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Psychology is probably the most important factor in the market – and one that is least understood.

— David Dreman, well-known contrarian investor and author

Today's environment is one consumed with fear and uncertainty. Second quarter 2010 left much to be desired. Global stocks posted their largest losses since the bull market began last year as the sovereign debt crisis in Greece threatened to spread to other European countries. Chinese government restrictions on lending and real estate, intended to prevent the world's third largest economy from overheating, added to concerns that global growth may slow. In the U.S., slowing growth in manufacturing, an unexpected jump in jobless claims, and a slump in home sales have fueled concern the economic recovery is faltering. As a result, the U.S. stock market had one of its worst Mays on record and experienced its steepest decline in the month of June in 13 years.

At odds are two, strongly opposing forces in the market: low valuations and increased economic uncertainty. The by-product is a lack of conviction and increased volatility. The media tosses around the term "double-dip recession" as if it is a common event. In fact, there have been only three double-dip recessions over the past 150 years, the most recent occurring in the 1920s. We believe this term is too casually used and is often bandied by the media exacerbating investors' fears and emotions. In reality, none of the conditions that have historically preceded a double-dip recession (such as an inverted yield curve and abnormally high inventory levels) are present today.

A clue to future economic growth lies in the bond market. Oftentimes the yield curve inverts (i.e., short-term interest rates are higher than long-term rates, indicating possible credit stress) before a bear market begins in equities. This condition occurred in both 2000 and in 2008. Today, the yield curve is fairly steep, which indicates that economic growth may be on the horizon. Essentially, the extra yield

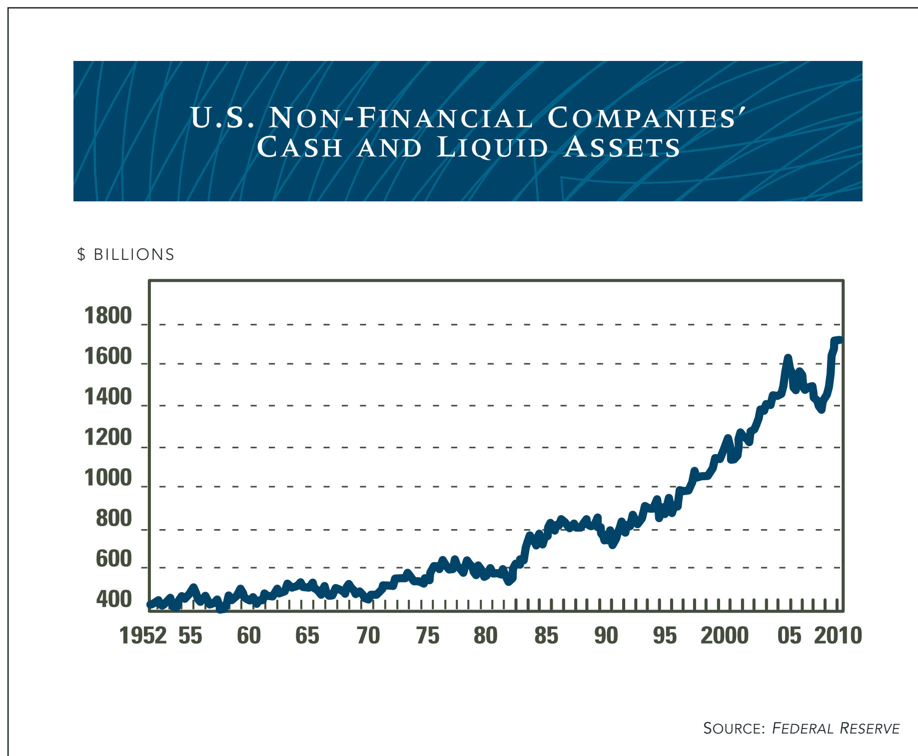
King Investment Advisors, Inc.
1980 Post Oak Boulevard, Suite 2400
Houston, Texas 77056-3898
Telephone: 713·961·0462
Fax: 713·961·5613
www.kingadvisors.com

that investors demand to hold 10-year Treasury notes compared with 2-year debt predicts positive economic activity.

