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DecisionMaker

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One buys two of everything and in the end owns a zoo.
— Warren Buffett

The first half of 2007 has been rewarding overall, albeit a bit choppy. For the quarter, the S&P 500 rose 6.28%, the Dow Jones was up 9.11%, and the Russell 2000 appreciated 4.42%. Perhaps the current state of the economy can be described as good but conflicted. On the positive side, economic data shows that disposable income continues to rise, as does household wealth. There are also encouraging signs that inflation is moderating and moving into a comfort range for the Federal Reserve Board (Fed). The most recent reading of the core Personal Consumption Expenditure (PCE) metric, the Fed's preferred inflation reading, rose at the slowest pace since March of 2004. The core Consumer Price Index (CPI) has moved from a peak of 2.9% last September to 2.1% in May 2007; impressively, three-tenths of that improvement has been reported since the May 9 Federal Open Market Committee (FOMC) meeting. It is likely that the Fed's description of inflation in upcoming meetings might include language that uses a more moderate tone. The labor market also remains strong, with the unemployment rate an extremely low 4.5%. Consumer spending, which accounts for 70% of GDP, continues to increase although at a slower pace than the first quarter.

Despite tangible signs that inflation is beginning to moderate, over the last several weeks one of the key stories impacting the markets has been the rise in the yield of the 10-year note as well as the change in the shape of the yield curve (which has steepened dramatically). While the financial media has been widely publicizing the rise in the yield of the 10-year note (which spiked to just over 5.30% towards the end of the quarter), investors seem to be overlooking what is occurring on the short end of the yield curve. The Fed's policy influences and is influenced by the short end of the curve, much more so than the long end of the curve. Depending on the time frame used, there is a 97% to 99% correlation between the Fed Funds rate (the Fed's target rate) and the 90-day T-bill. Sometimes the T-bill can drop before the Fed Funds rate when the Fed has hinted its next step to the bond market. But in other instances, the bond market could be forcing the Fed's hand or signaling to the Fed that its target rate should be lower. With the T-bill's rate this far below the Fed Funds rate (4.67% versus 5.25% as of quarter-end), Fed policy just became

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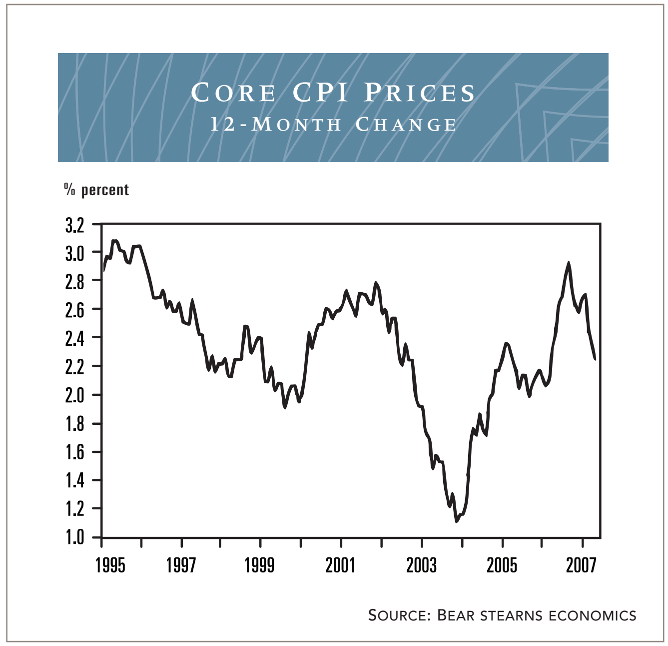
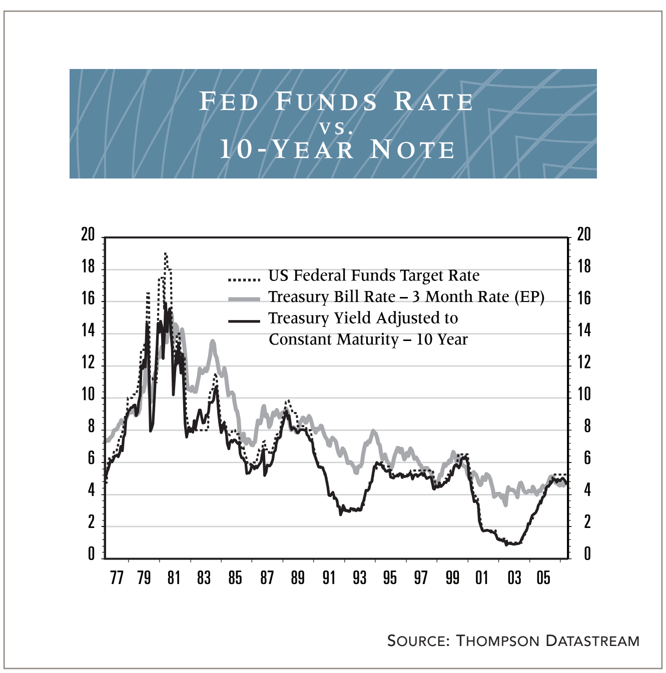
more restrictive without any specific action by the Fed. As has been widely publicized, the Bernanke Fed is going to be pre-disposed to inflation targeting, and that news should get better on this front, eventually giving them room to lower the Fed Funds rate.

