

DecisionMaker

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Experience is simply the name we give our mistakes.

— OSCAR WILDE

When things do not go as planned, we often chalk it up to “experience” or as Oscar Wilde described it, “our mistakes.” No doubt, there have been many mistakes made over the last few years leading us into the worst financial crisis since the Great Depression. There has also been ample blame to go around for all of those errors, whether it was blaming the lenders, the borrowers, the government, lack of regulation, speculation, derivatives, or hedge funds, and the list goes on. As with all mistakes and experiences, we hope we can learn from them and move forward; now is not the time to stare in the rear view mirror but to forge ahead.

As we mark the first anniversaries of the near demise of AIG and the total collapse of Lehman Brothers, we are reminded of how far we have come in a year, or have we? We remember, all too well, the fallout that ensued after these cataclysmic events, especially the collapse of Lehman that served as the proverbial straw breaking the camel’s back after a string of unprecedented events throughout the year. The stock market took its precipitous drop from mid-September to reach multi-year lows in November 2008. After a brief recovery in December 2008, stocks continued their decline until reaching new multi-year lows in March 2009. Since that dismal day of March 6, 2009, the S&P 500 has skyrocketed up from its intraday low of 666.79 to close at 1,057.08 on September 30, 2009, a 58.5% price increase. It has been a wild ride!

Since the market is typically a leading economic indicator, does the recent strength of the market mean the recessionary storm is over and there are clear blue skies ahead? As we will discuss, there are many signs that the recession is behind us and a recovery is on the way. Although we believe the worst of the storm is over, the economic forecast is partly cloudy at best, and we could experience further turbulence as we emerge from a deep recession.

According to the National Bureau of Economic Research (NBER), the economy entered the recession in December 2007 and officially exited it in July 2009, bringing the downturn to 19 months, nearly double the post-WWII average of 10 months for the recessions spanning 1948-2001. The downturn has been particularly painful as the peak to trough decline in real GDP has been -3.9%, nearly twice the -2.1%

post-WWII average. We have not seen a decline of this magnitude since the 1974-1975 recession, which lasted 16 months and registered a -3.2% peak to trough decline in output. In the analysis of measuring recessions, the NBER focuses on four primary economic series: personal income less transfer payments, business sales, industrial production, and non-farm payrolls to compose the Index of Coincident Economic Indicators (CEI). Modest gains in industrial production, business sales, and personal income offset further weakness in nonfarm payrolls. The Index was flat for the month of August following a revised 0.1% increase in July, which was slightly above the original estimate of 0%. These CEI reports, which followed eight straight months of decline, remain weak but have at least stopped falling.

While the CEI is marking the end of the recession, the Index of Leading Economic Indicators (LEI) is suggesting the recovery is just around the corner. Historically, the LEI has predicted economic recoveries anywhere from three to nine months in advance. In August, the LEI increased 0.6% on broad-based gains, the fifth consecutive monthly advance. Contributing positively to the Index were the Treasury yield curve, initial jobless claims, the factory workweek, vendor deliveries, stock prices, and non-defense capital goods orders. New orders for consumer goods have been relatively flat, and building permits and consumer expectations have now turned positive. These broad-based gains are impressive because economic breadth suggests economic durability. Those in denial over the economic recovery believe the stock market rise has just been a sucker's rally and are recommending getting out now in anticipation of a double-dip recession. The trouble with their logic is that it is not supported by the broad-based gains within the components of the LEI. Given the dramatic move in the market since March, a little profit-taking is expected even without the opinions of the "double-dippers."

Mixed evidence of recovery comes from the Institute of Supply Management (ISM) survey, which measures the breadth of manufacturing activity. After advancing four points in August to 52.9, the highest level since June 2007, the ISM Index fell to 52.6 in September. While the report was certainly disappointing, the reading above

50 still indicates expansion in the manufacturing sector and points to a noticeable pickup in growth for the second half of the year. Thirteen of the eighteen industries reported growth with the overall reading suggesting 3.6% annual growth. New orders declined in September following an uptick in August, and employment levels continued to contract. Prices paid remained elevated so manufacturers are feeling margin pressure, as they are unable to pass through price increases. Inventories continue to be a drag on factory activity, but this trend is expected to reverse soon because the spread between ISM new orders and inventories is beginning to narrow, having been at its widest gap since August 1975. As this trend reverses, it will add significantly to economic output going forward. Traditionally, inventory rebuilding has been a major contributor to output in the four quarters following a recession, and if this proves true with this recovery, the associated production and income should help sustain economic activity.

