

DecisionMaker

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Buy a business, don't rent stocks.

— WARREN BUFFETT

While the year got off to a good start, stock prices around the globe retreated toward the end of the quarter as concerns regarding rising inflation, subprime mortgage loans, the health of the economy, and U.S. protectionism unsettled investors. Concerns regarding the stability of the Middle East and the recent standoff in Iran caused oil prices to rise nearly 18% over the course of the last eight days leading up to the end of the quarter.

Because inflation continues to weigh on the minds of many, at the end of March, Fed Chairman Ben Bernanke explained why he sees inflation being tamed in America. He noted that inflation is a bit higher than he and the Fed would like to see, but still well below historical levels and at a rate that would have thrilled Americans for most of the past thirty years. Also, while the Consumer Price Index (CPI) has crept higher over the last several months, it is important to look at the composition of the Index. First, the recent decline in housing prices has not had an impact on this measure of inflation, as housing prices are not included in the Index. However, rental costs and rent-equivalency together account for approximately 40% of the CPI. As many subprime borrowers have sold their homes or lost them through foreclosure and moved into rented quarters, their extra demand has caused rents to rise. An eventual return to home ownership would cure the rental boost to the CPI. Additionally, demand for goods and services is currently running below the economy's ability to produce, a situation which certainly is not inflationary. Finally, while higher oil prices have boosted the CPI, the recent Iranian decision to release the captive British sailors should assuage fears of a significant spike in oil prices. Multiple pieces of evidence suggest that the worst may be behind us.

Another reservation on the part of investors is the overall health of the economy. Concern has been sparked by the near-hysteria generated by the reports that some 2% of American mortgages (mostly of the subprime variety) may be on the path to foreclosure. Despite the fallout, however, Bernanke believes that the financial industry is large enough, strong enough, and wealthy enough to absorb the majority of the problems generated by the defaults in the subprime sector. We tend to agree.

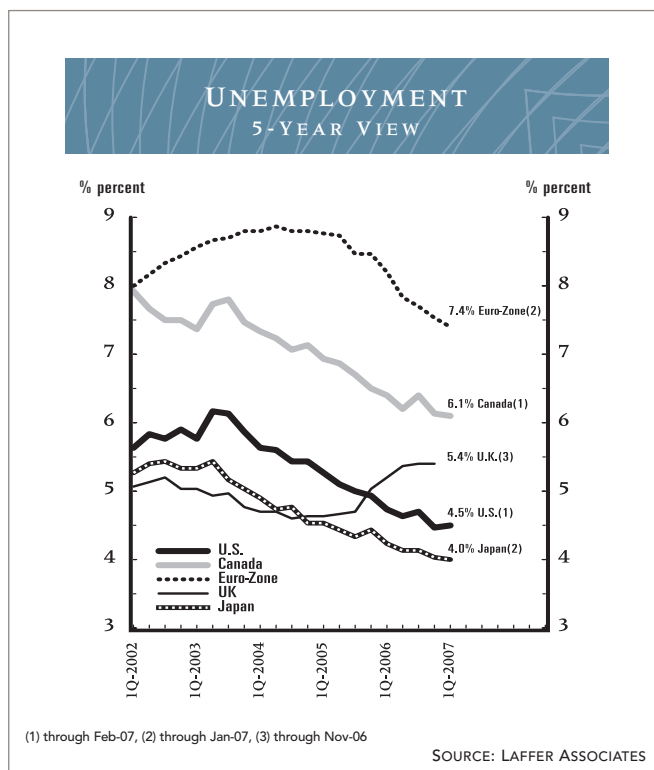
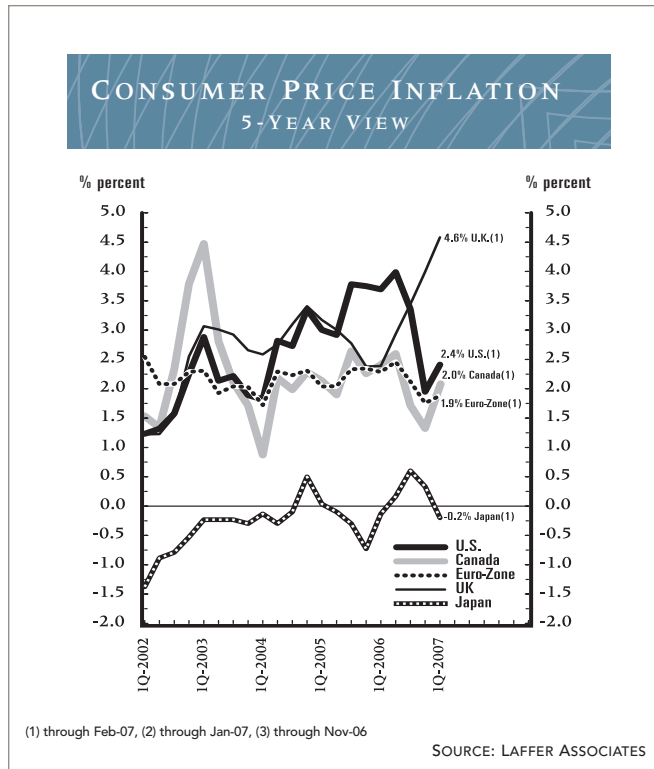
Why should the subprime crisis be contained? While the subprime implosion has been quite sensational due to the accelerated motion of these events as well as the

