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KING

DecisionMaker

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Socialism is a philosophy of failure, the creed of ignorance, and the gospel of envy, its inherent virtue is the equal sharing of misery.

— Winston Churchill

There is good reason why they call these ceremonies "commencement exercises." Graduation is not the end; it's the beginning.

— Senator Orin Hatch

The dog days of summer have faded. Vacations are over. Although January establishes the beginning of the calendar year, it is merely a prelude to a more appropriate commencement. Labor Day, that is when the *real* year begins! The passing of Labor Day ushers in a return to productive pursuits. On Wall Street, investment bankers and money managers, whose ranks were thinned during the summer months, return with whetted appetites to "get back to business." For families from coast to coast, school begins anew. It is the opening of the school year that triggers our brain to think of September as the start of a new year. The intertwining of the school year with our economic endeavors has produced a collective psyche that views this month as a period when, after a summer lull, business revs up while simultaneously students and families are galvanized into action by the demands of the educational clock.

In the United States, the Department of Education informs us that there are approximately 82 million students, almost 27% of the population, enrolled in public and private schools of all levels, of which about 18 million attend colleges and universities. The dedication and expenditure of time, effort, and financial resources by students and their families are major undertakings in this nation. The multi-year journey from kindergarten to high school and, for many, beyond to college is a common experience. Our persona has been shaped in no small part by the framework of our education calendar. Recall the excitement, and sometimes trepidation, upon entering the classroom at the beginning of each of those twelve or more years. Our psyche has been molded to mark September as the beginning of another year of renewal and discovery.

For a period that may extend as long as sixteen or more years, we wend our way through the education calendar. From the basics of 'readin' and 'ritin' and 'rithmetic,' to the sports, clubs, and a wide array of extracurricular activities, we are inculcated

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with the rituals of September through June. This cycle and its institutional rites of passage serve as milestones to mark the yearly progression along the lengthy path of achievement that finally culminates in that magical moment when graduates gleefully hurl their mortar-boards skyward. Thus, each school year that begins with Labor Day brings a new smorgasbord of studies and challenges.

As graduates, beyond that last day of class, we get that first job, often followed by a series of positions that in many cases have little relationship to what we thought we would be doing when that diploma or degree was granted. Regardless, we never leave the cycle of the academic year. Eventually, having invested the better part of our early lives in school, former students become parents. We shepherd and eventually watch our offspring on their own journey through the halls of academia. For some, this vicarious reprise may span two or three decades, depending on the spacing of births. We pursue careers, willingly or of necessity, deal with the everyday minutia of life, experience joy and sorrow. Yet, we remain wedded to the inexorable turning of the calendar that launches another ringing of the bell that calls us to a new year as summer draws to a close.

"A SCHOOL WITHOUT FOOTBALL IS IN DANGER OF DETERIORATING INTO A MEDIEVAL STUDY HALL."

— Frank Leahy, University of Notre Dame

One of the best examples of the power that rituals play in shaping the memories that bind us to the academic calendar and which also links successive generations is found in high school and collegiate sports, especially the latter. September, in particular, is a very special time; it is truly the kickoff month for a new year. Each year, there is a collective bubbling of excitement and anticipation among the students and alumni of schools and colleges at the prospect of another season of football. The glue of football melds the social fabric of generations. On a Friday night or Saturday afternoon in the fall, scan the stadiums of high schools and colleges. At the collegiate level, whether viewing a game on a gridiron in the Ivy League or in such power-packed conferences as the SEC or PAC-10, fans of all ages, adorned in their school colors, revel with delight at every touchdown. Rivalries are a call to arms. No Wolverine grad residing in Columbus would ever dream of rooting for the Buckeyes, especially if they were facing Michigan. An Auburn Tiger fan would be tempted to partake of hemlock before he would pull for the Crimson Tide as the teams square off just short of the goal line. Ah, a new year indeed!