When Will Uncle Sam's Rescue Lead to Inflation?

As everyone is well aware, the U.S. government has followed a very "hands on" approach to dealing with the financial crisis and the effort to get this economy rolling again. With the U.S. budget deficit soaring as Uncle Sam continues to save the day, inflation fears are beginning to emerge. While headline inflation is currently in deflationary territory (-1.4% year-over-year), this is mainly due to the precipitous drop in energy prices over the last 13 months. As the year-over-year comparisons become less dramatic, the headline inflation number should stabilize and turn mildly positive. However, given the considerable slack in the economy, price pressures are unlikely to become a real threat anytime soon.

As referenced earlier, the manufacturing sector is operating at record-low capacity levels and is unable to pass on price increases. This weakness in pricing power should remain for some time, as there is generally a four-quarter lag between a change in capacity utilization and the core Producer Price Index (PPI). As a result, excluding food and energy, consumer goods inflation should remain tame over the medium term.

The unemployment picture also points to considerable slack in the economy. The official unemployment rate stands at 9.8% and is still rising. Given a 5% natural rate of unemployment, which is the level of unemployment consistent with price stability, the current level is almost twice as high. An even broader measure of unemployment, the U-6 unemployment rate, includes the unemployed, the discouraged (unemployed but not looking for work because of the weak economy), and part-time workers who cannot find full-time work. The U-6 unemployment rate hit 17% in September. As economic activity improves, the official unemployment rate may not see improvement as these marginally attached workers pick up the slack.

Since labor typically represents the largest portion of production costs, the unemployment rate is even more important than capacity utilization in measuring slack in the economy. Whenever there is a significant increase in labor slack, consumer inflation decelerates. We have to go back to the 1981-1982 recession to witness this much slack in the labor market, and the disinflationary result was extraordinary. With ample room in the economy and the labor market in particular, the economy can expand without inflationary pressures for at least a few quarters. Longer term, the inflation story may be different, but near-term pressures appear subdued.



"I'd like to borrow enough money so that I'll be completely out of debt!"

Where is the Consumer?

The consumer will not be leading us out of this recession. At roughly 125%, the household debt-to-income ratio remains extraordinarily high. With unemployment at 9.8% and rising, household income has been decimated, and the average U.S. consumer is just not ready to spend. In fact, the American consumer who does have discretionary income is doing something he has not done in awhile—save!

John Mauldin, president of Millennium Wave Investments, describes the current situation for the American consumer:

Reality is staring back in the mirror at the American consumer, and especially the Boomer generation. The psyche of the American consumer has been permanently seared. We are watching savings beginning to rise and consumer spending patterns change for the first time in generations. Even as the authorities try to prod consumers back into old habits, they are not responding. Borrowing and credit are actually falling. Banks, for whatever reason, now want borrowers to actually pay them back. Go figure.

While we saw a jump in auto sales as a result of the government's "Cash for Clunkers" program, U.S. households are still feeling pressure from maxed out debt levels as well as unemployment fears. This financially stressed position of U.S. households will likely prevent them from being the primary driver of growth. With the consumer making up 70% of the U.S. economy, a skittish consumer will weigh heavily on the economy's near-term performance, at least relative to prior recoveries. Historically, an excess of 6% average growth has been attributable to the U.S. consumer in the 12 months following a recession. This time may be different because we do not foresee the consumer going on a spending spree anytime soon given widespread job losses, sluggish income growth, and tight credit.

