

DecisionMaker

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To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude and pays the greatest reward.

— SIR JOHN TEMPLETON

The first nine months of 2006 have proven to be a roller coaster ride. The early part of 2006 was marked by rapidly rising energy and commodity prices; fears focused on escalating inflation and how long the Fed was going to raise interest rates and to what level. Home prices around the country were somewhat stable. Today, weak growth has quickly become the dominant theme in the market, and could prompt the Fed to start easing interest rates in the first half of 2007. The latest round of housing data underpins these fears, as the slide in home builders' confidence continues from an already pessimistic level.

Concerns regarding inflation are starting to temper. In fact, the secular trend in inflation is flat, but cyclical ups and downs will periodically occur. The economy overheated last year and would have eventually triggered a sustained bout of higher inflation had the boom persisted and spread around the world. However, growth is cooling and has already had some disinflationary effects abroad. Moreover, the other main global demand engine this decade aside from the United States consumer, namely Chinese business investment, is also showing signs of rolling over—and authorities in China are determined to see it slow further.

Some of these recent events should create a more favorable environment for our holdings in client portfolios. Early in 2006 commodities and energy prices soared. Because our portfolios were underweighted in these groups, our relative performance lagged a bit. But lately, these asset prices have undergone a significant correction for a variety of reasons. The principal catalyst for the commodity sell-off has been the anticipation of a slowing economy leading to softening demand. For example, in mid-August, gasoline prices were approximately \$3.00 to \$3.20 per

gallon. In early October, the price of gas at the pump was close to \$2.00 per gallon. This represents a very substantial correction in a short period of time.

The recent drop in oil prices has offset only the most recent spike. Prior to this decline, oil prices had overshot relative to the deteriorating monetary backdrop and growing economic vulnerabilities. Consequently, oil should continue to trade at current or somewhat lower prices until economic growth is rekindled. The meteoric rise of base metals prices, however, has not yet fully reversed; record high prices have been a significant drag on the manufacturing and housing sectors at home and abroad. In the end, the factors that have been acting to brake economic activity will reverse. The bond market and oil prices have already reflected these concerns.

The sudden decline in commodity prices has also led to a major shakeout among more speculative groups such as commodity-exposed hedge funds. Their aggressive use of leverage frequently does not allow these "investors" to withstand a downturn of size in the instruments in which they invest. The most highly publicized blow-up was the

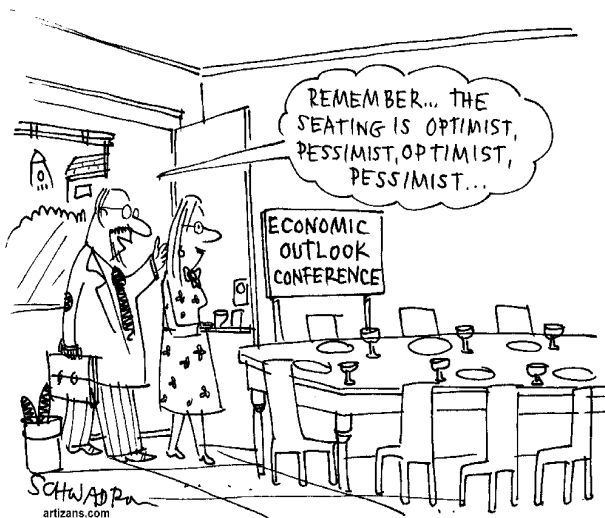
implosion of Amaranth Advisors, a hedge fund with \$9 billion in assets at the end of August, which subsequently lost over \$6 billion during the first three weeks of September after a series of natural gas bets went awry.

