

# DecisionMaker

Published Quarterly by King Investment Advisors, Inc.

---

*Fortune's wheel never stands still, the highest point is therefore the most perilous.*

— MARIA EDGEWORTH, IRISH WRITER; 1767-1849

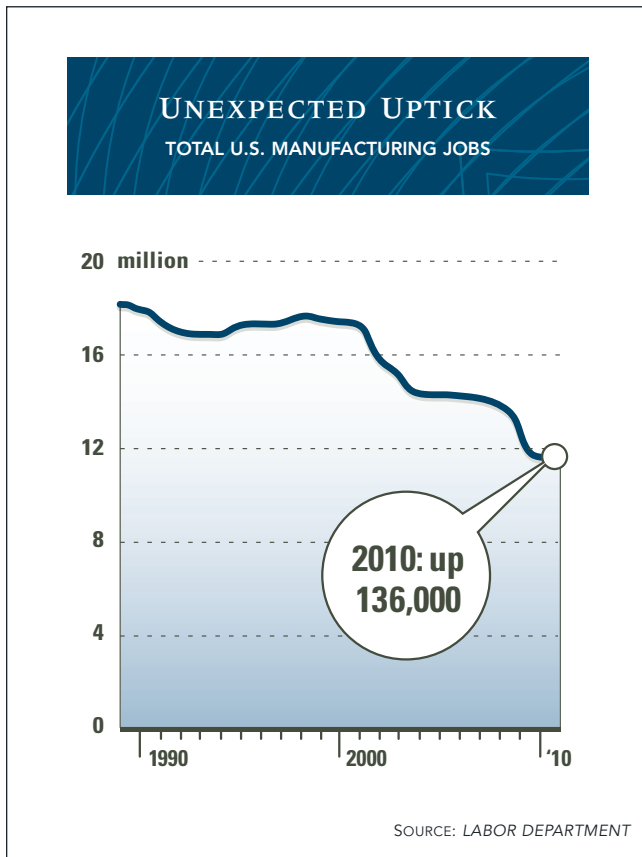
*Fortune's wheel never stands still, the lowest point therefore holds the most opportunity.*

— A VALUE INVESTOR'S COROLLARY

The wheel of economic fortune slowly turns. As we rolled into 2010, members of the financial community were moody and preoccupied with a dark view of world events. In these smitten experts' minds, there was little chance of repeating the strong equity returns of 2009. The returns of 2009 were thought to be an anomaly driven by out-of-control money supply growth and a technical rebound from the financial meltdown of 2007 and 2008. But slowly, in the last half of 2010, these frozen attitudes thawed and began warming to the steady stream of growing profits of American as well as international corporations. As investor momentum shifted, moods brightened, resulting in impressive gains of 11.0% for the Dow Jones Industrial Average, 12.8% for the S&P 500, and 16.9% for the NASDAQ.

The wheel continues to gain momentum in 2011. Based on the savvy prognostications of two of our favorite strategists, Ed Yardeni and John Maulden, as well as comments voiced in *The Wall Street Journal*, events are unfolding that should lead to another satisfying year for long-term investors. While all of these optimistic predictions may not occur, even realizing a few of them will continue to push the market forward.

***The United States should continue to swing from a muddle-through economy to more vibrant growth in 2011.*** After a decade of 1.9% annual GDP growth in the U.S., the economy is expected to have expanded by 3% in real terms in 2010. A similar 3% growth rate, perhaps more, should be expected in 2011. At least during the first half of the year, pent-up demand, coupled with rising real pay, should boost consumer spending. As anecdotal evidence, a Houston couple took their children on a surprise trip to Disneyland the day after Christmas. In four of the next five days,



the park sold out of tickets within two hours! Combining the evidence of this not-so-magical trip with sightings of crowded restaurants and Apple Stores lends credence to the thought that the American consumer is coming out of hibernation.

