

Summer 2004

Uncertainty is the friend of the long-term investor.

—WARREN BUFFETT

Over the last quarter, the equity markets have been “range bound” as the major indices have traded sideways with a downward bias. Despite very strong corporate profits, equity investors’ concerns have focused on some pivotal economic issues, namely escalating oil prices and attendant inflationary pressures, the strength of the economic recovery and job growth, and uncertainty regarding the pace and magnitude of prospective Federal Reserve interest rate hikes. In addition, much of the Islamic world is under terrific stress from its more fanatical enclaves around the globe that pose potentially significant threats to the global economic order.

The circumstances, both real and imagined, underlying these economic and geopolitical concerns should certainly give investors pause and not be lightly dismissed. As concerned as investors are with typical economic issues, the most gnawing fear for investors today seems to be the fear of terrorism. From a contrarian viewpoint, the long range of history suggests that even the most dire of possible outcomes be viewed in the context of historical perspective. Certainly, there are always risks that are somewhat unprecedented. Yet is it realistic to assume that, at the extreme, the consequences of another 9/11 or worse would bring the world economies to a virtual halt? Disrupting, yes, Armageddon,

no. We believe that the threat of terrorism, as disruptive as it is or may be, is a factor with which investors are slowly coming to grips. And we must admit to a bias that even though we believe the threat from fanatical terrorism will be with us for years, eventually it will be, if not totally eliminated, at least relegated to the dungeon. Uncertainty often breeds the fear from which opportunity surfaces. Thus, despite the fact that the overriding issue today is the Damocles sword of terrorism, we are of the opinion that the long path of economic growth will grind inexorably upward. We remain sanguine about the ability to generate attractive investment returns.

External factors such as wars, major disasters, scandals, and other unforeseen events, while often having a tremendous short-term impact on equity values, rarely have a major influence on stock prices and on the intrinsic values of companies over the long run. For example, when the Japanese attacked Pearl Harbor on December 7, 1941, the negative effect on the market was short-lived. During the four months after the surprise attack, the market declined approximately 7.6%. As America geared up to resist the Axis powers, the tide turned and the market increased 90.6% (13.75% annualized) over the next five years, a period which covered the entire Second World War.

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The post-Vietnam War and Watergate era witnessed a major oil price shock from OPEC, a long period of stagflation, and record high interest rates. But beginning in 1982, the markets began to recover from their 70s funk. They began a long bull market that was punctuated by the first Gulf War. Despite a significant decline of 13.81% over a three-month period, the markets returned to their bull track, spiraled upward until the mini-crash of 1987, then regrouped and churned higher until March of 2000. From its low in August 1982, to its peak in March 2000, the S&P 500 appreciated 1,145%, or 16% annualized. The resilience of the markets during periods of great economic, political, and military distress is a testament to the fact that economic fundamentals drive stock prices. We believe that the long-term pattern of economic growth in the world will be positive. Thus, despite the human tragedies, headline risks, and political implications of today's events, the long-term march of history suggests that a positive bias with an eye peeled for opportunity created by uncertainty will serve investors far better than letting fear foster emotional investment decisions.

Looking at the more immediate angst over inflation, the picture is not as negative as it might appear. While the inflation rate has certainly accelerated, it has been pushed up by the rising prices of many

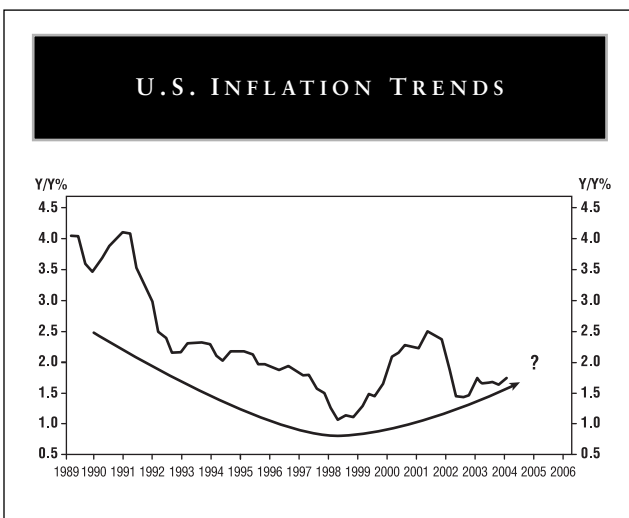
components that have increased at an unsustainable pace. Most notably, oil prices have risen dramatically over the last year, driven by both increasing demand as well as by fear of a supply disruption in the Middle East. Oil prices have peaked at just over \$42 per barrel (up approximately 18% since the start of the year). However, it is unlikely that oil prices will be above \$50 per barrel a year from now. Even if prices were to remain flat, a large component of inflation would be eliminated. Likewise, many food prices have also risen at an astronomical and unsustainable pace. For example, year-to-date, lettuce prices have risen 43%; pork prices are up 49%; butter prices have climbed by 43%; and milk costs have sky-rocketed 52%. It is unlikely that this level of appreciation will continue.