So what will cause the phoenix to rise from the ashes to lead us out of this recession? Look for a business-led recovery. Aside from inventory rebuilding, robust gains are projected in capital

spending. In an effort to weather the storm, many companies have postponed capital expenditures and are now in a position of needing to replenish their depleted capital stock. This is apparent given the fact that factory-wide industrial capacity has shrunk for only the second time in the history of the series, with the only other time being the capex collapse in 2000 following the Y2K ramp-up.

But where is the money coming from? Profits—yes, we said it, profits! It may be difficult to comprehend any companies earning profits when the economic news is still so daunting, but cost-cutting has been underway for about a year at many major companies, and money is flowing to the bottom line. While the human cost is high with rising unemployment, wreaking havoc on government budget deficits, personal budgets, and top-line revenue, the benefits of reducing head counts are beginning to take hold. Companies are leaner and meaner, and as corporate executives feel better about their companies' prospects, they should begin to loosen the grip on their checkbooks and increase business investment. Some indicators of corporate optimism, such as CEO business confidence, have rebounded sharply, suggesting that corporations are more

willing to spend. That being said, this road to recovery is and will continue to be a bumpy one, not the typical smooth trajectory coming out of a recession. Signs of economic recovery are coming in spurts, taking two steps forward and one step back. There are a lot of moving parts, and they are not all moving in the right direction just yet.

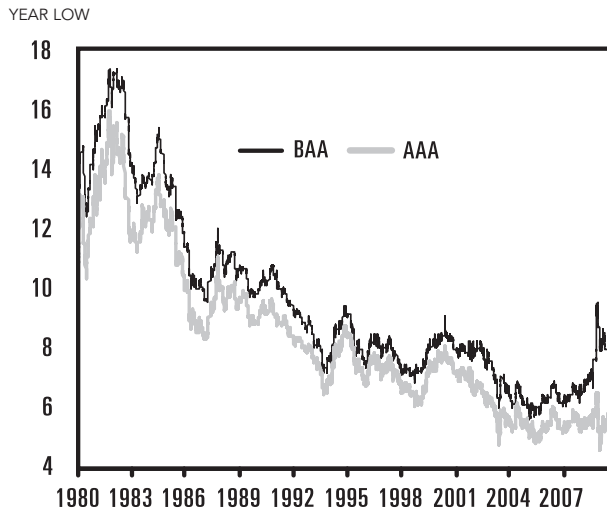
M&A is Back!

Many have used the phrase "cash is king" to reference cash being the best investment over a specific timeframe. Well, cash is king right now but not in the traditional sense. Cash as in "free cash flow" is king. As corporate profits rebound so does cash. U.S. companies are piling up cash net of interest costs like never before, setting the stage for significant merger and acquisition (M&A) activity. As the economy emerges from recession, cash flow may rise from the \$1.5 trillion reported by the Commerce Department for the year ending June 2009, according to data compiled by Credit Suisse and Bloomberg. Cash flow has reached a record level in the past 12 months as a result of major reductions in labor and interest costs. Labor costs have plummeted as we have witnessed the largest wave of firings since WWII, and interest costs are at historic lows as central bank rates hover just above 0%. Cash relative to share prices is expected to reach the highest level in at least two decades next year as compared to yields on corporate bonds. In fact, the gap between the free cash flow yield and the corporate bond yield, a key driver of M&A activity, is the widest it has ever been according to their data that dates back to the early 1990s. Of course, this is helped by the fact that investment grade bond yields are close to 30-year lows and U.S. corporate leverage is below trend levels.

If we were to expand on the phrase "cash is king," then "credit is queen." Another driver for M&A activity is easier and cheaper access to credit. Corporate bond spreads have narrowed significantly and are now below their levels before the collapse of Lehman, indicating investors feel better about loaning money to corporate America and are demanding