Importantly, while bond yields have risen, implied inflation expectations have not. This development reflects both stronger economic growth as well as external developments that might signal increased uncertainty. The external factors are the larger concern of the U.S. markets and the economic outlook. In the U.S., the back up in interest rates has coincided with a revival in second quarter growth expectations, following a meager 0.6% gain in real GDP in the first quarter of 2007. Current inputs point to a 3% to a 3.5% gain, despite a smaller rise in consumer spending, spiking food and energy costs, and falling housing activity.



The largest overall drag on the economy continues to be the state of the housing market, where news is not quite as optimistic. The National Association of Homebuilders housing index, a gauge of builder sentiment, was 28 in June, representing a new cyclical trough and its lowest level since 1991.The median price of an existing home sold last month declined to $223,700, down 2.1% from a year ago. Last month's decrease marked the tenth straight monthly year-over-year decline, the longest stretch on record. Sales of previously owned homes declined to an annual rate of just under six million, while the supply of unsold homes increased 5% to just over 4.4 million. At that rate, current supply represents nearly 8 ½ months worth of inventory.

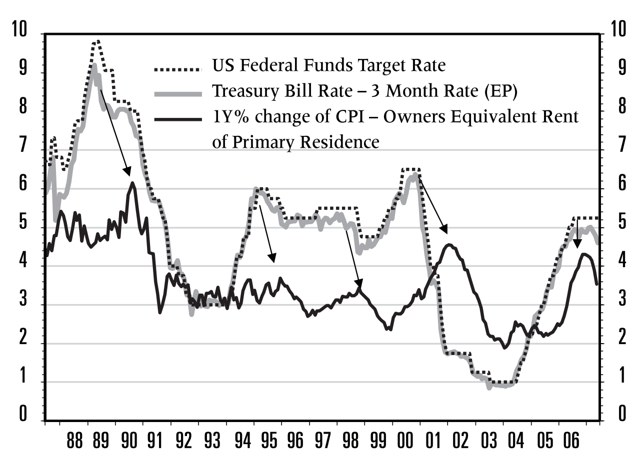


The flip side of the bad news on falling home prices is that it makes the Fed less likely to raise rates since doing so would put a strain on the already fragile housing market. The Chairman and CEO of Countrywide Financial, who recently visited our offices, had several interesting observations on the housing market. First, he believes that while noise concerning the housing market has died down a bit since the media frenzy of late February and early March when New Century and several other mortgage banking companies heavily dependent on subprime lending went belly-up, the underlying problems are still present, and it is likely that a second wave of bad news and foreclosures will hit the market over the next few months. In his opinion, the fallout in the subprime market has yet to run its course, and the pain in the housing market probably will not bottom until mid-2008. While the housing market remains spotty, some of these mortgage banking companies with strong liquidity and minimal exposure to the subprime market, like Countrywide, will be survivors and emerge as stronger entities with increased market share at the end of this cycle. Consequently, a few of these companies have very attractive risk/rewards profiles as long-term investments given that they are trading at valuations that already reflect a very bearish scenario for the housing market.