number of companies involved (approximately 30 have filed for bankruptcy since the start of the year), the belief that these events will start a contagion

that will severely impact the overall economy is probably overstated for a number of reasons.

First, consumers who drive the economy are not subprime borrowers; subprime borrowers have very little discretionary income. The Labor Department estimates that the bottom 20% of U.S. households accounts for approximately 8% of consumer spending. By contrast, the top 20% accounts for 40% of spending. If you assume that the subprime lenders will be found primarily in the bottom 20% and you further assume that the predictions of the default rate on these subprime loans will not top 20%, you are talking about a very small hit to consumer spending.

Second, many of the problematic loans were written by companies that were not banks or thrifts (such as New Century), and thus, were not under Fed supervision or regulation. Most of the large mortgage companies such as Countrywide, IndyMac, etc. do have exposure to some of today's problems, but their exposure is much more limited, as their underwriting standards were more stringent than the majority of subprime lenders. It is important to take a step back from the media hype and put the current "crisis" into perspective. On March 28, 2007, the Associated Press released an article that appeared in newspapers all over the country. The headline read, "Home prices continue downward trend." The subheading proclaimed: "Decline in housing prices stirs fear of a softening in economy." Then the article spoke of the steepest year-over-year decline in a home-price index in 13 years. The impression this article, as well as many others like this leaves, is that the housing market is in full retreat and headed for a severe decline. If we closely analyze the details of this article, we see that of the ten major markets covered by the article, three actually showed price



gains (and in one case a gain of 4.2%). Six showed pricing declines— with Boston being the worst— and one city was flat. Taken together with all other markets, the national average was down by **seven-tenths of a percent**, year-over-year. The article also stated that the current decline was the largest in 13 years. The 13-year reference was probably deliberately chosen as home prices fell by nine-tenths of a percent year-over-year just over 13 years ago. So the article made it sound like the current scene was a disaster. In addition, no reference was made to the fact that 14 years ago home prices (as defined by the median price of houses actually sold) fell 6% year-over-year— nine times as severe as the actual national decline of the past 12 months. This is not to say that there are not regional mini-bubbles in the real estate market that are undergoing an overdue, but painful correction, nor is it to say that there are not financial entities that had lax standards and had made poor underwriting decisions with respect to lending money. The point is that things need to be put into perspective and not exaggerated. Third, while problems are present in the mortgage market, personal income continues to be on the rise. In February, hourly wages rose 4.1% year-over-year, and unemployment dropped to 4.5%, approaching a six-year low. Historically, income and employment have had high correlations with the average consumer's ability to pay his mortgage.

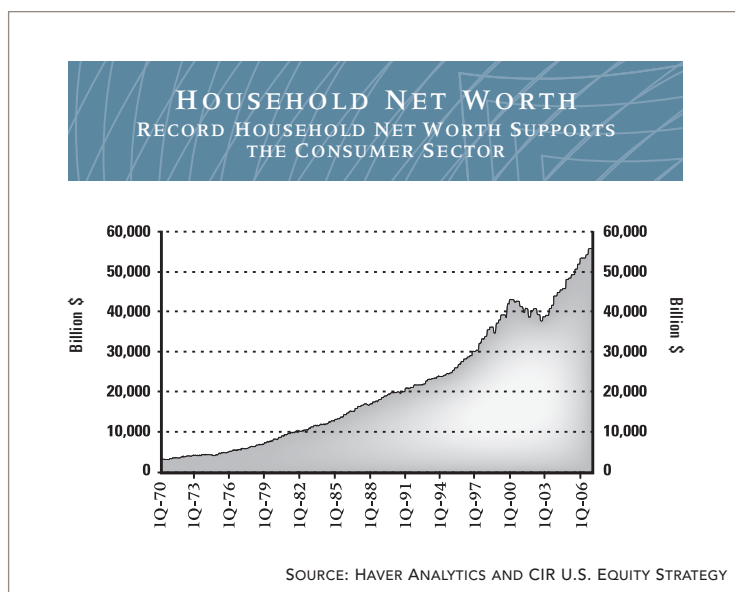
Interestingly, despite the recent turbulence in the financial markets, insider buying in the financial sector has hit a three-year high. As Peter Lynch, the legendary investor and former manager of the Fidelity Magellan fund, once said, "Insiders might sell their shares for any number of reasons, but they buy them for only one: they think the price will rise." He is of course correct. Insiders may sell stock to pay off debts, pay taxes, buy a house, buy a boat, diversify, or pay children's college tuition. When you see a report of insider selling, it does not tell you why they sold. But when insiders use their personal

