28
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Excellence

Spring 2009

KING

DecisionMaker

Published Quarterly by King Investment Advisors, Inc.

It is a mistake to look too far ahead. Only one link in the chain of destiny can be handled at a time.

— Winston Churchill

On April 9, Wells Fargo common stock skyrocketed 32% from $14.89 the previous day to close at $19.61. Wells reported a surprisingly strong first quarter, with operating earnings of $3.0 billion, up 7.8% from the first quarter of 2008. Nearly all banks moved up in tandem as investors grew euphoric that the Easter egg gift from Wells was an omen of good things to come. Still, as trading ended, Wells was still down a depressing 35% from its December 31 close, a sign that as robust as the rally in the markets from the March lows has been, at this stage they appear only to have clawed their way back from the depths of a panic-induced waterfall decline.

What may come as a surprise to many investors is we are in a new bull market. At least according to the classic Wall Street definition, in that as of April 3, all three major equity indices recovered more than 20% from their March lows. Only time will tell if a new bull market has finally gored the most devastating bear market since the Great Depression. We suspect that 2009, now almost one-third over, will be marked by both renewed optimism and higher prices, counterbalanced by a numbing realization that while the worst may be over, any future economic recovery will encounter a series of hurdles unlike any faced by our country in the past.

Investing has always been done with an eye to the immediate future as well as peering toward the more distant horizon. Thus, at present, investors find themselves at a point in time where the crisis atmosphere of the past few quarters is finally yielding some intriguing and rewarding opportunities for investment despite the continued existence of economic stress. Certain economic barometers support a more sanguine view of the near- and

intermediate-term. However, far more important are the truly revolutionary changes sweeping the financial and political world that will have an impact on the long-term outlook for world economies, international stability, the markets, and future rates of return. As economic stability is achieved and a more "normal" economic environment develops, the global economic world will be one that is very different from that of the last quarter-century. The implications for investors will be far-reaching and challenging, although they will not satisfy the dreams of most optimists; nor will they yield to the darker visions conjured up by the Chicken Littles.

First, let's take a close look at the road in front of our headlights. After plunging to new lows in March, global equity markets reversed course and sprang forward as if to confirm much of the conventional buzz in the investment world, that is, "the economy is still bad, but it is less worse." This recent and growing mindset is hardly a ringing endorsement for abandoning a cautionary approach to investing, but it has begun to loosen the purse strings of both institutions and individuals. There are shoots springing up that would seem to justify what President Obama calls "glimmers of hope." The actions taken by the Federal Reserve and the Treasury in the U.S. and their counterparts abroad are beginning to have an impact.

The biggest drag on the economy, housing, appears to be losing its grip as a negative force. Housing starts jumped by 22% in February over January. Sales of existing homes rose 5.1% in February, and new home sales grew an unexpected 4.7%. Lumber prices, a leading indicator for the housing market, rebounded 30% during the latter part of March and early April. California and Florida, two of the hardest hit areas, are showing signs of resilience. For all of California, home sales rose 101% in January 2009 vs. January 2008; 624,940 homes were sold in California in January, the first month over 600,000 since October 2005. Sales in Florida were up 24% in January 2009 vs. January 2008.

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The National Association of Realtors reports its index of housing affordability reached a new high of 166.8% in January. Thus, a family with a median income would have 166.8% of the income required to qualify for a median-priced house. The U.S. needs a minimum requirement of 1.0 million new housing units a year (Larry Summers, Director of the White House's National Economic Council, claims we need 1.7 million units). With a current rate of 510,000 units being

built, lower prices, affordability at a new high, and the Federal Reserve and government injecting capital into the mortgage market, housing is likely to recover sooner than is widely expected, making a significant positive contribution to the overall economy.

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In addition to home sales, durable goods orders and the ISM Manufacturing Index have registered positive improvements in economic activity as well. The TED Spread (the difference between three-month T-bill rates and three-month LIBOR rates), a key indicator of perceived credit risk, is back below 100 basis points after peaking last October at 464 basis points. Banks and other financial institutions are signaling their desire to move away from the government dole of the TARP program. A new roster of financial institutions, some recently formed, has begun to move into the vacuum created by the exit of talent from the former members of the shadow banking committee comprised of Bear Stearns, Lehman, Merrill Lynch, Goldman Sachs, and JPMorgan Chase.

Another sign that entrepreneurial spirits are being revived is the pickup in takeovers, mergers, and rumors of such activity, which are moving stocks and spurring call options buying. Allergan, Black & Decker, Expedia, Illumina, and Textron are but a few of the companies that have leaped upward as investors smelled opportunity among stocks on the bargain table.

Merger and acquisition (M&A) activity has also been accompanied by a widening of participation in the market upturn by

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a number of industry groups. The rally of November 2008 that faltered was led by defensive stocks and lacked breadth. The widespread strength of recent weeks could be signaling an improved outlook for a larger universe of corporations.