Thus, we wish you a Happy New Year as we begin anew. For investors, it is welcomed, for the past four months have been foul ones for markets around the world. August marked the fourth month in a row that equity markets have declined. After the declines of the spring, when fears of a double-dip recession first emerged, the markets rallied until the last few days of July and then they dropped dramatically in August. The European sovereign debt crisis, the wrangling in Washington over the increase of the national debt, the S&P "political downgrade" of U.S. debt, and renewed fears of a double-dip recession weighed heavily on the equity markets. Together with fears that we could be experiencing another period similar to 2008, market participants around the globe have been buffeted by a very high level of volatility as stocks decline. Further exacerbating the decline has been the heightened pace of high-frequency trading, which has accounted for as much as 70% of shares traded on a daily basis.

BUT THIS IS NO 2008 REDUX

In October 2008, the housing bubble had burst and the vortex of the mortgage-backed securities debacle sucked creditors and investors into an abyss of bank-ruptcies and panic selling. In the wake of the failure of Lehman Brothers the S&P 500 lost 27% of its value in only 18 trading days. The U.S. was plagued by the worst recession since WWII, and the global economy was sputtering. Shift forward to this Labor Day. Credit conditions have tightened in European markets, but

the contagion has not spread across the Atlantic. The U.S. interbank lending market is healthy and the majority of corporate borrowers continue to benefit from an extraordinarily low cost of capital. Taking inflation into account, the real return on short-term debt is actually negative. Most global credit markets too, remain liquid.

Ignored behind the daily recitation by the gloomsters of the media is the fact that corporate profits have expanded for 10 quarters. GDP, while not roaring, is growing. The slowdown in U.S. and global growth was accentuated by the lack of auto parts from Japan following the tragic March 2011 Tõhoku earthquake, tsunami, and subsequent nuclear accident. Auto production and sales have already shifted upward during the third quarter. Housing, while hardly a source of significant growth, is showing signs of stabilization and in some parts of the country sprouting shoots of growth. Buried beneath the fog of the depressingly high unemployment is the fact that the prices of existing homes averaged $172,500 in 2009, crept up to $172,900 in 2010, and were $174,000 in July. With many existing homes selling below replacement cost, it is unrealistic to expect them to decline significantly going forward.

True enough, economic risks have risen, but the odds still favor escaping a double-dip or a second recession. The August unemployment report that showed zero net new jobs were created (the first such monthly report since 1945), as dismal as it was, probably overstated the true character of the job market. Private employment would have been at least 45,000 higher if not for the strike of Verizon employees. The spillover effect of the strike among Verizon suppliers and subcontractors probably resulted in another loss of 30,000 jobs. These 75,000 workers will return to the payrolls in September. In addition, while corporations are not yet hiring on a continuous basis, they are also no longer announcing major layoffs. Another encouraging sign is the Institute for Supply Management's Purchasing Managers' Index which, although slipping slightly from 50.9 in July to 50.6 in August, still signals a growing economy. The Services Index surprisingly rose from 52.7 to 53.3 in August.

The headlines have given spooked investors and bearish institutions all the ammunition needed to exit equities. In fact, they have created opportunity for those with a time horizon that extends beyond the very near future. The markets are already discounting an economic downturn. A typical earnings recession results in a 25%-35% decline in corporate earnings. The sell-off of the past few months has already discounted a decline in earnings of 25%-30%, and yet, the S&P 500 has an operating earnings power of $100. A recession might bring it to $80. With a recession P/E multiple applied to $80, the S&P 500 Index could, on a worst case basis, decline to 1000, or perhaps 10%. With normalized earnings of at least $100 (and looking forward to growth in an environment that is more business friendly), a multiple of 15 would seem reasonable and would propel the S&P to 1500—a boost of nearly 30% from its present level.

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Stocks are also very inexpensive versus bonds. KING's investment philosophy has always rebutted the efficient market hypothesis that states that the market properly prices all securities correctly all the time. KING's analysts are scratching their heads with the market inefficiencies and pricing anomalies we are finding in these current volatile markets. To illustrate, if you are a long-term investor, which would you rather own? Would you follow the masses and purchase a ten-year U.S. Treasury bond that has recently been downgraded by Standard & Poor's yet yields only 2.00% for

its remaining life? Or, would you rather go against the crowd and own a basket of AAA-rated global companies that have a current dividend yield of 3.00% and increase their dividends by an average of 9% annually? Based on the chart below, the rational answer is obvious. As a long-term investor you should choose equities.