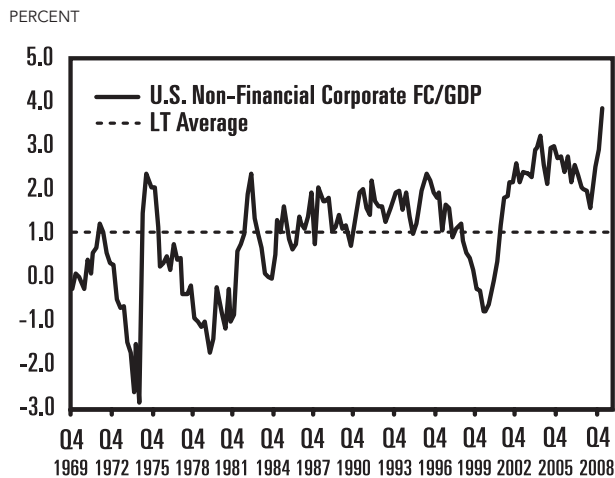


**INVESTMENT GRADE BOND YIELDS
ARE CLOSE TO A 30-YEAR LOW**



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**U.S. FREE CASH FLOW
IS AT AN ALL-TIME HIGH
AS A % OF GDP**



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less in return relative to comparable U.S. Treasuries. Given this more amenable credit marketplace, corporate debt issuance is rebounding sharply. Through mid-September, corporations have issued almost \$900 billion in gross debt since the beginning of the year, surpassing the total 2008 debt issuance of \$800 billion. If this keeps up, debt issuance is on track to reach the 2007 \$1.1 trillion record.

Global M&A activity has been in a depression, down 35% year-to-date as compared with 2008 and down 62% versus 2007. U.S. cash-financed M&A activity is below trend levels and very close to its 10-year low. Typically, M&A activity lags the cycle. In the last upturn, M&A activity troughed eight months after the ISM new orders and averaged slightly more than a year over the last two cycles. This suggests M&A activity should start picking up now from these depressed levels. Again, corporate optimism plays a role in the willingness of corporations to spend, and a rising market, such as we have seen since March, helps to fuel the momentum for M&A activity.

So who is going to be merging with whom? From a global perspective, U.S. companies appear to be in the better position to be bidders. Continental European companies are more indebted than their U.S. counterparts, and the gap between the free cash flow yield and corporate bond yield is not at its all-time high as it is in the U.S. Similar to the U.S., companies in the U.K. are not as leveraged as those in Continental Europe. They have a higher gap between the free cash flow yield and corporate bond yield, and cash is at record levels.

★ This resurgence in M&A activity reflects an improvement in investor psychology, is a good sign for the market, and represents a vote of confidence for the economy. ★

We are beginning to see evidence of this expected M&A activity with recent announcements from Xerox buying Affiliated Computer Services in a \$6.4 billion deal. Abbott Laboratories agreed to buy the drug unit of Belgian conglomerate, Solvay, for \$6.6 billion in cash. Kraft has made an unsolicited bid for Cadbury, which was rejected, but the company has until November 9 to make a formal offer. In addition to these, Disney agreed to buy Marvel, and eBay is moving forward with its plans to sell its Skype unit. Closer to home, Dell Computer is acquiring Perot Systems for \$3.9 billion in an all-cash deal, and Baker Hughes is acquiring BJ Services for \$5.5 billion. In the first three weeks of September alone, U.S. companies announced 256 deals worth \$33 billion, 42% below the same month last year but rising rapidly.

This resurgence in M&A activity reflects an improvement in investor psychology, is a good sign for the market, and represents a vote of confidence for the economy. As investors expect a near-term correction following this explosive six-month rally in the stock market, a resurgence in M&A could give the market the upward momentum it needs to keep the rally going. Companies have been hoarding cash and are beginning to do what is necessary to compete in their respective industries by investing for the future. The key will be value, with acquirers trying to find companies whose shares have not recovered significantly from their bear market lows.

Peter J. Tanous, president and director of Lynx Investment Advisory in Washington, D.C., sums up the current M&A environment:

This is an extraordinary opportunity for combinations of businesses at prices that make sense. There was a period of time when acquisitions were based on exuberance, but the numbers

didn't quite work. The numbers work better now. I think we're going to see a lot more M&A activity, and this time it's going to be a lot better thought-out and more sensible.

Peter Cardillo, chief economist at Avalon Partners in New York, says:

Companies are looking forward and beginning to pull in some of their missing links. The more consolidation and more mergers we see suggests that corporate America is certainly more enthused about the global economic rebound as opposed to consumers.