**Small business in the United States is making a comeback.** The extension of former President Bush's tax cuts has contributed to averting another recession. Between 50%-70% of the so-called rich are small business owners and the backbone of U.S. job creation. With more money in their pockets, such entrepreneurs want to grow their businesses by looking for new products and new markets. This growth leads to more jobs. While we have not seen a surge in hiring, the good news is that two job creation indicators, job openings and job creation plans, both reached new recovery highs. The percentage of small business owners reporting hard-to-fill job openings rose four points to 13%,

the best reading in two years. Plans to create jobs gained two points, rising to a net 6% of all owners, the best reading in 27 months. While the unemployment rate continues to be dismal, these early indicators show a light at the end of the jobless tunnel.

**Emerging economies should thrive.** A true consuming economic class may rise in the global emerging economies. Hundreds of millions of workers are earning enough money to be considered middle class. As they prosper, they will begin shopping for discretionary goods and services. It is no coincidence that Wal-Mart, the world's largest retailer, has launched new websites in Latin America and China as well as acquiring one of South Africa's largest retailing chains.

**European economies should remain resilient despite the ongoing sovereign debt crises.** As problems still loom over the PIIGS countries (Portugal, Ireland, Italy, Greece, and Spain), the European Central Bank will be forced to purchase more bonds of these debt-challenged nations. While the smaller countries of Europe may fall into recession, the larger countries of Germany, France, and the United Kingdom, powered by their vast corporate and national resources, should be able to prevent a disaster in the region.

**Corporate profit levels in 2011 should be very similar to that experienced in 2010.** Profits should remain strong although the year-over-year growth rate may slow. Interest rates on the short end of the yield curve should remain fairly level. Longer-term bond yields are bound to rise based on better than expected economic growth. Moreover, long-term rates will ratchet up further if our leadership in Washington, D.C. does not show progress in reviving fiscal discipline in the United States. The 10-year Treasury, now at 3.4%, could climb back up to 4.0% or higher by the end of the year.

**The country is in the sweet spot of the third year of a presidential cycle.** Since 1955, the S&P 500 has been up an average of 18.4% for the entire third year of every presidential term without a single down year.

First-term presidents, wanting to be reelected, do what they can to stimulate the national economy. President Obama appears to be following the script. He has already appointed aides who worked previously for Bill Clinton, the model for a president who moved from left to center after taking a shellacking in the mid-term Congressional elections. The President's choices are telling according to Ed Yardeni:

Bill Daley will be the new White House Chief of Staff, leaving his post as Midwest Vice Chairman of JPMorgan Chase & Co. He came highly recommended by Jamie Dimon, JPMorgan's Chairman and a prominent adviser to the President. Under former President Clinton, Mr. Daley served as Secretary of Commerce during the second term and special counsel to the President on issues relating to the successful passage of NAFTA. Daley was also an outspoken opponent of two of President Obama's most prominent legislative victories: health care reform and the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Gene Sperling will head the National Economic Council as he did for President Clinton from 1996-2000. In 1999, Mr. Sperling was the chief negotiator of the Gramm-Leach-Bliley Act that repealed large portions of the Glass-Steagall Act of 1933, thereby opening the market among banking, securities, and insurance companies. He is also the author of *The Pro-Growth Progressive*, which argues that liberals should harness financial market forces in pursuing progressive goals.

***U.S. banks are starting to loosen their purse strings.***

In the third quarter of 2010, lenders made 36 million consumer loans, up 3.7 % from 2009, according to Equifax and Moody's Analytics. That is the first year-over-year gain since the financial crisis began. While still half of the pre-recession level, consumer loan originations are expected to rise almost 6% this year. Credit card companies, which had reined in their marketing due to higher loan losses and new regula-

tion, are now stepping up their marketing. It is not just the "super-prime" borrowers who are being shown new offers; mailings to subprime borrowers surged 90% in the fourth quarter of 2010, according to Synovate, an industry monitor.