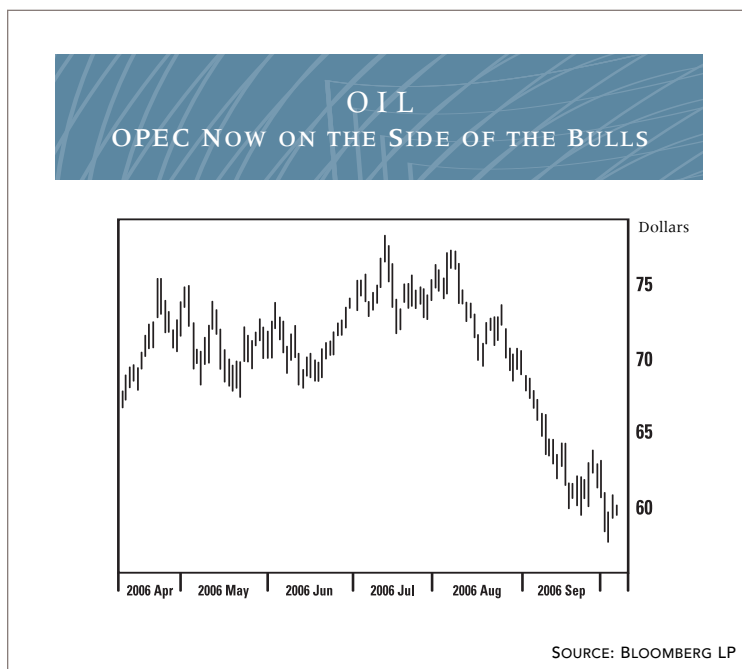
KING'S Current Positioning

Our firm's investment philosophy is bottom-up oriented, meaning that we closely scrutinize a company's fundamentals and purchase companies that meet our strict buy criteria utilizing the Business Valuation Approach. This approach has steered us away from a significant weighting in commodity-oriented equities and has led us to invest in many healthcare and financial companies over the past year. We believe many of these companies have outstanding fundamentals and have the potential to significantly outperform the market over the long term. While each company offers its individual strengths, it is important to understand the positive factors affecting each of these industries.

Because healthcare is a more defensive group, it tends to do well overall when the economy begins to slow; we are about to enter such a period. Healthcare services are less sensitive to economic conditions than some other major industries. For example, if an individual needs a pacemaker or a hip replacement, he or she will usually have one implanted regardless of what the economy is doing. As a result, cash flows among a number of healthcare companies tend to be more stable and have a long duration.

Pharmaceutical stocks have underperformed for a number of years, but fundamentals for many companies have improved due to increased pharmaceutical use as a result of the implementation of Medicare Part D in January 2006. In addition, a rise in drug consumption has occurred after a





marked streamlining in corporate employment costs. The combination of increased demand and leaner operations has boosted industry productivity and powered a series of stronger profit reports. Generic drugs are also seeing a much more positive pricing environment for the first time in years due to the aftereffects of consolidation (as participants are exercising price rationality).

Sports medicine is one of the fastest growing segments of the medical device industry. In the U.S. and other developed countries, professional sports are widely popular events, which produce lucrative benefits for corporations and for those athletes with sufficient talent to establish careers in professional sports. This commercial appeal has increased the demand for top athletic talent across the entire sports spectrum. To fulfill this need, sport-specific infrastructures that bring young people into competitive athletic programs at early ages are now commonplace. Such competitive athletic programs are widespread and heavily integrated into communities, public and private schools, and business enterprises. The competitive

nature of these programs demands that participants strive to excel, often beyond physiological limits. In recent years, the number of sports-related injuries requiring medical intervention among amateur and professional athletes has grown at a rapid rate. These trends support the demand for general medical services (i.e., hospitals, surgeons, physicians, etc.), painkillers, hip and knee replacements, spinal implants, anti-inflammatory medications, and the like.

Favorable demographics, such as aging populations in many countries, also significantly support the demand for healthcare services. Importantly,

while these factors seem to paint a rosy scenario for all healthcare companies, problems still exist for many. We have generally avoided investing in companies that have too much Medicare reimbursement risk. We accomplish this by investing in companies with greater exposure to private-pay insurers or by investing in companies with advanced cutting-edge technologies, which frequently are not the target of steep Medicare cuts. Another problem exists with the largest market-cap companies in the industry—the Mercks, Pfizers, and Johnson & Johnsons of the world. These companies have grown dramatically over the last two decades. While the long-term outlook for large-cap pharmaceuticals is generally positive, the issue now becomes how to manage a very mature, slower growth business and how to go about garnering enough exposure to the rapidly expanding areas of the healthcare industry to make an impact on the company's overall growth rate. On the other hand, many small- and mid-cap companies are well positioned in these high growth and highly coveted niches. Johnson & Johnson (JNJ) is a good example of a large company that faces lower growth