Although serious problems are present in several countries in Europe, the overall continent may not be as unhealthy as equity prices would lead us to think. For example, in Germany, unemployment fell for a 12th consecutive month in June, dropping by 21,000 to 3.23 million, the lowest since the end of 2008. Germany represents Europe's largest economy and is the third largest exporter in the world; thus, strength in this country is not insignificant. Automobile and engineering companies have been rehiring and introducing Saturday shifts. LIBOR spreads in Europe have also dropped considerably since the news about Greece first broke, which is an important and very positive sign. In 2008, as we entered into an ugly bear market, credit seized with LIBOR rates escalating at a rapid rate to record highs. LIBOR spreads in Europe spiked in April but nowhere near record highs, and they have declined significantly since. In fact, France recently issued debt at record low interest rates.

While economic growth has slowed in Asia, growth in this region is still robust, and positive signs are emerging that a healthy, long-term, sustainable rate of growth is achievable (as opposed to a "crash landing," as many fear). In China, at least 9 of the more than 30 Chinese provinces and cities raised minimum wages by as much as one-third in early July. Migrant workers, who have traditionally earned the lowest wages in assembly line jobs, are having some success in extracting higher pay and better working conditions from foreign companies in a tight labor market. In Japan, a study released in early July showed a surprisingly sharp rise in business confidence among large manufacturers. An improvement in capital spending plans was also revealed.

Investors worldwide suffered a considerable decline in market value in 2008, and these declines are fresh in their minds. As a result, many are hypersensitive to the fear of losses today. With that said, it is important to take a rational look at the world through an analytical lens. Some perspective is also helpful. The release of the June employment data several weeks ago sparked a significant sell-off in the U.S. equity markets. However, for all of the gloom, there were pockets of strength, which were widely overlooked. The labor market is slowly improving. The data suggests that slower economic growth is likely over the remainder of the year; however, it does not indicate that the economy is expected to sink into a consumer-led recession. Payroll employment in the private sector increased by 83,000 during June—emphasis on "increased."



Today, new jobs are being created. In fact, since the start of the year, private payrolls are up 593,000, as opposed to early 2009—just over a year ago—when the U.S. economy was losing a distressing 500,000 to 700,000 jobs per month! The bleeding has been stopped, and unemployment is headed in the right direction, albeit at a very slow pace. Interestingly, the temporary-help industry hired 20,500 people during June, accounting for about a quarter of June's private payroll gains. Why is this good news? The temporary-help industry is a leading indicator for full-time employment. Furthermore, the employment report stated that average hourly earnings (adjusted for inflation) rose to a record high during June, another sign that employment may begin to increase.

Consumer spending has also been on the rise. Auto sales have continued to surprise on the upside during 2010, and the sales levels during some months in the spring were equivalent to the same levels seen during the Cash for Clunkers program last year. In the U.S., high-end/luxury items account for approximately one-third of all consumer spending. This portion of the market seems to be in a slow but sustainable upturn. Recently, Burberry, Coach, and Tiffany & Co. reported much stronger than expected sales.

Corporate financial health and balance sheets are exceedingly strong overall. Companies are sitting on a record level of cash, nearly $2 trillion. Of course, there is both a bull and a bear argument to this scenario. The bear argument is that companies are afraid to spend and demand is not present. The bull argument is that these high cash levels could lead to accelerated merger and acquisition activity (which would buoy stock prices), a pickup in share repurchase programs, and increased dividends. KING falls into the latter camp, but regardless of one's view, it is comforting that most corporations are not in a situation where they are trying to repair their balance sheets in today's environment. Instead, they are in the enviable position of not having to raise capital in a difficult market and having the resources to hire and spend when global demand starts to improve.

Strong overall corporate financial health may be the reason that insider buying has been on the rise. Presumably, a corporation's management team knows the most about the company, having