Moreover, if you move down the credit spectrum just a bit, to the rating recently earned by the United States Treasury, an S&P AA-rated basket of stocks (i.e., Chevron Corporation, Novartis AG, Total S.A., and Wal-Mart Stores, Inc.) earns a current dividend yield of 4.2% and grows its dividends at a 13% clip. Over ten years, these AA-rated stocks will earn a total dividend return of 77% on a $1,000 investment. This $770 gain is almost 4 times greater than the $202 earned by those who purchased the Treasury bond in 2011! Throw in the capital appreciation potential of these stocks and the favored tax treatment of dividends and there is absolutely no contest between these two investment choices. (We do not own all of the stocks mentioned, as we believe many other equities offer a better risk/reward. This is, however, a simple analysis to illustrate how attractively stocks compare with other investments, such as bonds.)

	TEN-YEAR U.S. TREASURY	**BASKET OF AAA-RATED GLOBAL COMPANIES** (ADP, XOM, JNJ, MSFT)
Credit Quality	Currently AA+/Aaa by S&P and Moody's; further downgrades by S&P threaten	AAA/Aaa; no current threat of downgrade
Liquidity	Extremely Liquid	Very Liquid
Current Annual Coupon/ Dividend Payment	$20.20 on $1,000 Investment	$30.20 on $1,000 Investment
Current Yield	2.02%	3.02 %
Projected Annual Increase in Annual Payment	0%	9.3% based on 5-year historic dividend growth
Ten-Year Total $ Return on $10,000 Investment	$202	$469 132% more than the U.S. Treasury
Ten-Year Total % Return on $10,000 Investment	20.2%	47%
Tax Status	Subject to Ordinary Income Tax Rate	15% Tax Rate
Additional Upside	None	Capital appreciation of stock as earnings grow, stock buybacks

ADP = Automatic Data Processing Inc.
XOM = Exxon Mobil Corporation
JNJ = Johnson & Johnson
MSFT = Microsoft Corporation

Calculations are as of September 9, 2011
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In the meantime, investors are peering at Washington and the capitals of Europe. Europe remains under considerable pressure to deal with its banking and sovereign debt issues. Still stuck in denial, European leaders will be forced to move more quickly and decisively to deal with the debilitating impact on European banks that hold the sovereign debt of the weaker members of the Union. It is essentially a case of when, not if, they will finally address their dysfunctional economic environment.

Should the locus of political power begin to shift to one that is at least neutral toward business as opposed to one which is presently perceived as anti-business, the psychology of investors could take a 180-degree turn. In short, the risk/reward for investors has improved over the past four months and there are reasons to think that a fundamental shift in favor of the investing class will unfold in coming months. One key indicator of a positive sign for the future is insider buying. Insiders, who have a better view of corporate business trends than high-frequency traders, are providing us with feedback that their take on current business trends is not quite in line with how the markets are behaving. In recent weeks, as stocks have cascaded downward, corporate insiders have dramatically accelerated their buying of equities. The stocks of a broad spectrum of companies are being accumulated by insiders at levels typically seen at major market bottoms. Historically, when insiders buy their own stocks at such an accelerated rate, they are almost never wrong (but sometimes they are early in their timing).

In the U.S., the slow economic growth, the debate over the debt ceiling, widespread unease with regulatory overreach, and the bankruptcy of welfare statism are creating the seeds of an economic rebirth. In Washington, President Obama delivered another hyperstatic speech calling for more of the same government centric efforts to jump-start the economy. While calls for infrastructure spending and payroll tax relief may ignite some initial excitement, they are not likely to have a significant impact on job creation and long-term economic growth. However, one of the major positives to emerge this summer from the debate over raising the debt ceiling is the development of a growing awareness among the population of the necessity to address the underlying causes of slow economic growth and the untenable nature of future expenditures on social welfare.