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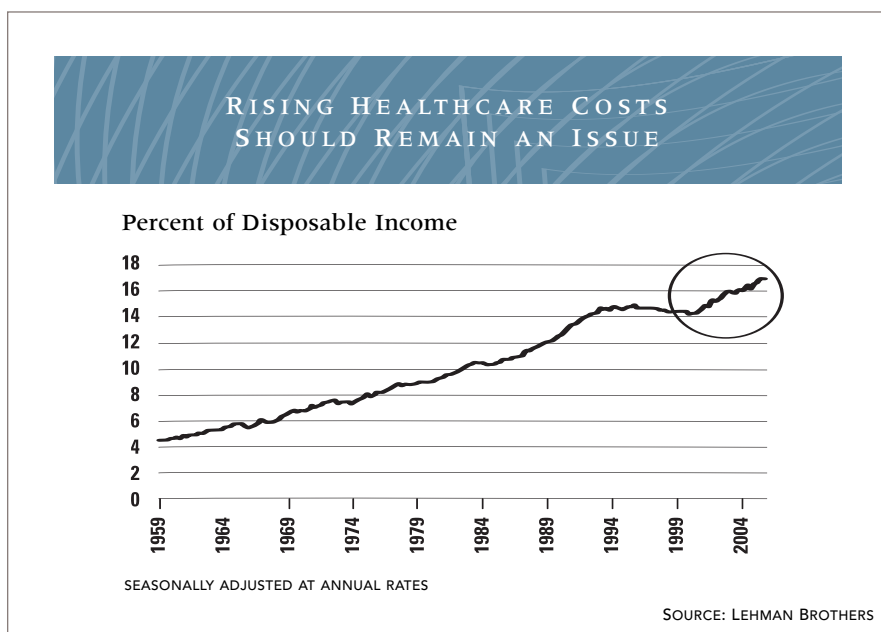
prospects. It is an obvious acquirer in the medtech space as mergers and acquisitions are intrinsic to its business model. In addition, JNJ had approximately \$17.6 billion in cash on the balance sheet and generated \$7.8 billion in free cash flow in 2005. It is representative of many larger companies that are flush with cash, liquid assets that could be returned to shareholders in the form of buybacks or dividends or used as a war chest to make acquisitions to enhance shareholder value. Because of JNJ's diversified business model, the Company will continue to be linked with acquisitions across the

entire healthcare space. The same could be said of General Electric, which has a growing exposure to healthcare. In recent months, the CEOs of both Merck and Bristol-Myers Squibb have talked openly about the possibility of acquiring a medical device company. Several larger generic pharmaceutical companies are also on the hunt for acquisitions to increase the breadth of their pipelines. As a result, M&A is likely to accelerate over the next year or so.

Our exposure to financials might seem counterintuitive at first, as the Fed has been raising interest rates for approximately two years. In addition, headlines such as the housing slump, fraudulent loans, and credit card delinquencies are concerning. While the environment for many financials has been difficult for some time, many financial stocks have actually been outperforming the market over the last several months.

This past spring's inflation scare has now been replaced with fears of slowing economic growth. During the last three years, cyclical inflation pressures have been building, thanks to a booming

economy and hot energy and commodity sectors. These cyclical forces, until recently, offset the secular disinflationary backdrop that has been in place for the past two decades. It is this mild upturn in inflation that has forced the Fed to target slower growth. However, recent economic reports show that the Fed's efforts have been successful and that inflationary pressures are starting to taper. As



a result, it is now likely that the Fed will start cutting interest rates sometime in 2007 in an effort to guide the economy in for a “soft” landing. A rate cut should create a more favorable environment for equities in general, and for financials specifically.