In addition to being a drag on economic growth, the housing market should also have a deflationary effect on the economy. Over the last several years, the core CPI has increased at a moderate rate. One component having a significant influence on the CPI has been Owner's Equivalent Rent (OER), which is an estimate of the cost of owning a home. The OER comprises more than 30% of core CPI and 20% of the core PCE, so it has a major influence on core inflation. With the current turmoil in the housing market continuing to unfold, this component of the CPI should begin to deflate those inflation readings.

A second concern weighing on the financial markets is the rising price of oil, which has once again surpassed $70 per barrel. The recent spike in energy cost and the issues relating to the housing market have raised concerns about consumer spending. While bears love to stress this side of the story, they frequently forget to relay the other, equally important part of the puzzle, that of rising income and wages. Over the past three years, personal income has increased at a 6% annual pace, about seven-tenths of a percentage point more than its fifteen-year average— a fairly significant rate. Those seven-tenths of a percent have largely paid for the increase in the consumers' energy tab, giving households an extra $75 billion over and above their average income growth. The income numbers have simply overwhelmed higher energy costs, providing the best explanation for the resilience in consumer spending in the face of increasing energy costs. Incomes have risen $1.7 trillion over the past three years to $11.4 trillion, enough to handle the extra $50 billion to $80 billion of added energy expense each year. Also interesting is the fact that the price of oil remains below its peak and has not changed significantly since Hurricane Katrina, over 20 months ago. Since that time, households have seen their incomes grow $1.3 trillion.

T-Bill & Owners Equivalent Rent are Dropping



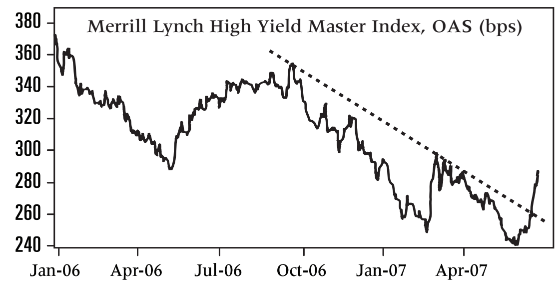
Source: Thompson Datastream

Lastly, overall credit quality and leverage remain a concern. These fears resurfaced as news broke near the end of the second quarter that Bear Stearns, a well-regarded firm in the mortgage and fixed income businesses, is working to pay off $9 billion in loans to a Bear Stearns hedge fund. Bear Stearns hedge funds are estimated to hold more than $20 billion in assets, and a significant percentage of these assets are bonds backed by subprime mortgages. This news created notable turmoil in the markets as the quarter came to a close. The bailout rivals that of Long-Term Capital Management in 1998 and may cost Bear Stearns nearly half of its operating earnings for 2007. The recent activities at Bear Stearns and other sponsors of private equity and hedge funds call into question whether competent financiers enticed by profits have been turning a blind eye to the methods used by hedge funds to value investments and emphasize how lax industry underwriting standards and lending practices have been. Since the announcement of the Bear Stearns issue, spreads between high-grade debt and junk bonds have widened, a trend that may continue over the months to come.

As Bear Stearns unwinds its positions, the ultimate sale prices for those securities could easily trigger a pricing revision in other securities, bringing on the next leg in a general downward revision of values for low-grade credits in the U.S. market. The danger for other markets is that if subprime securities cannot be sold because the bids are considerably lower than their computer-generated model values, the underlying funds will sell other securities to meet redemptions. This situation could snowball given the amount of leverage that has been employed in this space. The unwinding of the credit bubble in low-grade and no-grade credits in the U.S. is not at an end; it is at a beginning. Over the next sixteen months, adjustable rate mortgages (ARMs) will reset at much higher rates as the ultra-low interest rate loans that were made during the trough of the interest cycle in 2002 and 2003 come to the termination of their guarantees. Shorter-term ARMs, which ratchet up every 12, 24, and 36 months, have been slowly bleeding their holders. However, many homeowners holding teaser rate mortgages have already felt most of the pain as their mortgages have aged.