***U.S. manufacturing may experience a renaissance.***

As reported in *The Wall Street Journal*, U.S. manufacturing, viewed as a lost cause by most investors, has begun to create more jobs than it has eliminated for the first time in thirteen years. In 2010, the number of manufacturing jobs in the U.S. grew 1.2%, or 136,000—the first increase since 1997. Moreover, economists project a gain of 2.5% (or 330,000) manufacturing jobs in 2011. Some of the most significant contributors come from machinery, transportation (including automobiles), and fabricated metal products. This job growth is expected to continue as companies replace aging equipment, take advantage of government incentives, seek energy savings, and rediscover that it is cheaper to produce some products that are large and heavy, such as ovens and construction machinery, at home rather than shipping them long distances. While the country has a long way to go to make up the six million manufacturing jobs lost since 1997, this improvement is a shining star of the present recovery.

---

★ While we have not seen a surge in hiring, the good news is that two job creation indicators, job openings and job creation plans, both reached new recovery highs. ★

---

Along with these broad macroeconomic and political factors discussed above, we at KING follow a number

---

★ The financial meltdown of 2007-2008 has tremendously hurt the revenue-generating power of all fifty states. While all have the challenge of balancing their budgets, there are certain states that are following very different paths to prosperity. ★

---

of more targeted economic and political developments in our fundamental research of companies and their stocks, both in the United States and on a global basis. Sometimes such exogenous factors inspire us to look at specific economic sectors and industries for companies that can benefit by a prominent trend. On the flip side, developing negative trends can cause us to sell a security from client accounts or pass up a potential purchase candidate.

Presently, there are two developing stories that have and will continue to have a significant effect on individual stocks, depending on a company's industry or the geographic concentration of its customers and employees. The first is the fascinating contrast between the policies our fifty states are implementing to overcome the deficits created by the recent recession and financial meltdown. The second story focuses on the Executive Branch's current efforts to use the federal government's regulatory authority to achieve its mandates. In 2011, both of these developments bear watching by investors to discover opportunities to earn attractive profits or avoid pitfalls in their portfolios.

### THE GREAT EXPERIMENT

The founders of this great republic envisioned the states as autonomous political bodies, with wide latitude given to each state's taxing and spending powers. Every state is free to test different ideas, allowing the rest of the country to learn from its experiences. A

strategy's success or failure can easily be judged by the movement of people and jobs from state to state. One of the greatest strengths of the U.S. is the mobility of its citizens, with their ability to move to "greener pastures" in search of better opportunities.

We live in a fascinating time in which a great experiment has already begun. The financial meltdown of 2007-2008 has tremendously hurt the revenue-generating power of all fifty states. While all have the challenge of balancing their budgets, there are certain states that are following very different paths to prosperity. Economists and political scientists have never had a better laboratory to study the effects of taxation, spending restraint, and free-market incentives. On one side are the reformers intent on slashing spending and reviving growth. On the other are the holdouts that are drifting further into the abyss of tax and spend. The difference in strategy has huge implications on the local, regional, and national levels.

The results are already coming in. As shown in a chart from Laffer Associates, the 2010 census portrays a significant shift in population from 2000 to 2010 to pro-growth, low-tax states. It is no coincidence that the nine states with no income tax were among the biggest gainers while the nine states with the highest income tax rates experienced the lowest growth rates. As the wheel of time moves forward, here are a few of the states to watch as noted by *The Wall Street Journal*.

## ILLINOIS – PROBABLE LOSER

Illinois became the first state of 2011 to sock it to its citizens, passing a massive tax hike. State legislatures approved a 66% increase in the personal income tax rates; an Illinois resident who now owes \$1,000 in state income taxes will pay \$1,666. Corporate income tax rates were increased 45%. In quick response, neighboring Governor Scott Walker dusted off an old tourism slogan, “Escape to Wisconsin,” as he blitzed the Chicago media markets to notify Illinois businesses that Wisconsin is working to enact the total elimination of corporate income taxes for two years. Returning with the double punch, Michigan’s governor, Rick Snyder, is ending the 22% surcharge on his state’s job-killing business tax. With chasms like these, it may be difficult to find a U-Haul trailer for rent in Chicago in the not-too-distant future.

