

# DecisionMaker

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*You pay a very high price in the stock market for a cheery consensus.  
Uncertainty actually is the friend of the buyer of long-term values.*

— WARREN BUFFETT

The third quarter of 2007 was certainly a volatile three months for U.S. equity investors. After posting solid returns for the first six months of the year, the major U.S. equity indices sold off sharply during the third quarter before recovering in the month of September. Unrelenting bad news regarding the precarious state of the domestic housing market continued as the third quarter began. This time, however, the bearish data points on the housing market were combined with new fears of a classic “credit crunch.” Fear and uncertainty not surprisingly led to selling pressure that grew stronger in August. The equity markets stabilized in September and rallied sharply when the Federal Reserve lowered the discount rate and the fed funds rate.

The first day of trading at the outset of the third quarter gave no indication of the coming market turmoil as the Dow rose 127 points on positive manufacturing data. A few weeks later, on July 17, the Dow closed over 14,000 for the first time ever. The celebration would be short-lived, however, as subprime mortgage market worries resurfaced and sent stocks lower. Trading volumes began to accelerate ominously on the downside, and in late July, for the first time, more than 5 billion shares changed hands on the NYSE on a day that saw the Dow shed over 300 points.

Worries about the continued softness in the domestic housing market and questions about the health of the average subprime borrower were compounded by an even larger worry when Bear Stearns announced in late July that two of its hedge funds that bet heavily on mortgage-backed securities, including collateralized debt obligations (CDOs), had suffered sharp losses. Shortly thereafter, *The Wall Street Journal* reported that Bear’s more levered fund, the High Grade Structured Strategies Enhanced Leveraged Fund, was “virtually worthless.” Participants in this fund received a painful education in the perils of “Enhanced Leverage.” After the Bear news, investors questioned the portfolio quality of numerous financial entities, including the largest money center banks, usually viewed as pillars of stability given

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their size and business diversity. Concerns that the “subprime contagion” would spread outside the U.S. and become a worldwide phenomenon gained credence when banks and hedge funds in Germany, Singapore, and Australia reported large losses from mortgage-backed security holdings.

In the wake of these multiple write-downs, the three letters “CDO” became the most ubiquitous acronym in the financial media landscape. A CDO is an asset-backed, structured credit product that offers credit exposure to a portfolio of fixed income assets and divides the credit risk among different tranches, or classes of debt (the higher the return, the riskier the tranche). The problem with CDOs is that even the supposedly less risky, higher rated tranches carry real risk because a CDO is essentially a re-packaged debt instrument taken from the lower rated tranches of a mortgage-backed security (derived from a large number of mortgages pooled together). In other words, even though the highest rated tranche of a CDO may be the least risky for that CDO, all tranches of the CDO were derived from the lower credit quality tranches of a mortgage-backed security. The bottom line is that a AAA credit rating for a CDO tranche is very misleading. To make matters worse,

several years ago the ever-creative financial minds at the large investment banking houses created a product that is a CDO of a CDO, or a CDO squared (CDO<sup>2</sup>). A CDO<sup>2</sup> is created by taking the lower rated tranches of a CDO (which itself is derived from the lower rated tranches of a mortgage-backed security) and slicing them up into another structured security with various ratings based on credit risk. Our personal favorite is the CDO<sup>n</sup>, a generic term for a CDO cubed and higher! Obviously, the farther one gets from the original mortgage-backed security, the higher the risk and the more meaningless the credit rating of the upper tranches.