★ Given the extremely low valuations of mortgage-related equities, we believe that investors have largely discounted a dire scenario in the housing market. ★

A rate cut should also cushion the deflating housing bubble, a deflation which is not as bad as many believe. During the last several years, economic activity in real estate has been very strong, due to low interest rates and easy credit. This is not surprising, since the single largest cost of residential real estate purchased with mortgage financing is usually interest paid on the mortgage. Homeownership was already high when the latest boom started, but with abundant liquidity and interest rates so low, many new buyers had less than stellar credit. As a result, a large percentage of mortgages were structured as adjustable rate mortgages (ARMs), which allowed buyers to qualify for loans with lower monthly payments.

The increase in interest rates from their lows of 2003 will lead to painful mortgage rate adjustments for the vast number of homeowners who purchased homes utilizing ARMs over the last several years. How big is this problem? In Southern California alone, the owners of eight million homes

who purchased three-year ARMs are faced with a scenario in which their mortgage payments will increase by 50% in the next sixteen months. Rather than go through foreclosure, many of these homeowners will attempt to either refinance or sell their homes. Refinancing will be challenging, because any refinancing option will give them a higher interest rate than they currently have. According to a recent *Business Week* article, “Between \$400 billion and \$500 billion in ARMs are due to be reset by the end of 2006. The following year will be even more dramatic, when more than \$1.5 trillion will be reset.” Eventually, however, a decline in rates will ease the burden for those who purchased a home using an ARM.

With news like this, many might ask, Why own any stocks with an exposure to the mortgage market? Given the extremely low valuations of mortgage-related equities, we believe that investors have largely discounted a dire scenario in the housing market. There is ample evidence that the Fed, with the blessing of most other central banks around the world, will pull out all of the stops to elongate the housing cycle. This is not a typical business cycle of the past when authorities have allowed the excesses of the prior cycle to be expunged. The excesses are clearly accumulating and yes, housing prices in some parts of the U.S. are at very high levels. While prices will undoubtedly come down, the Fed has an interest in cushioning the decline, given the risk that a housing collapse would pose to the U.S. and world economies.

On a more micro note, many financial companies have become considerably more sophisticated in managing risk due to advances in technology, credit-screening and profiling. For example, two leaders in the industry, Countrywide Financial and IndyMac, do not hold a meaningful percentage of mortgages on their books. Rather, they have sold these riskier “assets” and have positioned

themselves very well for a downturn in the housing market. Also, while there are some regional bubbles in the market, it is interesting that nationally, the average price of a residential home has fallen only 1.7%. During the past five years, the average price has risen approximately 40%, and over the past ten years, the average price has appreciated about 100%. In recent weeks, real estate loans have accelerated following a nine-week period of sideways movement. Former Fed Chairman Alan Greenspan recently stated that the “worst may well be over” in the U.S. housing market. Certainly the housing industry is facing some bumps in the road, but the dire predictions of a nationwide “bust” are overblown.

Outlook

Although the economy is slowing and the headlines regarding housing are likely to cause concern as the regional bubbles in the market unwind, the drag on stock valuations from rising interest rates are already showing signs of abating. Higher rates have been a principal reason why stocks have not fully celebrated the surge in earnings over the past few years. A slowing economy is a necessary ingredient to ending the interest rate drag on equity valuations. In addition, a reversal in the investment stampede into commodities and real estate during the past several years is underway and should be beneficial for select areas of the equity market over time. The corporate sector is in solid shape in terms of profitability, and there is a wide gap between the return on capital and the cost of capital. Capital spending should hold up better than consumption because businesses have not overspent this cycle and exports should stay strong.

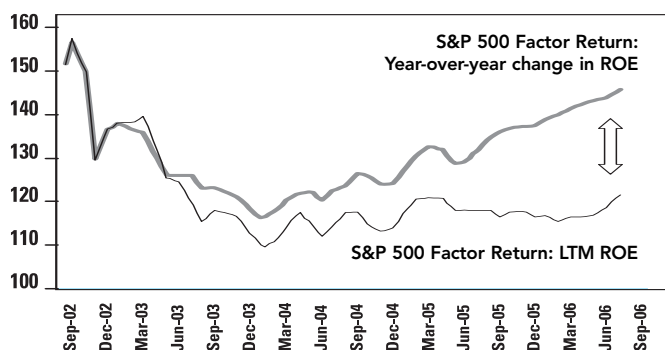
Business investment remains extremely low as a percentage of sales and cash flow, and there is still considerable pent-up investment demand

for infrastructure following a decade of neglect. Thus, while consumer spending has driven much of the economic expansion over the past several years, business spending might begin to kick in as an economic driver as interest rates fall and companies pursue long-term expansion plans.