cash to buy shares, there is only one reason why— they expect to make a profit as the stock goes up. Insider buying has been present in stocks such as Citigroup, IndyMac, and CompuCredit, among others.

★ ...household net worth hit a record high at the end of the year, providing continued support in the consumer sector. ★

While the housing market is sure to continue to grab headlines, the reality is that the majority of consumers will not be overly impacted by the market adjustments that are occurring around the country (unless you are actually selling your house in one of the harder hit areas during this time). Forgotten amidst the cascade of negative news stories is the fact that household net worth hit a record high at the end of the year, providing continued support in the consumer sector. Interestingly, real estate has not been the primary driver of the enormous amounts of wealth that have been created over the last several decades. To put this into perspective, consider this: If you purchased a home in Washington, D.C. in 1982 for \$100,000, it is likely worth approximately \$560,000 today. A \$100,000 investment in the Dow Jones 30 Industrials would now be worth more than \$1.5 million over the same time frame. This is despite two market crashes and numerous market corrections.

Even Mr. Bernanke recently commented that consumers have proven "quite resilient" despite the housing slump and the recent increases in energy prices. According to Bernanke, consumers could continue to spend at a pace that would make



the economy grow faster than is currently expected, given a strong job market that is producing heftier paychecks. Several Fed Governors have also commented that they expect the economy to rebound a bit in the second half of the year. While at least one interest rate cut is expected before the end of the year, the Fed has room to cut interest rates even further if the housing market does continue to deteriorate and a second-half rebound fails to materialize.

Finally, in the face of a declining housing market, consumer sentiment is not too bad. The Conference Board's Consumer Confidence Index fell to 107.2 in March from 111.2 the previous month, when it reached the highest level since August 2001. In contrast, the consumers' assessment of the present situation actually increased to 137.6 from 137.1 in February, reaching its highest point since 2001. This increase is important because it suggests that on the whole, consumers are fairing reasonably well with respect to income gains and their personal balance sheets. Also driving the Index higher was an increase in the percentage of respondents who said that jobs were plentiful. This metric, which historically has had a high correlation to employment trends, increased to

30.5% from 27.8% in February, its highest level since August 2001.

The Role of Hedge Funds in Our Financial Markets: Risks or Opportunities?

While recent headlines have focused on the woes of the subprime mortgage market, another significant development with wide ranging impact on financial markets is also gaining increased attention, namely the growth and impact of hedge funds. Hedge funds have become a dominant and very influential participant in

today's financial markets. In fact, they have altered the financial landscape in many respects. In order to understand many of today's investment trends, risks, and opportunities, it is important to gain some insight into how many of these funds operate and what their relationships are with Wall Street.

According to *HedgeFund Intelligence*, hedge funds manage approximately \$2 trillion— this is a dollar amount that is in excess of many major central bank reserves. Despite this vast sum, the hedge fund industry is challenged because it has to generate very high gross returns before expenses in order to satisfy investor expectations, maintain the generous payouts to the hedge fund managers, and pay the high execution costs to the investment banks. Hedge funds end up paying approximately 4% of their assets under management to the investment banking industry (for prime brokerage services, margin interest, and commissions) and another 4% to 5% to their individual managers. To maintain these revenue pools and satisfy investors, hedge funds need gross returns of nearly 20% on a year-in and year-out basis. The problem in trying to generate these returns is that many hedge funds follow spread-driven long-short strategies, where the expected return on assets (ROA) tends

to be lower than the ROA from a directional bet on securities or markets. Only leverage can square a high expected return-on-equity (ROE) with a relatively low ROA.