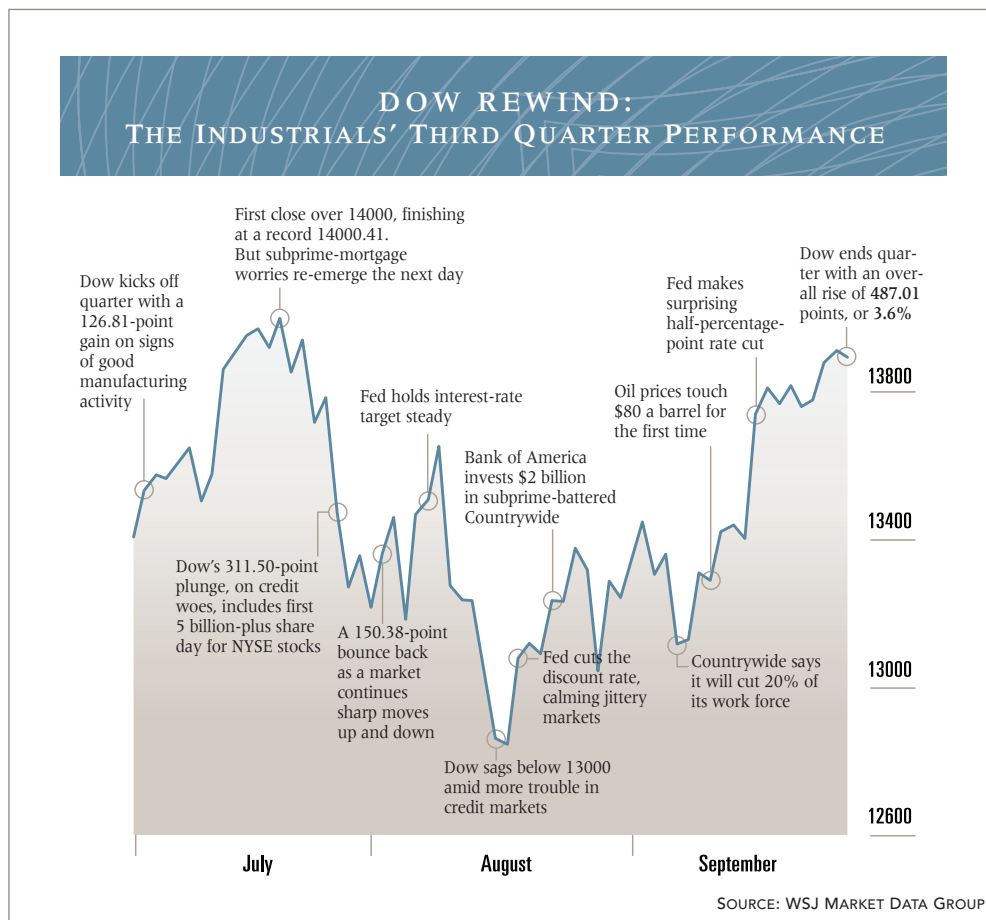
If these structures do not sound dangerous enough on their own, many hedge funds and other financial players have used leverage to amplify their returns on these CDO investments. The Bear Stearns news exacerbated the existing unease surrounding these instruments, and the implied value of CDOs fell farther as measured by the ABX Index, which assesses the risk of owning bonds backed by home loans to people with poor (subprime) credit. Valuations of lower-rated tranches derived from the ABX Index declined to almost unprecedented levels, much lower than the forecasts of the “models” of these supposedly astute CDO investors. It is important to remember that these securities are backed by mortgages of real homes on real property that have real value (even in the case of a borrower default). In other words, the fire sale prices implied for some CDO tranches by the ABX Index were, in all probability, too low. The problem was that CDO investors such as hedge funds, especially those that were leveraged, did not have the luxury of waiting for the storm to subside because they had to mark their portfolios to market. These hedge funds found out the hard way

that the value of their securities was whatever the market would bear at the time, not what a theoretical computer model spit out on a screen. Leverage is a dangerous animal on the downside—a hedge fund levered ten to one needs only to experience a 10% decline to wipe out all of its equity.

Given the precarious positions of leveraged funds invested in CDOs, multiple prime brokers sent out margin calls to these funds informing them that their collateral had become insufficient. The fund managers who received these margin calls obviously were forced to sell securities, and sell they did! Other fund managers who may not have experienced margin calls but suffered hits

to performance nonetheless sold as a proactive measure to raise funds for anticipated investor redemptions. Selling usually begets selling, and the equity markets continued to move lower as the level of fear increased. To make matters worse, numerous companies in the mortgage arena that had never had problems accessing the capital markets found themselves shut out as banks withdrew credit lines. Access to the commercial paper market, usually an extremely reliable source of short-term financing, essentially froze for all but the most credit-worthy borrowers. Leveraged buyouts (LBOs) by private equity firms, fed by easy access to cheap credit and a driver of stock price appreciation over the past few years, ground to a

screaming halt as private equity firms and investment banks had their hands full simply finding buyers of debt issued to fund buyouts announced months ago. Finding buyers of debt for potential new deals suddenly became out of the question. Bear Stearns CFO Sam Molinaro offered a succinct assessment of credit conditions, "I've been out



here for 22 years, and this is as bad as I've seen it in the fixed income markets."