The action of the U.S. dollar has also played a role in recent inflation numbers. One can never overestimate the importance of what the dollar exchange rate does to U.S. inflation. Over the last two years, the U.S. dollar has depreciated dramatically, therefore inflation numbers measured in U.S. dollars have been biased upward significantly. This has been reflected in gold and commodity prices. Given the recent strength in U.S. economic growth, it is now unlikely that the dollar will depreciate substantially going forward. As a result, for exchange rate reasons alone, it is not likely that we will see higher measured inflation numbers a year from now. As long as interest rates rise fast enough to keep the dollar relatively stable, inflation should be well contained.

While a shortage of goods and services can contribute to a rise in prices, inflation is essentially a monetary phenomenon. The level of interest rates is not as important as the supply of money created by a central bank. The creation or existence of too much money created by the Federal Reserve will result in too much money chasing too few goods. The Federal Reserve appears to be on a path of supplying enough money to the economy so as

to create a Goldilocks scenario—not too hot and not too cold. Given the tremendous amount of excess capacity that exists today, and the right recipe for money growth by the Fed, the goods side of the inflation equation looks very healthy. Given that the economy should continue to grow at a healthy clip over the next year or two, the availability of goods should remain plentiful. Coupled with appropriate money growth, the supply and demand side of the inflation equation should be very beneficial in controlling inflation.

After a period of abnormally low interest rates, it is probable that we are entering a period where the Federal Reserve is set to raise the Fed Funds rate several times. However, contrary to what many believe, rising rates are not necessarily bad for the equity markets. Modestly rising rates can translate into solid growth in the economy. Again, the key is that rates cannot rise too rapidly. And, as mentioned, it is the supply of money that is critical too. How do rising interest rates affect growth? If you know that interest rates will be higher next quarter than they are this quarter, what do you do? Many companies will accelerate borrowings and capital purchases before the next rate increase. This translates into a very rapid rise in real output,



Source: Haver Analytics; Bear Stearns & Co., Inc.

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real employment, and production—a net positive for corporate earnings and stock prices.

There are several reasons why interest rate hikes should not weigh too heavily on stock prices. First, the level of interest rates matters more than the change in interest rates. Even after several rate hikes, rates will still be low in real terms and will also be low relative to recent (post 1960s) economic history. Second, the positives from job growth should offset some of the impact of interest rate hikes. Third, foreign economies are strengthening, offsetting some of the effect of the U.S. rate hikes. For example, Japan is coming out of a deflationary situation and China's growth, while slowing, has shifted more toward consumers and rural areas. In fact, domestic demand outside the U.S. is finally growing strongly, reaching its fastest pace since 1990. Fourth, U.S. households are sizable net creditors with long-maturity liabilities (primarily through mortgages), so interest rate hikes will add to disposable income (as consumers will have higher returns on their money markets, CDs, etc.). Fifth, rate hikes will probably be gradual. It is the momentum of inflation and how rapidly