The role of leverage further complicates issues affecting the financial markets, as there is potential risk if we see hedge funds or private equity begin to have problems. For example, one of the Bear Stearns' funds was leveraged 20 to 1 before its troubles began. Long-term capital was leveraged 100 to 1 at one point. The ability to offload subprime securities at a respectable price is likely to be impaired and the amount of leverage employed to hold up the subprime pyramid is likely to change, if not from pressure via the regulators, then by the lenders themselves. The estimates of how much leverage has been added to the capital markets in recent years vary widely. Debt held by U.S. brokers is up 26% year-over-year, and margin debt levels recently hit at all-time high of $318 billion on the New York Stock Exchange. LBO loan volume hit $121 billion in 2006, compared with $31 billion in 1998, the peak of the previous cycle, according to S&P. Volume in 2007 has reached $88 billion thus far. Collateralized debt obligations (CDOs) issuance is up an enormous 350% since December 2004 and 50% year-over-year. (CDOs are a type of asset-backed security and structured credit product. CDOs gain exposure to the credit of a portfolio of fixed income assets and divide the credit risk among different tranches, or classes of debt. Losses are applied in reverse order of seniority, and junior tranches offer higher coupons to compensate for the added risk.) The Bear Stearns news is most likely not the last we will hear of hedge funds that have imploded due to being too highly leveraged and caught on the wrong side of a trade.

High Yield Spreads Breakout



Source: Merrill Lynch

On the positive side, the subprime issues do seem to be contained at the moment. Credit fears of this nature often tend to lead to a contraction of credit, which would have a negative impact on stocks (especially companies that utilize a fair amount of leverage). While fears are certainly present, in reality, the overall credit market appears to be healthy. One gauge of fear in the credit market is the overall health of the commercial paper market. In 2002, after the Enron bankruptcy, the credit markets essentially closed; commercial lending suffered its tightest conditions since the Great Depression and even large-cap companies such as Sprint PCS could not tap the commercial paper markets. Commercial paper (CP) is the largest instrument in the money market industry and is extremely important to companies seeking working capital for transaction purposes. SEC rules, in fact, require that commercial paper be sold for transaction purposes only, so when the CP market expands, it is usually a good sign that companies are confident in continued expansion and are building product for resale, and eventual return of capital to CP investors. The CP market continues to expand at a healthy rate, increasing $11.4 billion in the week ended June 20, 2007, to a record $2.132 trillion. It has grown approximately 20% since last year and at a 30% pace over the past three months.

The abundance of credit has sparked an enormous amount of merger and acquisition activity (M&A) over the last several years. Private equity firms have been able to take advantage of low global interest rates and favorable credit markets and financing terms. Investors have responded by pouring money into private equity firms in order to seek above average returns. In reality, these investors are demonstrating that they have been willing to take on a fairly high level of additional risk for very low additional returns, as the "risk premium" remains at an extremely low level. This extra yield, or spread, that investors demand to own speculative bonds instead of treasuries has fallen from over 800 basis points in 2003, to 340 basis points at the beginning of the year, to 265 basis points in May 2007. Both of the 2007 numbers are at extreme lows historically.

A day does not seem to pass without hearing news of a company being acquired by private equity. Operating in a private context allows many companies the flexibility to make necessary changes in an efficient way, without the scrutiny of short-term investors and the burden of public company costs. They can then reenter the public market as stronger, more efficient companies. This is good business not only for the companies, but also for the executives who run them. In the first half of 2007, private equity firms raised a record $260 billion for new investment funds globally. Already in 2007, LBOs have surpassed the $500 billion mark. Private equity as a percentage of this total M&A activity has increased dramatically, rising from 4.9% of deals in 1999 to 25.5% in 2006. With so much money chasing fewer and fewer quality acquisition candidates, one inevitably wonders how long this trend is sustainable. It also begs the question of how much lending is too much? In the late 1980s, banks aggressively loaned to aggressive LBOs, seduced by large, up-front fees that they could book as profits. Predictably, the frenzy ended badly as many of the deals went bust. Many banks fell below their capital requirement as a result of the writedowns, which meant they had to curtail new lending. The situation is different today in that banks are much better capitalized and much more diversified, and most have learned their lessons from the past. However, the days of making massive loans to private equity may be reaching its zenith.