The best candidates for being on either side of the M&A equation are companies with strong assets, particularly strong free cash flow, and low debt levels. This bumpy road to economic recovery is the perfect backdrop for the cream to rise to the top. "Survival of the fittest" could not be more apparent in corporate America than it is today. Those companies with healthy balance sheets that have easy access to credit, or better yet, have plenty of cash to spend will outshine those heavily laden with debt.

This approach to finding good merger/acquisition candidates falls right in line with one prong of our Business Valuation Approach (BVA) that we use for equity investing on a regular basis. Our investment approach has always focused on companies with strong balance sheets, healthy free cash flow, and trading in the public market at significant discounts to our appraisal of their private-market values (PMV).

We define PMV as the value an informed third party would pay to purchase all of the assets of a given company. We calculate PMV by scrutinizing the balance sheet, as well as the company's cash

flows. It intrigues us if a company trades at a minimum of a 50% discount to its PMV; we would consider the stock as a possible buy. KING has benefited from M&A activity over the years because of this emphasis on buying stocks trading at a steep discount to their PMV; a company with solid fundamentals and strong cash flows, trading at 50 cents on the dollar, usually does not stay unrecognized for long.

Since 1995 (the year that KING first began tracking M&A activity in client portfolios), over 50 small- and mid-cap companies held in our clients' portfolios have been acquired.

Average Gain (from buy to sell)	Average Holding Period	Average Number of Acquisitions in a Year
91.04%	1.04 years	3

What is compelling about this data is how it validates our selection process of purchasing companies that are trading at a 50% discount to their private-market values (or 50 cents on the dollar). Theoretically, based on these calculations, there should be 100% upside to a given stock. Since 1995 the average gain over our holding period with these announced acquisitions has been 91%, solid evidence that our methodology is sound and our PMV calculations are accurate.

The key variable of our PMV approach lies in our ability to focus on inefficiently valued companies that possess high, and somewhat predictable cash flows combined with high barriers to entry and solid, niche franchises. Another key variable is the presence of a catalyst to unlock shareholder value. A catalyst may take many forms such as industry consolidation, a major share repurchase, a sale or spin-off of a division, a change in management, or a major new product launch. In addition, since we manage focused portfolios (on average, clients own 30 to 35 stocks), one or two transactions per year—particularly at a nice premium—can have a significant impact to their long-term returns. Over the past 15 years, our clients have benefited from an average of three transactions

a year (i.e., approximately 8.5% to 10% of the portfolio has benefited from acquisition activity).

Industry consolidation is a theme which we believe will accelerate throughout 2009 and into 2010. Many large-cap companies, especially outside of the financial industry, are flush with cash yet are facing declining revenues in the near future. Specific examples today include large-cap pharmaceuticals and medical device companies, many consumer goods companies, and many large-cap tech companies. Cash may not be held long in the pockets of industry giants, especially with small- and mid-cap valuations just off their historical lows.

Within our portfolios, we currently own many healthcare companies selling at prices well below their PMVs. Collectively, these are companies with high margins, unique franchises, strong pipelines, and possess the ability to generate

solid cash flows as well as strong earnings growth. Due to the proposed healthcare reform initiatives, we believe that many large-cap companies will see their margins squeezed and will attempt to seek earnings relief by buying companies that are focused on growth areas such as cancer research, or are focused on smaller, unique niches in healthcare which are better insulated from pricing pressures. As a result, a wave of M&A activity may emerge.

Historically, KING has had much success in discovering value in the healthcare, financial, technology, and consumer staples industries. While we do not depend on mergers and acquisitions to generate superior long-term returns, the ability to benefit from consolidation activity is a by-product of our research process and has certainly benefited our clients over the long run. Our ability to identify undervalued companies with steady cash flows, coupled with a catalyst to unlock value, has been consistent over the past 28 years.

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The year 2009 marks KING's Twenty-Eighth 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-eight 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., Peter Cardillo, Credit Suisse, Deutsche Bank, John Mauldin, Peter Tanous, Ed Yardeni



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