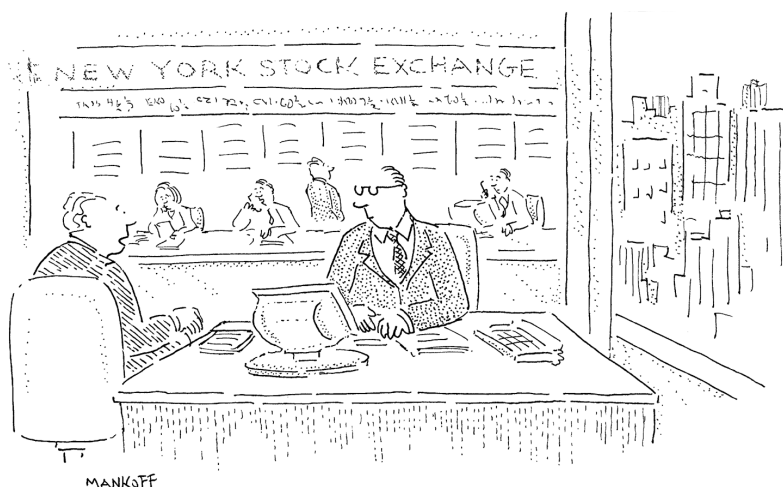
rates rise that could put a crimp in the performance of equities. The worst environment for stocks is one where inflation accelerates too quickly. However, we do not believe that this is the type of environment that lies ahead. Sixth, U.S. demand growth is shifting toward corporate spending. Corporations are unusually liquid and are ending a period of risk aversion—most still have low inventory levels. Finally, the low interest rate environment of the past has an important silver lining: the distribution of interest rate risk has improved in a pro-growth way. Lower rates have allowed many middle class households to lengthen their liabilities and shift toward fixed rate mortgages. Many growing firms issued debt or lengthened maturities. The result: a redistribution of long-term capital in a way that makes the economy more stable.

Are the Hedges About to Get Trimmed?

While we are optimistic about the current economic backdrop, one potentially disturbing development in the markets has been the explosive growth of hedge fund assets. Hedge fund assets are expected to reach \$2 to \$4 trillion by the end of the decade (current assets approach \$1 trillion, spread among 8,000 funds). To put this in perspective, the total

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market value of U.S. stocks is \$13.7 trillion. Average hedge fund assets under management are now around \$29 billion for each advisor, and global hedge funds pulled in over \$38 billion in new assets in the first quarter of 2004—the fourth consecutive quarter of record flows. Many mutual fund companies are setting up their own hedge funds or funds-of-funds to counter the attractions of hedge funds. As this occurs, the lines are getting blurred between the offerings of traditional fund companies and hedge fund managers as the former seek to



"I'm looking for a hedge against my hedge funds."

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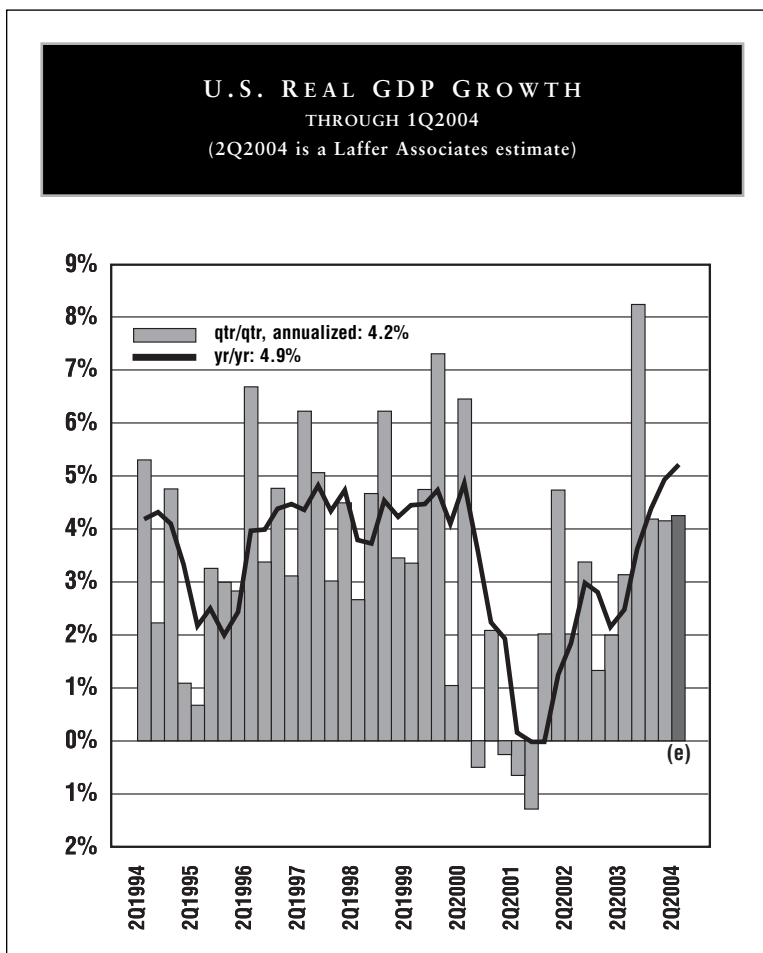
compete with the latter. Funds-of-funds have blossomed as a result of this competition. In fact, the funds-of-funds industry now controls over 30% of the hedge fund business. Thus you have an exponentially increasing level of assets pursuing similar investment styles. As more hedge funds try to exploit the same market-inefficiency opportunities, returns should decline. This phenomenon is illustrated well in *When Genius Failed: The Rise and Fall of Long-Term Capital Management* by Roger Lowenstein, which narrates the spectacular collapse of Long-Term Capital Management (LTCM) in 1998.