It is also important to note that the world economy is cooling before inflation has produced a sustainable head of steam. Excess savings should be the dominant investment force over the balance of the year. While the employment picture is still good, the extra spending driven by the housing boom is unwinding (in terms of equity withdrawal and the “feel-good” factor from rapid housing price increases). Consumers did not feel the need to save when housing price inflation was running at double-digit rates, but this tailwind has turned into a consumer headwind. The savings rate has stopped falling and is primed to edge higher. Surplus savings should help hold down inflation and depress interest rates, bullish catalysts for both bonds and equities. The savings trend is not just a domestic phenomenon. Globally, savings rates are very high. China currently saves close to half its GDP. Until very recently, this huge pool of savings was largely absorbed by a persistent rise in domestic capital spending. However, with the Chinese authorities’ efforts to rein in capital expenditures, excess savings are growing. Savings in other parts of the world are also increasing. The commodities boom helped resource-rich countries build reserves and wealth, but a lack of domestic spending among the oil-producing nations has clearly contributed to the rising pool of surplus savings in these economies. Some of these savings will flow into our capital markets, boosting stock and bond prices.

While the dollar has recently weakened, the U.S. and several other mature markets will continue to attract capital because of reduced volatility in their

MAYBE THE LBO COMMUNITY
IS ON TO SOMETHING:
RISING ROE IS WORKING



Calculated as the cumulative returns to a portfolio that is long the top quintile of stocks ranked by the noted factor and short the bottom quintile, rebalanced monthly.

SOURCE: MORGAN STANLEY QUANTITATIVE RESEARCH

young people training to enter the work force than Europe or Japan. Eventually this will positively impact consumer demand and, in the long run, will make the U.S. the industrialized country in which to invest.

Finally, many of America's top companies are flush with cash. According to an S&P report from July, the companies of the S&P 500 have over \$300 billion in unrealized liquid assets. This can be added to the over \$600 billion in cash reported by the S&P in May. Ultimately, this cash provides liquidity to the market, as companies can afford to support their

increasingly knowledge-based economies. The United States is a world leader in intellectual capital across many high growth businesses. Because this is increasingly a knowledge-based global economy, global demands favor the U.S. The U.S. and others have developed largely into strong economies where companies have kept high value-added functions in-house— research, development, treasury, and marketing— and have outsourced the most volatile portions of business— production and inventory— to external producers in emerging markets. A revolution in financial technology is allowing risk to flow to those able to support it, reducing the volatility of economic cycles in the U.S. and in emerging markets as they evolve from agricultural economies to more stable production economies. These developments allow consumers and corporations to borrow more, and the global increase in capital leads to shrinking risk premiums and higher asset prices. Demographically, the U.S. is in the best economic shape of any of the industrialized countries. Basically, the U.S. has more

own stock price through share buybacks. No CEO has become a Captain of Industry by possessing the largest bank account. The M&A temptation must be growing. In addition, return on equity is on the rise in many industries, a phenomenon that has not gone unnoticed in the private equity community. Through early September, leveraged buyout activity accounted for nearly one-quarter of the entire deal volume. What this group of investors finds enticing is the combination of low leverage, excess cash on the balance sheet, and cheap financing, factors which should serve as catalysts for undervalued companies to achieve their private-market values.

We are very sanguine about the potential of our client holdings and expect to see their prices significantly higher a year or two down the road.

Leah R. Friday, CFA
Senior Vice President

The year 2006 marks KING's Twenty-Fifth 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-five 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.

OTHER CONTRIBUTORS TO THIS ISSUE

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SOURCES FOR THIS ISSUE

BCA Research, *CBS Market Watch*, *Market Intelligence Report*, Morgan Stanley Quantitative Research, PIMCO, Secular Forum Summary 2006, UBS Financial Services



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