Considering this dire backdrop, investors sold first and asked questions later. Stocks in the financial sector were hardest hit. As is usually the case in turbulent times, investors fearing the worst about a potential credit crunch and the worsening subprime mortgage situation did not differentiate among financial equities and sold these shares across the board, including those financial issues with limited exposure to the credit crunch. Though the financial sector suffered the worst declines, the selling was widespread on heavy volume. Even lower beta behemoths such as General Electric and Microsoft sold off, which upon further examination makes

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sense because these stocks are some of the most liquid names in the market and easy sales for those hedge fund managers in need of quick cash. Action in selected smaller issues was even more violent, and in some cases shocking. Teleflex, a \$3 billion conglomerate typically no more volatile than any other company its size, declined from a high of \$87 on July 23 to an intra-day low of approximately \$60.75 on August 9 on no news. Incredibly,

the stock closed at \$74.91 the next day! The roller-coaster action of Teleflex was but one example of investors taking advantage of troubled players forced to liquidate stocks at any cost. On the morning of August 16, the Dow declined over 300 points to reach an intra-day low of 12,518, less than a month after its first close above 14,000. With the credit markets still not functioning adequately and the amount of commercial paper outstanding continuing to contract, Fed Chairman Ben Bernanke had seen enough.

Before the markets opened on August 17, Bernanke lowered the discount rate (the rate charged by banks who borrow from the Fed) by one-half percent. The equity market stabilized over the next few weeks, and on September 18, the date of a regular Fed meeting, Bernanke acted again by cutting the discount rate another one-half percent and lowering the fed funds rate one-half percent. Stocks across all sectors reacted immediately and rocketed higher. Pundits in some circles had derided Bernanke as purely an academic with little real-world experience, and thus ill-suited to the task of successfully and pragmatically steering the economy through a credit crunch. Far from having his head buried in the sands of academia, the new Fed Chairman analyzed the situation rationally and made the initial, surgical move of cutting the discount rate. When this move stabilized the equity markets but provided little relief to the struggling credit markets, the Federal Reserve lowered the discount rate again and decisively cut the fed funds rate not by 25 basis points as some had expected, but by a full 50 basis points. We believe that Bernanke handled the credit crisis admirably by intelligently taking the proactive action of a full 50 basis point fed funds cut in an effort to ensure adequate liquidity going forward.

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The credit markets have been repairing themselves since the Fed's action on September 18. Total bond issuance in the month of September reached a record of \$110 billion. The commercial paper market has been improving as well. For the seven-day

period ended Wednesday, October 4, the total amount of commercial paper outstanding increased for the first time in eight weeks, continuing a period of normalization begun three weeks earlier. Stabilization in the commercial paper market is also evident in commercial paper rates. The rate paid on 30-day asset backed commercial paper (the area of the market hit hardest) recently fell to 5.26%, down a sizable 1.09% from the peak set on September 12. Finally, one of the best measures of credit fears in the bond market is the 10-year swap rate—especially when one considers that the interest rate swaps market makes up about 75% of the \$400 trillion derivatives market. When financial players with interest rate exposure worry about the possibility of wider credit spreads (as they did during the market sell-off), they rush to swap their floating rate obligations for fixed rate obligations, driving up the swap rate. This phenomenon happened in August when the 10-year swap



spread spiked to 80 basis points from only 50 basis points a few months earlier. Since then, the spread has narrowed to slightly over 60 basis points.