It is estimated that program trades (which are frequently used by hedge funds) account for, on

average, 55% of the daily volume in the equity markets. Program trading is the computer-driven buying or selling of baskets of 15 or more stocks by index arbitrage specialists or institutional traders. It has been blamed for excessive volatility in the markets, especially on Black Monday in 1987. Hedge funds are by nature generally very short-term oriented and tend to be heavy traders. As a result, volatility is increasing and the average investment horizon of “investors”—which currently stands between 10 and 11 months—continues to shrink. In addition, the use of leverage has grown rapidly. According to the *Wall Street Journal*, margin debt used by investors in funds-of-funds has increased substantially. Moreover, the funds

themselves will then combine their investors’ leveraged money with their own borrowed funds and proceed to invest those assets into additional hedge funds which in turn frequently employ a significant amount of leverage. In effect, the progression from margined investor through hedge funds’ investing leads to a multiplier effect, much like an upside-down pyramid balanced on a small block of equity. An extreme example of hedge fund leverage was illustrated by Long-Term Capital Management, which at one point was leveraged 100 to 1 via the use of derivatives in 1998! It only took a small negative change in several “bets” made by the PhD geniuses running LTCM for the Fund to implode and spark a global contagion that forced the Fed to come to the rescue of our financial system.

As we know, expectations can change rather rapidly. Up until a few months ago, many thought the U.S. still had a deflation problem, not to mention an unemployment problem and a growth problem as well. Now the concern has



Source: Haver Analytics; Bear Sterns & Co., Inc.

flip-flopped to inflation, causing wide fluctuations in bond yields, mortgage rates, interest rate expectations, and currencies. With the extensive use of leverage today, as long as interest rates remain relatively low, a major catastrophe may be avoided. However, if rates rise at a faster pace than hedge fund managers expect, then watch out! We may witness the old adage, “When the Fed slams on the brakes, someone always goes through the windshield.”

Back to the Basics

In some respects, investors must occasionally feel like the white-knuckled travelers whose stomachs are in their throats as a nervous attendant informs all passengers that they are experiencing heavy air turbulence. Our investor-passengers want to know when they are going to get out of this mess. While our seat belts are fastened, and in spite of some nasty bumps, in most seasoned accounts we are relatively fully invested, with some reasonable cash reserves. How can we be comfortable with this position when economic and political uncertainties abound? A key reason is because our clients’ capital (as well as our own) is invested in businesses with growing values and because, in most cases, we have paid no more than 50% of our estimates of a business’ corporate worth. In addition, we can capitalize on the anxiety of others. With the growing influence of hedge funds and given that global violence and terrorism are likely semi-permanent conditions of today’s environment, it is worth noting that volatility and uncertainty can create extraordinary investment opportunities in the markets.