As Congress and the President return from recess and vacation, we would urge them to take a vow patterned after the classical Hippocratic Oath: "I will follow that system of regimen which, according to my ability and judgment, I consider for the benefit of my patients, and abstain from whatever is deleterious and mischievous." In short, DO NO HARM. Volumes have been written about the damage government does by "doing good." We should all flee from the bureaucrat who says, "I'm from the government, and I am here to help you." How blessed we would all be if the legions of federal government workers would go (and stay) on a very long vacation or take a Rip Van Winkle snooze. The actions of the EPA, the National Labor Relations Board (NLRB), the National Mediation Board, the U.S. Fish and Wildlife Service (which raided and shut down Gibson Guitar, searching for ebony from Madagascar and alleging a violation of a law in India), the EPA (which is waging war on hydrocarbons via its examination of hydraulic fracturing fluids), ad nauseum, are literally killing jobs. *Please, no more help.* Sensible, fair, and measured regulation is necessary. However, government overreach has thrust both consumers and businesses into a world of mission creep that is challenging small entrepreneurs and major corporations with untold billions in costs and immeasurable uncertainty about their future. We also need to mention Sarbanes-Oxley, Dodd-Frank, and the potential uncertainty of ObamaCare, which a growing majority of Americans want repealed. Since President Obama entered office, federal agency budgets have increased 16% and federal regulatory employment has surged 13%.

The pushback has already begun. Pressed with cries from both labor and business—not to mention anxious politicians concerned about voter backlash—President Obama has directed the EPA to withdraw the draft

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Ozone National Ambient Air Quality Standards. The President also announced the results of an 8-month government-wide review designed to reduce the regulatory impact on business. The White House claims that the reductions of red tape will result in a "savings" of at least $10 billion over five years. Of course, $10 billion out of annual federal expenditures of $3.729 trillion (2012 budget) is a mere drop in the bucket. These retreats are not seismic shifts, but they are evidence of the growing resistance to federal intrusion and regulation. In Congress, a key element of the GOP jobs agenda will be aimed at eliminating federal regulations that are needlessly burdening business owners and hampering job growth.

In coming weeks, there are likely to be measures undertaken in Washington that can be agreed upon by both sides of the political aisle, but major structural change will probably have to await the elections of next year. President Obama retains high levels of personal popularity. He manifests admirable qualities as a husband and father, yet the nation has lost confidence in his ability to deal with the economy. He and his key supporters remain wedded to a philosophy of government with which a growing majority of Americans have become disillusioned. It is a long time until November 2012, but President Obama's approval ratings of his management of the economy do not bode well for a second term. On September 2, the White House—with undoubtedly great disappointment—predicted that unemployment would likely stay above 9% through the 2012 election and will not drop below 6% until 2016. One almost wonders if the President is not in fact focused on achieving his goals of government activism through regulation while resigned to departing in January 2013. Since WWII, no U.S. president has won reelection with a jobless rate above 6%, with the exception of Ronald Reagan, who faced 7.2% unemployment in 1984. However, it should be noted that unemployment had dropped three percentage points during the prior two years.

Economic growth will be a major factor in reducing unemployment and raising federal tax revenues. Growth will not come without major changes in the role played by the federal government in tax and fiscal policy, but those who are pessimistic about the future should pause to examine the long history of this country and the inherent strength that the American people have manifested in past periods of turmoil and uncertainty.

"ANYONE WHO STOPS LEARNING IS OLD, WHETHER AT TWENTY OR EIGHTY."