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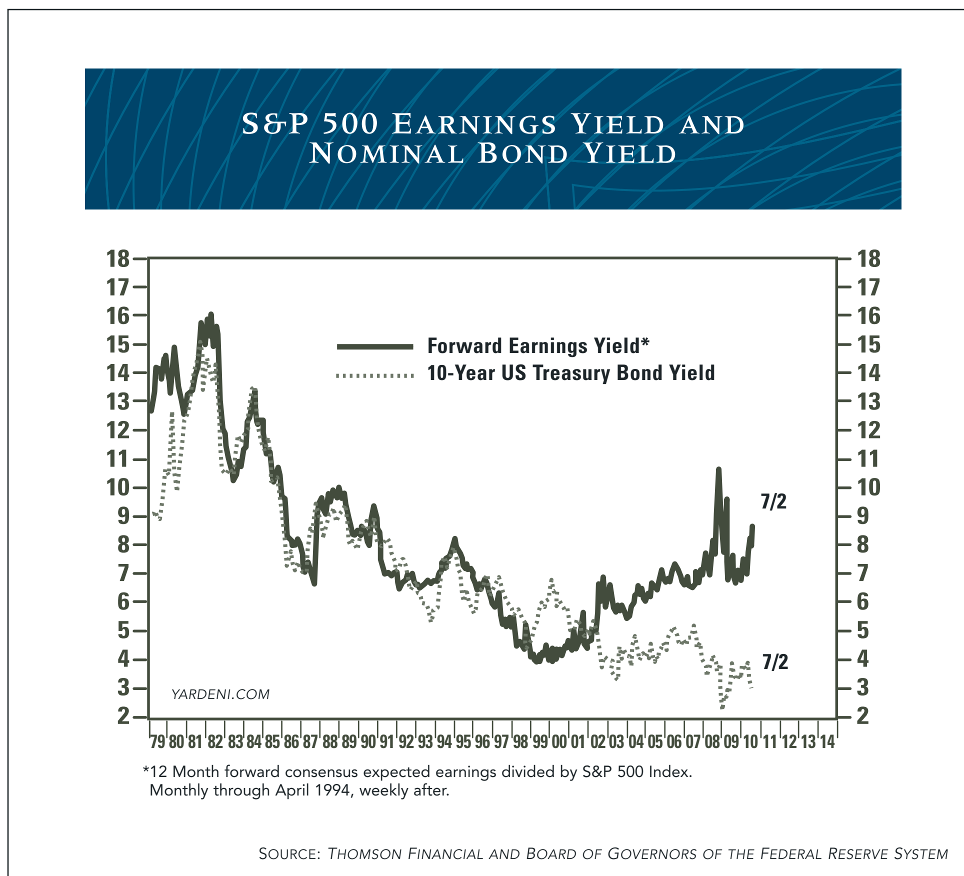
insights as to its profitability and its plans for the future. In early 2000, insiders were rapidly unloading their stock. February and March 2010 also saw a spike in selling activity. However, insiders have rapidly gone from being net sellers to net buyers. In fact, insiders are buying stock at a level we have not seen since 2003, when the market turned and came roaring out of the bear market that occurred in the earlier part of this decade. Although this insider buying may not mark the start of a bull market as was the case in 2003, insiders may be telling us that investors are too pessimistic and that equity prices are too low. Energy is one sector, in particular, where insider buying has been very strong. The energy sector was one of the hardest hit groups in the second quarter due to the BP spill and created an attractive buying opportunity for numerous stocks. While the disastrous oil spill has clearly impacted near-term drilling in the Gulf of Mexico, not all oil companies have major exposure in the Gulf. Drilling will continue around the globe, and the demand for oil will rise over time. As a result, we believe several oil companies represent good, long-term risk/rewards. Many of these stocks have entered the third quarter on a strong note.



*12 Month forward consensus expected earnings divided by S&P 500 Index. Monthly through April 1994, weekly after.

Source: *Thomson Financial and Board of Governors of the Federal Reserve System*

Global economic growth is slowing. However, it is likely to experience a soft landing rather than a hard landing during the second half of the year, as long as another global credit crunch is not in the offing—an event we think is

unlikely. Profits should remain surprisingly robust as companies find enough growth to leverage up into strong earnings with ongoing increases in productivity. As a result, inflation-adjusted wages should continue to rise. End demand may also improve more than generally expected.