## NEW JERSEY – POSSIBLE WINNER

New Jersey’s Chris Christie is proving that a governor can take on powerful unions and special interest groups and not only survive but also attract an enthusiastic following as well. Due to Governor Christie’s 2010 veto of a tax bill targeting the state’s highest earners, New Jersey has pulled itself up from dead last in the Tax Foundation’s annual ranking of state business-tax climates to number 48, edging out New York and California. To be more competitive with other states, Governor Christie says New Jersey needs to cut income taxes across the board and cut business taxes in a broad-based way.

## 2010 CENSUS POPULATIONS

States with Lowest Marginal Personal Income Tax Rates			
STATE	2000 POPULATION	2010 POPULATION	2010 CHANGE
Alaska	626,932	710,231	13.3%
Florida	15,982,378	18,801,310	17.6%
Nevada	1,998,257	2,700,551	35.1%
New Hampshire	1,235,786	1,316,470	6.5%
South Dakota	754,844	814,180	7.9%
Tennessee	5,689,283	6,346,105	11.55%
Texas	20,851,820	25,145,561	20.6%
Washington	5,894,121	6,724,540	14.1%
Wyoming	493,782	563,626	14.1%
<b>AVERAGE: 15.6%</b>			
States with Highest Marginal Personal Income Tax Rates			
STATE	2000 POPULATION	2010 POPULATION	2010 CHANGE
California	33,871,648	37,253,956	10.0%
Hawaii	1,211,537	1,360,301	12.3%
Maine	1,274,923	1,328,361	4.2%
Maryland	5,296,486	5,773,552	9.0%
New Jersey	8,414,350	8,791,894	4.5%
New York	18,976,457	19,378,102	2.1%
Ohio	11,353,140	11,536,504	1.6%
Oregon	3,421,399	3,831,074	12.0%
Vermont	608,827	625,741	2.8%
<b>AVERAGE: 6.5%</b>			

SOURCE: 2010 CENSUS

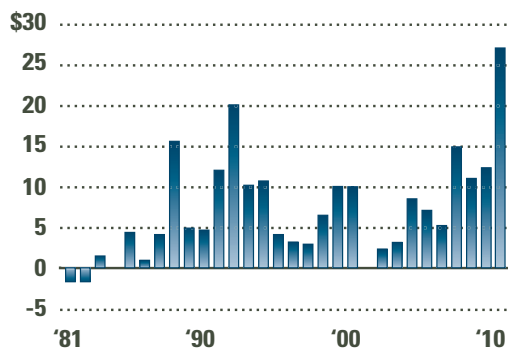
Even though having to deal with a state legislature full of “tax and spend” incumbents, the governor has been instrumental in the New Jersey legislature

introducing 25 new tax cuts. If Governor Christie can continue to win reforms that transform New Jersey into a growth state, his star will be bright on the national stage in the 2012 or 2016 presidential elections.

State economic and tax policies matter. Beyond the interesting political implications of these states' drastically diverging strategies, the projected outcomes have a significant impact on KING's fundamental analysis of companies and their stocks. As an example, if we conclude Illinois is going to be a low-growth state for the foreseeable future, any stock position we take in a community bank in Chicago will have to be purchased at a discount to a similar community bank in Texas, one of the country's high growth states. The movement of citizens to the Lone Star State helps the local Texas banks grow faster while the Illinois financial institutions face a serious headwind as their depositors close their accounts on their way out of town.

### COST OF NEW MAJOR FEDERAL RULES

Cost of new major federal rules of more than \$100 million each, in billions adjusted for 2009 dollars, since 1981



Sources: OMB (1981-2009), Heritage Foundation (2010)

SOURCE: 2010 CENSUS

### HYPERACTIVE FEDERAL REGULATION

One of the most important stories of 2011 that will affect stock prices, on an individual or institutional basis, will be federal regulation. Without the support of the House of Representatives, the White House will drive its agenda via rule-making and regulation rather than democratic consent. While these maneuvers would take place under the auspices of the Republicans as well as the Democrats, over the last four years, it has grown increasingly more expensive for companies and individuals to comply with major regulatory reform. As seen in the Cost of New Major Federal Rules chart, the previous high cost of regulation was \$20 billion in 1992 when many of the Clean Air Act Amendments of 1990 were launched. Based on filings in the Federal Register, The Heritage Foundation estimates the 2010 cost of regulatory compliance will exceed \$26.5 billion.