Despite seemingly diversified investment strategies, the common denominator for many hedge funds is a leveraged bet on stable or converging risk premia across many asset classes. As a result, return correlation has increased massively since 2003 (from the lows of 30% to 40% in mid-2003 to 80% to 90% at present). We can think of many hedge funds as leveraged sellers of deep out-of-the-money put options which are short volatility. A risk is that in a virtuous cycle, more such bets trigger more convergence, which in turn triggers more bets. But the decline of risk premia and volatility in different markets may not have much further to fall. In fact, according to many sources, the aggregate performance of the hedge fund industry is trending down over time, with returns falling on average 1.2 percentage points each year as a herd of participants are chasing the same assets. If something makes the prevailing convergence bets unattractive or dangerous, a rapid liquidation (a great unwind) across many asset classes could be triggered and cause unpleasant consequences for many. As a result, we could see several hedge funds fail due to forced asset liquidation. Despite the potential fallout in the hedge fund industry, the banking industry as a whole should be fairly well protected. Banks themselves have become significantly more sophisticated in risk management over the past decade, making a global meltdown created by a derivatives failure unlikely.

One cannot underestimate the importance of hedge funds to investment banks. Hedge funds contribute an estimated 15% to 20% of global investment banking revenues, highly disproportionate to the 1% (without leverage) of global financial assets they manage. Approximately 25% of pre-tax profits at the investment banks of Credit Suisse, Deutsche

Bank, and UBS can be attributed to hedge funds. U.S. bank revenues from trading derivatives rose 31% to a record \$18.8 billion in 2006, driven by high client demand among hedge funds and other institutional investors. U.S. banks' total derivatives holdings hit a record \$131 trillion at the end of 2006. The \$131 trillion in derivatives represents the face value, not the amount at risk of the underlying assets. Thus over the last several years, the relationship between the hedge funds and the investment banks has become a symbiotic one, and in some cases, possibly a parasitic one.

Because of the importance of hedge funds to Wall Street (both in terms of investment banking and trading commissions), there is a strong incentive for investment analysts' reports to be geared toward their largest generators of revenue and therefore to be very short-term in focus. To illustrate, the average Wall Street firm collects \$33 million a year in stock-trading commissions from the average hedge fund, versus \$16 million from a mutual fund or typical long-only money manager. Since 2003, when ten of the largest securities firms agreed to pay \$1.4 billion in fines and banned their analysts from compromising their research to win investment banking fees, research departments have had to rely on sales and trading for funding. The practice of pandering to hedge funds has become so pervasive that many analysts have actually left Wall Street. One former analyst, who recently left Wall Street, stated that while working as a sell-side analyst, "Half the people I talked to did not care what companies actually do, they're wondering, 'Will I make money if I trade this stock?'" The shorter time frame of such investors and their disdain for depth has caused research reports to lose most of their value." While hedge funds control approximately 3% of global financial assets (with leverage), they account for a disproportionately larger share of 30% to 60% in the turnover of many markets. According to Greenwich Associates, hedge funds pay approximately 30% of all equity commissions in the U.S.

Given that asset prices are set by the marginal trader buying or selling at the last price (rather than by inactive owners), the impact of hedge funds on daily asset pricing is significant. And with Wall Street catering to the short-term trading nature of the hedge fund community, the stock prices of many companies have begun to reflect the sentiment of the day about a stock, and not what the intrinsic value of the company is in reality.

The silver lining in this cloud of myopic opportunism is that this inefficiency of pricing creates substantial opportunities for long-term investors such as KING, who are willing to do their own research and take a longer-term view. Private equity firms are another example of a group of investors who are taking advantage of this divergence and the pricing inefficiencies created by hedge funds. Private equity firms have provided significant fuel to the explosion in the merger and acquisition (M&A) activity over the last several quarters.

Over the last 18 months there has been a significant rise in M&A activity by both private equity and by corporations buying other companies. Last year there were \$391 billion in leveraged buy out (LBO)-related mergers and acquisitions—a huge year for transactions. During the first quarter of 2007, the value of announced LBOs surged 40% to

\$188 billion, led by Kohlberg, Kravis, and Roberts (KKR's) record \$44.1 billion attempt to acquire Dallas-based TXU. In fact, LBO firms have raised an additional estimated \$210 billion since the start of 2006, and low bond yields mean they can borrow enough to afford at least two trillion dollars of acquisitions. In addition, many of the transactions are at significant premiums. A key question is, why are acquirers willing to pay premiums to buy businesses? Three major factors are primarily responsible.

