and debilitating. It often tries your patience and humbles you. But, above all, it can bring tremendous satisfaction when you achieve success for your clients. As we look forward, we believe our Business Valuation Approach should continue to serve our clients well in a future that will be marked by occasional pitfalls, but one that will be full of rewarding opportunities as well.

Roger E. King, CFA
Chairman and President

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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: Bear Stearns & Co., Inc.; Bloomberg; Haver; *Investor's Business Daily*;
John Dessauer's Investor's World; Laffer Associates; *The New York Times*

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