Some 195 major rules are currently on the docket, and the number is growing. Here is a partial list provided recently by *The Wall Street Journal*:

- The Dodd-Frank financial law, which calls for hundreds of new rules by dozens of existing and two new agencies;
- ObamaCare, which gives federal agencies authority to fill in the details of the legislation, a process that will take years or decades to complete;
- the Federal Communication Commission with its focus on net neutrality;
- the Food and Drug Administration with its oversight of food safety and medical devices;
- the Department of Labor with its bias toward union demands; and
- another major offender, the Environmental Protection Agency, which is rewriting environmental law with almost no oversight. The EPA's goal is to impose the carbon emission limits that Congress rejected last year. It is also re-regulating conventional air pollutants, often bypassing the usual notice and public comment. Unless Congress intervenes, it will be among the costliest regulation in government history.

KING is keenly aware of the impact of regulation on a company's balance sheet and its underlying stock price. The prospect of future regulation is a key factor in our valuation of a stock. Sometimes this can be an advantage as in the case of a portfolio holding of a small company that has developed a drilling fluid used in oil and gas production that is water-based instead of the traditional diesel-based products. The company stands to benefit tremendously from future EPA regulation and Congressional oversight.

In some cases, we discount the probability of regulation in valuing a stock. A good example is a broker-dealer firm that specializes in facilitating large trades between dealers such as JPMorgan and Goldman Sachs. The founder and CEO of the firm was in our office in mid-January explaining that he expects the operating expenses and cost of capital will increase under the new rules of the Dodd-Frank regulation. While his firm will see some margin compression, management predicts many of its smaller competitors may be driven into its arms as the cost of the new regulation becomes too high for the smaller players to bear. KING sees this as an attractive investment.

As security analysts, our research process is based on the evaluation of many factors. Macroeconomic and political projections include anticipated economic growth, shifts in demographics, and regulatory

changes, to mention only a few considerations in our fundamental analysis. These macro elements provide an overlay to our more concentrated study of individual companies and their valuations. Before we purchase a security, we review its financial health, analyze the quality and motivation of its management team, and understand its product and competitive

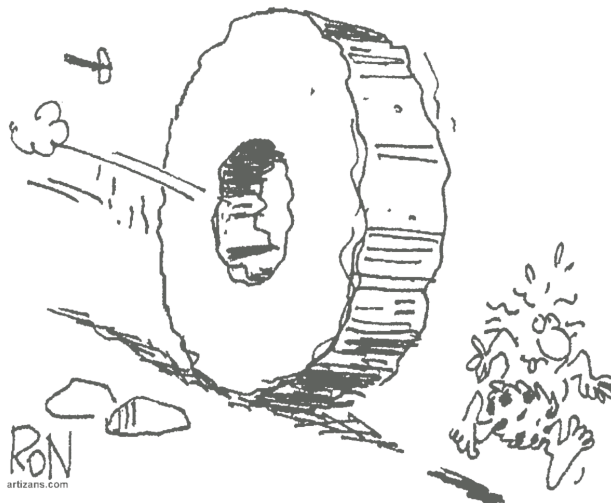
---

★ KING is keenly aware of the impact of regulation on a company's balance sheet and its underlying stock price. ★

---

position. In particular, we closely examine the growth prospects of potential investments and identify the catalysts that will propel the stock price upward. Only then, when we conclude that the potential gain in a security's value significantly outweighs the downside risk, do we add it as a holding in our client portfolios. This is the essence of our Business Valuation Approach, our long-term investment philosophy that has served our client's well over the last three decades.

Pat H. Swanson, CFA  
Managing Director



The year 2010 marked 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

*Chicago Tribune; Ed Yardeni, Yardeni Research; Investor's Business Daily; John Mauldin, Thoughts from the Frontline; Laffer Associates; The Wall Street Journal*



King Investment Advisors, Inc. is an investment advisor registered with the Securities and Exchange Commission offering investment management services for individual and non-taxable accounts. This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. The opinions expressed are our opinions only. We welcome your inquiries.