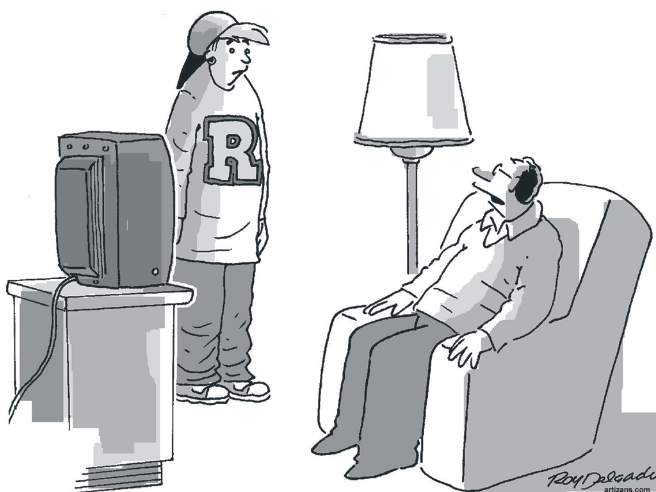
— Henry Ford

Panic is the friend of the bold, long-term investor. We would be well served to heed the wisdom of legendary investor, Warren Buffett, who wrote in his February 2011 letter to Berkshire Hathaway shareholders:

> *Money will always flow toward opportunity, and there is an abundance of that in America… Commentators today often talk of "great uncertainty." But think back… to December 6, 1941, October 18, 1987, and September 10, 2001. No matter how serene today may be, tomorrow is always uncertain.*
>
> *Don't let that reality spook you. Throughout my lifetime, politicians and pundits have constantly moaned about terrifying problems facing America.*

> *Yet our citizens now live an astonishing six times better than when I was born. The prophets of doom have overlooked the all-important factor that is certain: human potential is far from exhausted, and the American system for unleashing that potential—a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War—remains alive and effective.*
>
> *We are not natively smarter than we were when our country was founded nor do we work harder. But look around you and see a world beyond the dreams of any colonial citizen. Now, as in 1776, 1861, 1932, and 1941, America's best days lie ahead.*

What might investors look for as they begin to focus on the future beyond the political jockeying that is likely to occur over the next few months? Perhaps we can gather a clue from one of the Republican presidential candidates least likely to be nominated: Jon Huntsman, former Governor of Utah and Ambassador to China. Huntsman recently unveiled a pro-growth jobs plan in New Hampshire titled "Time to Compete." CNBC's economic analyst, Jim Pethokoukis, ventured that, "The Huntsman tax plan is—easily—the most pro-growth proposal ever offered by a U.S. presidential candidate.… The Huntsman plan looks like pro-free market populism, anti-crony capitalism." Following are some of the key components of the Huntsman plan, which we believe will be embraced by not only Republicans, but Independents and moderate Democrats as well:



" You can't find a job? . . Have you tried Asia? "

- Three individual tax brackets of 8%, 14%, and 23%
- An elimination of the capital gains and dividends taxes
- An elimination of all deductions and tax credits
- Reduction of the corporate tax rate to 25%
- Repeal existing regulations, including ObamaCare, Dodd-Frank, and Sarbanes-Oxley
- Curbing the excesses of independent agencies such as the NLRB and EPA
- Privatizing Fannie Mae and Freddie Mac
- Increase overall domestic energy production
- Make free trade a priority again

Huntsman argues that we cannot tax and spend and regulate our way to prosperity but "must compete our way to prosperity." His call for growth will be echoed in many quarters of the country in the months to come.

With the hurdles that face our nation and its economy the period ahead will be challenging indeed. The pendulum, however, is swinging back from the excesses of the welfare state. Mr. Buffett is correct; our best days lie ahead of us. Those who invest by looking in the rear view mirror and giving into emotional selling will miss the opportunities and rewards that lie ahead.

As we watch the ascent of the magnificent office towers under construction in New York at the site of the heinous terrorism visited upon this nation ten years ago, we can take pride in our resilient spirit which is characterized by individual initiative, liberty, and American exceptionalism. Let us hope that it is a set of values that will be rekindled in our homes and classrooms as we begin another New Year.

Roger E. King, CFA, CIC
Chairman and President

The year 2011 marks KING's Thirty-First 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 thirty-one 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.

FOOTNOTES, Page 4 Table: KING does not own all of these securities in all accounts. This information is not to be construed as a recommendation or a solicitation of an offer to buy or sell any security, financial product, or instrument, or to participate in any particular trading strategy.

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SOURCES FOR THIS ISSUE

Barron's, Bloomberg L.P., *Daily Wealth, Investor's Business Daily, The Wall Street Journal*

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