THE CASE FOR EQUITIES

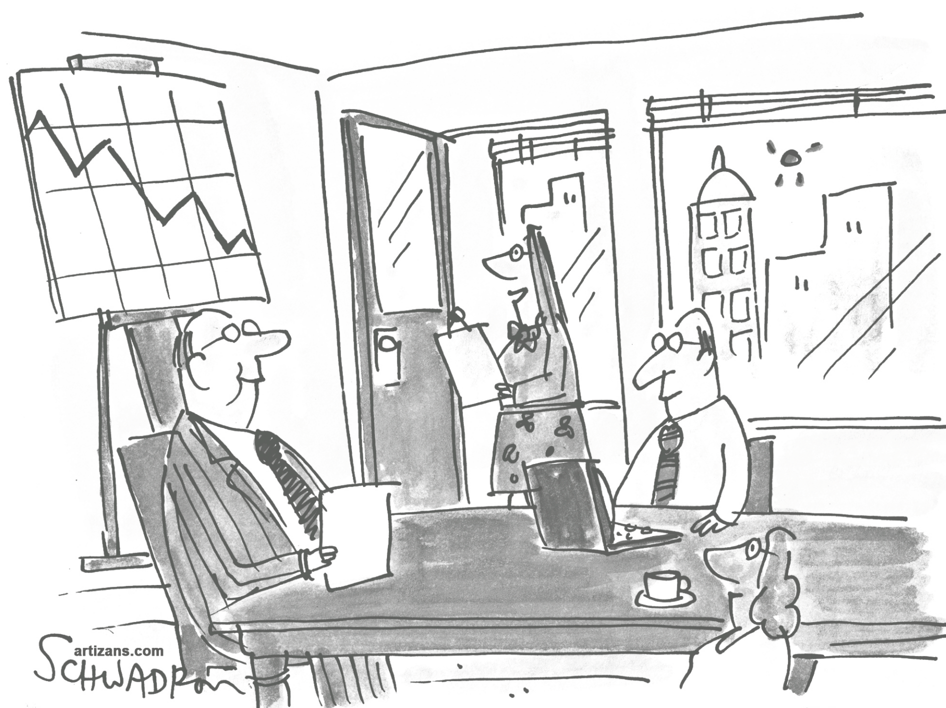
Today a large number of investors detest equities, a sharp contrast to the earlier part of the decade. It was not uncommon to hear people talk about their latest dotcom purchase or the most recent IPO in which they participated, where they saw their new issue increase two- or three-fold on its first day of trading. This group euphoria eventually devolved into a painful bear market over the following years (2000 through early 2003). Similarly, "house flipping" was all the rage in 2003-2007. Many investors bragged about their home or condo prices doubling or even tripling within a few short years. One needed only to turn on a TV to see how many shows were dedicated to house speculation and the idea of house flipping. Needless to say, the buying frenzy in housing and the flawed financial engineering which supported the mania were major factors underlying the most recent bear market. Is the fact that equities are not loved a positive sign of things to come?

Two of the asset classes that interest many investors today are fixed income and gold. Investors have piled into fixed income over the last two years. Yields have declined to levels so low that the interest income is almost imperceptible. The yield on a 1-year Treasury bill is 0.25%, the yield of a 10-year note is 2.95%, and the yield on a 30-year Treasury bond is less than 4%! Thirty years is a long time to tie up your capital only to earn a meager 3.98% per year. However, the motivation of many fixed income investors has not been to make a large return, instead it has been to protect capital. With so many investors having committed billions of dollars to fixed income instruments directly or through ETFs or bond funds, the stage is set for an eventual bubble in the fixed income markets. Longer dated bonds and leveraged bond funds will suffer a meaningful erosion in market values as rates begin to rise. It is important to realize that many closed-end fund managers have had to stretch for yield by leveraging up their funds. For example, if the duration of a bond fund is four years (which does not seem long at face value) and a fund is leveraged by three, a 1% increase in interest rates could lead to a 12% loss in the fund's price. This could be a very unpleasant surprise for many whose motive for owning bonds was to avoid losses. Interest rates today are very low, and the Federal Reserve repeatedly has stated that it intends to keep rates low for "an extended period," thus, a scenario along these line is unlikely to occur over the near term. The problem lies in the timing. When will rates begin to climb? We do not know, but it will occur. For many bond investors with concentrations in bonds with long maturities or leveraged funds some unpleasant surprises will result.