With many private equity companies either going public or planning to go public, private equity players seem to be abandoning their basic business models in order to cash out. The Blackstone Group, one the largest private equity firms, went public on June 22, 2007. The company raised $4.13 billion, making it the largest U.S. IPO in five years. Many observers believe this ironic twist might signal the top of the private equity boom. After all, private equity makes money based on calculating inefficiencies that exist in the public markets (i.e., the stock market) and taking companies private. Additionally, Blackstone founder Steve Schwarzman stated at a conference in early 2007, "I think the public markets are overrated." Interestingly, while Blackstone wants to tap the liquidity of the public markets and insiders want to cash out, management does not wish to be accountable to investors. Blackstone will not be structured like a typical public company, but rather what *The Wall Street Journal* called a "privlic firm." Despite being a publicly-traded firm, Blackstone will continue to be a limited partnership, will have no annual meetings, and shareholders will have very limited voting rights. Schwarzman is known as one of the more savvy financiers on Wall

Street. He founded Blackstone with Peter Peterson in 1985; each originally invested $200,000 in the company. His stake in the company, after the IPO, is approximately $7.7 billion. Within the first week of trading, the stock fell below the $31 initial price. Perhaps Schwarzman knows something that investors are overlooking.

While there are concerning signs in the financial markets, such as within the subprime industry and the leverage in the hedge fund and private equity markets, the overall fundamentals of the economy remain solid, and the

✶ Corporate profits continue to grow at a solid rate and economic growth is on the rebound. ✶

fight against inflation appears to be gaining traction. There are always pockets of the market that are frothy at different times— tech in the late 1990s, real estate in the 1999-2006 period, commodities in 2005-2007, and today the overuse of leverage has created some areas of concern. This is not a negative for the entire market, however. Corporate profits continue to grow at a solid rate and economic growth is on the rebound. Also, while consumer spending has slowed, it is still growing at a healthy rate, as is corporate spending. In fact, Fed Chairman Bernanke recently commented that he expects GDP growth to accelerate during the last six months of the year. Corporate balance sheets also remain very strong and while the M&A frenzy that has occurred in private equity may subside, we believe that large-cap companies with pristine balance sheets will look to make acquisitions over the next several years. We are firmly convinced that opportunity abounds for investors with a long-term focus.

KING's Outlook and Our Business Valuation Approach

Though we have focused on our unique investment strategy in past issues of the *DecisionMaker*, we have not emphasized another strength of KING's investment approach, namely our focused portfolios. KING has a track record of producing solid results for our clients over the long term. An advantage of the firm is that we hold portfolios of 25 to 35 stocks (on average) for clients. These focused portfolios are a positive for numerous reasons. Most importantly, following a limited number of stocks enables our investment staff to focus our efforts on our best ideas and allows us to better "know" and understand the companies in which we invest. To illustrate this point, by owning fewer names than most investment managers, we are able to speak with management teams on a regular basis by phone, tour manufacturing facilities and company headquarters, accompany sales reps on calls, and perform many other acts of due diligence. There are only so many hours in the day, and we prefer to focus our time and efforts on a select number of stocks which we believe offer our clients the best risk/reward profiles. If we were to hold 150 or more stocks, our efforts— like any money manager— would become compromised and our talents would be spread too thin. Haphazard coverage of investments leads to errors, which in turn leads to subpar performance over the long term.