With the Dow and the S&P 500 back where they started before the credit crunch began, where do we go from here? Doomsayers predicted that the demise of the private equity-led buyout craze

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would spell an end to the bull market. With the Dow and the S&P at new highs of late and LBO activity at a trickle, those fears were obviously misplaced. The loss of LBO activity is, in many respects, a non-issue. LBOs add very little economic value. One actual positive to the end of the LBO frenzy is that LBOs crowd out the credit markets by absorbing capital that would otherwise have gone to businesses seeking funds to expand their companies. What matters more to the economy is the ability of a given company to build a factory, not whether a company (or a private equity firm) can finance the purchase of

another company. Equally as important, no investor should lament the decline of structured products volume such as CDOs as a sign of macroeconomic malaise. CDOs and other similar products are merely just packages of debt that have already been packaged in the first place. What is most important to the economy is debt origination and the initial securitization of the debt, not the subsequent repackaging and slicing into various tranches. Indeed, as former Fed Chairman Alan Greenspan recently stated, there is "a limit to how many (new products) you can create, and we're way past that limit as far as I'm concerned. A lot of structured products are going to have short life expectations." Good riddance, as far as we are concerned.

As painful as the third quarter sell-off was, it should not have been a complete shock as it had been over four years since the S&P 500 experienced at least a 10% correction. Admittedly, things are not rosy in all sectors of the economy. Persistently high commodity prices are pressuring the consumer, and the housing market remains bleak with an 18-year high in inventories of unsold homes and soft sales constrained by several factors, not the least of which is the expectation that prices have farther to fall.

Despite these headwinds, we remain confident about the prospects for equities and believe that fears of a recession are most likely misplaced. Economic unease made headlines in August when the government reported a loss of 4,000 jobs. On October 5, however, this figure was revised to a gain of 89,000 jobs, and it was also reported that 110,000 new jobs were created in September, numbers that do not exactly point to an imminent recession. These revisions are yet another example of the dangers of making decisions based on

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knee-jerk reactions to monthly numbers. Though GDP growth has certainly slowed from its previous pace of the last few years, the growth rate over the next few quarters is likely to be strong enough to support continued stock price appreciation. If growth comes in below expectations, Ben Bernanke has already proved once that he will use all of the tools at his disposal to avoid a debilitating recession. Strong U.S. exports and less reliance on imports, reflective of healthy economies overseas and a weak U.S. dollar, are boosting domestic production and job creation. Also, U.S. corporations are well positioned to withstand a contraction in economic growth should one occur. Prior to previous economic downturns, business capital spending usually grew too fast. Consequently, most of the decline in GDP during past economic contractions was attributable to inventory liquidation, which translated into cutbacks in production and jobs, sharply lowering capital spending. The conditions of excessive capital spending do not exist today. U.S. corporations have become much more nimble in adjusting their production schedules. As a result, business inventories outside of the

housing sector are very lean, greatly reducing the potential impact of any slowdown in demand on production and employment.

Corporate America has also constrained investment spending while maintaining high cash balances. Corporate cash is extremely high relative to capital spending, indicating that companies have plenty of internal funds to fuel their expansion plans. This cash hoard has driven corporate buybacks to record heights this year. Insider buying, usually a positive harbinger of future stock price action, picked up markedly during the summer months. During August alone, public company executives and directors purchased more stock in any single month since 1990. Domestically, corporate profits are still growing, and the engine of global economic growth continues to run efficiently. In terms of the U.S. consumer, real disposable income has historically been the dominant factor that drives consumer spending. Labor markets remain tight, and rising personal incomes will go a long way in offsetting the adverse impacts of declining home prices and elevated energy prices. September's employment gain was very encouraging given that the month covered a period of severe financial dislocation, highlighting the fact that trouble on Wall Street does not automatically lead to turmoil on Main Street. Valuations of domestic equities are still attractive despite the recent market recovery, and we remain convinced that our Business Valuation Approach will continue to reward the patient investor.

Ryan C. McCleary, CFA  
Vice President

The year 2007 marks KING's Twenty-Sixth Anniversary. 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-six 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 FOR THIS ISSUE

Bloomberg L.P., John Maudlin, Miller Tabak, *The Wall Street Journal*



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