First, the cost of debt is relatively low. KKR co-founders Henry Kravis and George Roberts paid 14% in interest on loans and bonds when they engineered the \$13.3 billion takeover of RJR Nabisco in 1989. RJR Nabisco was the largest LBO until this past year. As a comparison, when KKR agreed to buy HCA recently, the third largest LBO, the debt-financing cost was approximately 8.5%. The debt financing for TXU would most likely be even lower. The reality is that LBOs are easier to fund today due to cheaper debt and more relaxed debt covenants. In fact, loans for LBOs jumped 65% to \$1.4 trillion during the past year and sales of bonds rated below investment grade climbed \$218 billion, up 73% from the previous 12 months.

Second, and a critical factor, is the previously mentioned short-term time horizon of today's market participants. When the emphasis and time horizon of the majority of today's "investors" is just a few weeks in length, the ultimate value of a company is often being overlooked by existing shareholders (i.e., its longer-term pipeline, a major product launch that might be a few quarters away, opportunities for a company to unlock value in its balance sheet or in overlooked divisions, etc.). An investor who has the ability and willingness to look out over a time horizon of 18 to 24 months—an eternity for today's traders—can more accurately gauge what the cash flow of a company will be and what the actual potential of a company's stock is (or may be). These are elements for which



"I don't know whether mortgage rates had gone up. Now may I continue?"

a sizable percentage of today's "investors" are not accounting when putting money to work in the market. As a result, inefficiencies in various stocks are continually developing, and private equity and corporations can capitalize on these trends by either taking these companies private or acquiring them under the umbrella of a larger corporation—even at significant premiums to today's market prices. These longer-term investors can earn annual returns of 30%+ over the course of about three years. Boston Scientific Corporation is an example of investor myopia. Boston has been plagued by numerous short-term concerns as well as some safety issues related to drug-coated stents. At current levels, investors are assuming that the markets in which the company operates will never rebound, and very little credit is being given to its pipeline or management's ability to generate cash flow. Theoretically, the company could do an LBO as the co-founders own approximately 30% of the shares outstanding. In an LBO-type of scenario, a dollar price in the low twenties could be paid with the acquiring party making an internal rate of return in the 55%-68% range by 2010—not a bad return for someone willing to look a short two to three years down the road!

The last factor is a misalignment between some management teams and long-term investors. Today, many companies are not adding value for shareholders as they are sitting on too much cash on their balance sheets, cash which is earning returns that are less than what the company earns on its core operating assets. These companies are becoming sitting ducks for private equity or other corporations. Part of the problem is the disconnect that exists due to the misalignment of incentives throughout the financial system: private equity firms are paid to take on leverage in order to recoup cash flow as soon as possible, while corporate executives are "safest" in a post-Sarbanes-Oxley environment if they run their businesses with high cash balances and lower-than-average risk profiles.

The final piece of the Misalignment Triangle centers on hedge funds, most of which are willing to sell shares at a price that is less than fair value because of a "pop" from an announcement or due to some other very short-term trend. This misalignment creates pockets of opportunity where some stocks will trade at prices that represent significant discounts versus their respective private-market values. Investors who are more long-term oriented can take advantage of these discounts and truly create significant wealth for either themselves or for their clients.

While we believe that we may face some short-term chopiness in the economic backdrop, the overall fundamentals of the economy are on sound footing, and corporate profits should continue to grow at a healthy rate (albeit slower). Furthermore, in today's environment we believe that there are many attractively valued companies with strong balance sheets and healthy cash flows that have the potential to produce solid returns for our clients over the next few years. While merger and acquisition activity is not the cornerstone of our investment approach, we do place an emphasis on buying companies which are trading at a significant discount to their private-market values. The presence of hedge funds fixating on short-term issues and overlooking long-term potential is presenting us with many attractive investment opportunities. In addition, we are not the only ones conducting this type of analysis, as evidenced by the current M&A environment. As a result, we would not be surprised to wake up on any given morning and see one of our holdings acquired at a healthy premium. Even without any takeovers, we are optimistic about the fundamentals of the companies that we hold in clients' portfolios and believe that 2007 will be a rewarding year!

Leah R. Bennett, CFA
Senior 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.

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SOURCES FOR THIS ISSUE

Adrian Van Eck's Hotline, Bank of America, Bloomberg L.P., Citigroup, *David C. Jennett's Investment Letter*, Dresdner Kleinwort, *Market Intelligence Report*, Miller Tabak, Morgan Stanley



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