Despite occasional missteps, we consider ourselves to be long-term owners, not traders or speculators. Our time horizon when purchasing a stock is approximately one to three years. One of the hallmarks of our investment process is our focus on private-market value, or intrinsic value. Private-market value, conceptually, is the price a rational,

independent buyer and seller would negotiate in an arm’s length transaction for a given company. If the stock price of a company is at least 50% below the calculated private-market value, then we believe the situation could prove to be an attractive investment opportunity.

At any given point in time, intrinsic value is largely a function of earnings power and cash flow. Whether stocks trade at, above, or below intrinsic value is often a function of investor psychology. Barring a major change in the company itself or a technological change within the industry, a company’s private-market value or intrinsic value is not altered substantially over a few quarters. However, intrinsic value and equity prices are two very different things. Emotion and shortsighted “investment horizons” will periodically drive the price of a stock materially above or substantially below intrinsic value. Those periods when a stock price is significantly below intrinsic value are exactly when the most attractive investment opportunities abound.

To illustrate, assume one buys the stock of a company for one-half of its intrinsic value and that company grows its value by 12% per year through retained earnings. If the stock price rises to reflect that corporate worth in the fifth year, the investment would have compounded at a very attractive rate of 29% per year. Interestingly, two-thirds of the return would come from the perception gap between the market price and the actual value of the company closing (i.e., the stock price finally reflects the value inherent in the company); only one-third of the return would come from the value of the business growing.

What is interesting about the private-market value approach is that it can find value in any market cycle or during any economic condition. It does benefit clients during periods when there is a high level of liquidity in the capital markets, but it is

not dependent on merger and acquisition (M&A) activity. Undervalued businesses may reach their intrinsic worth in several ways. Market realization is one way. Over time the market may recognize a business' true value. Share prices of companies with true earning power and strong cash flow generation should be bid up by the market as these companies report better earnings. This was true with our investment in Boston Scientific, which has risen dramatically since we first purchased it in 1998. When initially bought, we believed a disconnect existed between the long-term potential of the company and the market's short-term focus on the company's quarterly problems which, in fact, were temporary in nature. Another example is Countrywide Financial, which has risen approximately 225% since it was first purchased. Investors failed to appreciate the inherent strength in the business of Countrywide, which was structured to benefit from both a booming housing market as well as capturing market share in a more stable market. The value of its franchise has kept growing over a multi-year period as investors viewed it as simply another cyclical interest play.

A company can also reach its intrinsic worth through merger and acquisition activity. Undervalued companies often attract other strategic or financial buyers who will make a bid for them, often at a healthy premium. KING is not the only one who utilizes and has benefited from this type of valuation process and we are generally not surprised when such activity occurs. Throughout the history of the firm our clients have benefited from this merger and acquisition activity as a byproduct of our emphasis on private-market value. A company's stock price may also reach its intrinsic value by partially liquidating its assets or operations through spin-offs of subsidiaries or by selling a part of its business. Finally, a major share repurchase program can enhance shareholder value if repurchasing shares is the capital allocation choice with the highest return. Management can

then grow the value of the business and shrink the number of owners sharing the returns.

Throughout the years, we have found many stocks that have met our buy criteria. However, in addition to meeting our valuation standards, we also look for companies that have a catalyst of some sort in order to avoid so-called "value traps" (i.e., stocks that are "cheap" but which remain "cheap" for years). We also look for a catalyst that will enhance the growth of a company's earnings or cash flow (examples can include a new technology, launching a differentiated product, etc.).

We believe that our adherence to private-market value will continue to reward our clients over time. Despite what history has taught us about the valuation of stocks, in uncertain times the mass media and most mainstream financial publications, along with the general public, will accentuate and be mesmerized by the negatives that exist around the world (high commodity prices, escalating oil prices, global violence, terrorism, etc.) precisely at the time that such conditions are already discounted in stock prices. In the near future, we believe that the focus will shift back to fundamentals, accelerating economic conditions, and healthy corporate profits. Stocks will begin to move upward again. In the meantime, short-term volatility should continue to present pockets of opportunity for our clients and other far-sighted, patient investors.

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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.

Sources: Barron's *Dictionary of Finance and Investment Terms*; Bear Stearns & Co., Inc.; Haver Analytics; Schwab Soundview Capital Markets; Laffer Associates; Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*

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