We are often asked about gold. The past eight years have seen gold prices rise dramatically. Is gold a "safe" investment? One could argue that gold is a speculative asset; it does not generate earnings nor does it pay a dividend. Bullion derives its value only from the fact that others find it valuable. Nevertheless, gold has been the rage. As with most commodity prices, gold prices are largely driven by supply and demand. Caveat emptor should be the watchword for gold investors. The increase in gold prices has resulted in a notable increase in supply. Between 2007 and the first quarter of 2010, a total of 12,074 tonnes of new gold supply entered the market from various sources (mines, central bank sales, and the recycling of old jewelry), but only 8,246 tonnes of gold were bought for applications and jewelry demand. This

excess supply represents nearly two years of mining output and implies that to sustain gold prices at current levels, a large increase in investment demand needs to occur. This may be difficult as gold supply continues to hit the markets. Just as during the housing boom, gold ads are prevalent in the media. In fact, gold parties, much like the Tupperware parties of the past, are in vogue. There are also gold-buying shops of all kinds popping up on every corner, all offering the highest prices for gold sellers. Is anyone else reminded of a period three and four years ago when mortgage companies were everywhere you looked? These businesses are not multiplying because of a shortage of sellers. The more supply that enters the market, the more investment demand is needed to offset the supply. This is probably not a sustainable situation over the near to intermediate term. Another important factor to consider is that gold demand is also partially driven by falling real interest rates. When real interest rates fall, the opportunity cost for holding gold is reduced, and it becomes a more attractive investment. Thus a low interest rate environment is a key support for rising gold prices.

The question one has to ask is, "Is the excitement in bonds and gold a precursor to the same outcome as equities in 2000 and housing in 2007?" Maybe not to the same extent, but we would strongly argue that the upward path for these two asset classes is increasingly uncertain and that investors may well be rushing in at the wrong time. On the other hand, globally, stocks are "under-owned." This is a positive sign because there are fewer potential sellers and many more potential buyers. As we discussed earlier, corporate balance sheets are generally very healthy. An investor today can



"PUBLIC OPINION POLLS LOOK GOOD. INSTEAD OF HATING WALL STREET, PEOPLE NOW HATE BRITISH PETROLEUM."

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buy solid companies trading at 10x earnings or less, that have the potential to grow earnings and reward investors via share purchases, M&A, and higher dividend payouts. In fact, the yield on the S&P 500 is approximately 2.03%, which is better than the current yield on a 5-year Treasury note. Bull markets in any asset class have never emerged when investors “feel good.” In fact, complacency and a herd-type mentality that everyone should own something (be it houses, stocks, gold, etc.) is often a very bad indicator of things to come. All of the buyers are in, everyone owns the same thing, and all it takes is a domino or two to fall before there is a mass exodus. At present, it appears stocks are at the extreme opposite end of the spectrum; and often an environment of extreme pessimism can give birth to a period of much better than expected returns

The third quarter began with a relatively strong start after a very difficult May and June. Contributing to the turnaround is the early reporting of some key corporate reports. Intel, Alcoa, State Street, and CSX Corporation have all surprised investors on the upside. Corporate earnings have been strong for several quarters, but many companies have beat expectations on earnings via cost cutting and have not announced a pickup in revenues; however, this situation is starting to change. In fact, 83% of companies in the S&P 500 grew revenues year-over-year in the first quarter of 2010 versus 56% in the fourth quarter of 2009. Thus far in the second quarter, instead of relying on cost cutting and an improvement in margins, CSX (a major railroad), Intel (a major tech company), and Alcoa (a major commodity company) have each reported increases in end demand. These three companies represent a broad spectrum of industries and are fairly reflective of the global economy. The management teams of Intel and Alcoa felt confident enough to revise upward expectations for the remainder of the year. In addition, it has been one year since corporate earnings growth turned positive. The second quarter of 2009 was the first quarter coming out of the recession where we saw positive corporate earnings growth year-over-year. This is an important barometer for gauging the overall health of corporate earnings. In an ideal environment, we want to see expected earnings growth compounding on a prior year’s growth versus expected growth off of a negative period, such as occurred in the first quarter of 2010. This June quarter’s 25%-30% expected earnings growth of the S&P 500 companies illustrates this point. Unfortunately, in an environment engulfed in fear, these facts are largely lost in the media.

We are not Pollyannas and we acknowledge that many challenges remain; however, we believe these reports suggest positive signs of things to come and that equity prices are well oversold versus long-term fundamentals. We are optimistic about the outlook for equities and believe investors will be rewarded, perhaps sooner rather than later. Valuations on many stocks are at levels where it takes very little in order to unleash value and realize significant price appreciation.

Leah R. Bennett, CFA
Managing Director

The year 2010 marks KING's Thirtieth 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 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

BCA Research; Bloomberg L.P.; Ed Yardeni

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