Second, over the long term, focused portfolios tend to outperform portfolios that hold hundreds of stocks. The key reason is that managers who own many stocks are not able to take larger positions in their best ideas. As a result, they become closet indexers who have little chance to outperform the market. On the other hand, at KING we will buy an average position of 3.3% at cost and take up to a 5% position in our favorite ideas. If a manager owns several hundred stocks, his best idea may ultimately be only a 1% weighting in the entire portfolio. In the end, even if the stock rises 100%, it will have a very small impact on the performance of the overall portfolio. The University of Michigan published a study in 2003 showing that more concentrated portfolios outperformed funds which held a much larger number of stocks by an average of nearly 1.4% per year over a 15-year time frame— a fairly substantial margin once you consider the impact of compounding. One of the finance professors in charge of the study (Lu Zheng) was quoted as saying, "Conventional wisdom suggests that funds should widely diversify their holdings across industries to reduce their portfolio's idiosyncratic risk, however, managers might want to hold concentrated portfolios if they have superior information to select profitable stocks in specific industries." The researchers found that mutual funds with more concentrated portfolios may indeed have informational advantages, and that the greater performance of these funds' portfolios is primarily due to superior stock selection by their managers.

Another way to look at the problem of over-diversification is that many money managers today are less focused on overall absolute returns, and are much more focused on their respective tracking errors (i.e., how much they beat or lag a specific index). This focus is a disservice to investors because it causes some institutional investors to purchase large baskets of stocks in order to ensure that their tracking error is as close to zero as possible (i.e., performance exactly in line with the market). This short-term gaming strategy distracts managers' attentions from focusing on their best ideas and from selecting stocks that will provide the best returns over the long term for their clients. Numerous managers also have this short-term emphasis due to current compensation structures (performance fees, etc.). As a result, these managers have forgotten what their ultimate goal is (i.e., to generate the best absolute returns possible independent of the market), and this misguided focus has led many to manage very large portfolios in their attempt to control stock-specific risk, holding nearly four times the number of stocks needed to meet diversification targets.

While rewards can be very attractive when discussing concentrated portfolios, the question arises, Does owning a more concentrated portfolio cause one to have diversification risk? Many studies have showed that diversification can be achieved with approximately 30 to 35 stocks. In other words, you can have a return profile with approximately the same amount of risk as the overall equity market by holding between 30 and 35 stocks. By holding two stocks, you reduce your non-market risk by approximately 42%, by holding four stocks your risk is reduced by 68%, by 83% by holding eight stocks, by 91% by holding sixteen stocks, and by 96% by holding thirty-two stocks. Why does the average mutual fund hold nearly four times the number of stocks it needs to hold in order to meet diversification targets? The answer is that the average portfolio manager is not concerned about total risk, but rather with risk measured relative to a performance benchmark (the index). Seth Klarman, the author of *Margin of Safety*, was recently quoted as saying, "There are no winners in the short-term, relative performance derby. Attempting to outperform the market in the short-term is futile… The effort only distracts a money manager from finding and acting on sound long-term opportunities… And as a result, the clients experience mediocre performance." Rather than worrying over absolute returns, many professional investors spend hours sweating over relative performance. To them, it is not total portfolio risk that matters, but tracking error, which is not necessarily consistent with a client's long-term goals and objectives.

By utilizing our proprietary Business Valuation Approach and by managing focused portfolios, we believe that we are well-positioned to find value for our clients in any market. We remain optimistic about the prospects of our holdings over the next 12 to 18 months, and we believe that many offer the potential for 30% to 50% upside.

Leah R. Bennett, CFA
Managing Director

Jill Silver
Senior Trader

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.

OTHER CONTRIBUTORS TO THIS ISSUE

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SOURCES FOR THIS ISSUE

Bank of America, Bear Stearns Economics, Bloomberg LP, Citigroup, *HaysAdvisory.com*, John Mauldin's *Outside the Box*, Miller Tabak, *Market Intelligence Report*, Merrill Lynch, *Naked Capitalism*, PricewaterhouseCoopers, Sandler O'Neill + Partners, *TheStreet.com*, *The Wall Street Journal*, University of Michigan

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