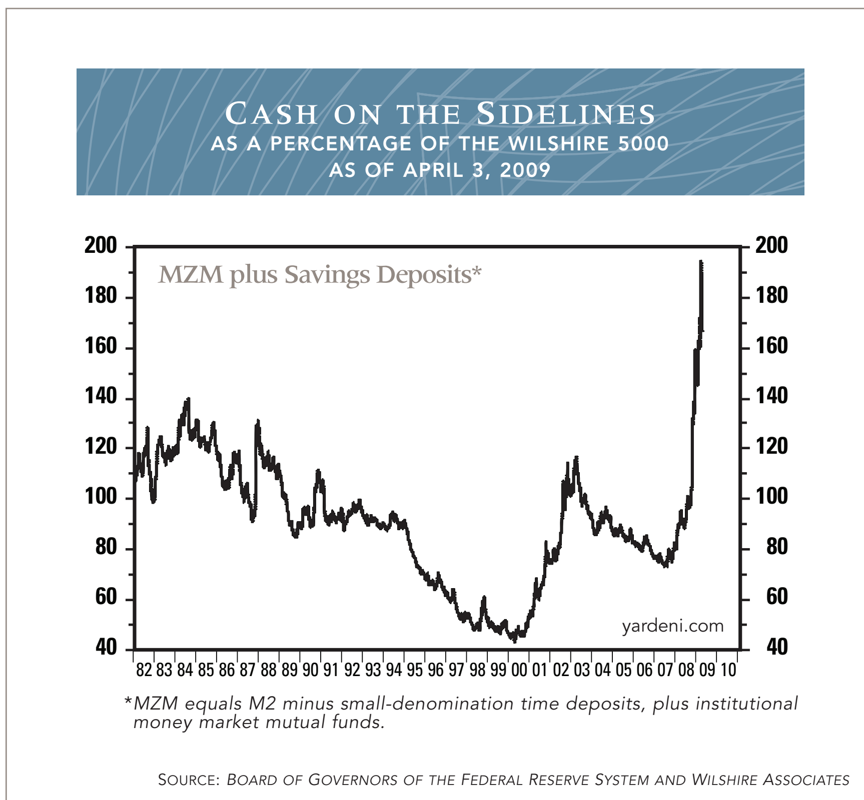
Lower levels of panic as measured by the CBOE Volatility Index (VIX) mark a return to a market characterized less by irrational fear and more by measured risk taking based on economic fundamentals. After peaking at 89.53 last October, the VIX is down to a more reasonable level around 40.

Commodity prices are also flashing signs of a potential improvement in economic activity. Agricultural and industrial commodities, after suffering severe sell-offs that began during the summer of 2008, have started to recover. Copper, considered to be one of the best leading indicators of economic activity, has moved higher by 32% in the first quarter.

While housing has been at the epicenter of the collapse of the economy, auto sales of domestic and foreign manufacturers have been in a depression as well. Sales of nearly 14 million units are needed to replace the units being scrapped. Yet recent sales were running at a 9 million unit sales rate. Used car prices often lead new car sales. Here too, there is an indication that a bottom in new car sales may have been reached as the prices of used cars have been moving upward. The Manheim Index, which tracks wholesale prices of used cars, moved up in all three months of the first quarter. Encouragingly, February and March figures are heralding an upturn in new auto sales as well.

Countless studies have documented the fact that the equity markets turn upward three to seven months before the economy bottoms. Of course, there can always be exceptions, and the present economic downturn is a severe one. However, the previously mentioned signposts reveal growing evidence that certain economic fundamentals are deteriorating at a slower pace at the same time others are showing signs of stabilization, if not outright growth.

Another interesting development of the last several weeks is the metamorphosis of a number of former bears into emerging bulls. Some of the most bearish investment professionals of the past few years have shifted to a more bullish stance. Among the more notable are Jeremy Grantham, who has shied from most equities for the past decade; Bill Fleckenstein, a notable short seller, who has closed his 13-year old bearish fund to go long; Steve Leuthold, manager of the Grizzly Fund; and Whitney Tilson,



*MZM equals M2 minus small-denomination time deposits, plus institutional money market mutual funds.

SOURCE: *BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AND WILSHIRE ASSOCIATES*

another well-known bear, all of whom have seen a light at the end of the tunnel. They have joined Warren Buffett, who—although somewhat premature for his bullish call in October of 2008—has been deploying the capital of his Berkshire Hathaway while investing his personal funds in the equity market.

The year of 2008 was the worst for the equity markets since 1932. We have stated previously that 2009 would mark a year of recovery. Of course, the first two months of this year were marked by a continuing downturn in equity prices. Although March was a solid month of recovery, the major averages were still down at the end of the quarter. Much uncertainty remains, but the global efforts to stabilize the financial system, inject capital into lending institutions, and generate stimulative fiscal policy are beginning to impact the economy. Economic activity, however haltingly and irregularly, is beginning to show signs of improvement globally and domestically. Thus, the near-term picture is becoming one in which the sun is showing through the haze. The recovery and the markets will not move upward at an even, regular pace, but the odds have improved significantly enough that a more positive bias is warranted and should be justly rewarded in time.

Beyond the foreseeable future and the economic recovery, which seems to be taking shape, some larger developments are occurring which will impact both the structure and vitality of future economic activity. These developments take their genesis in the failures and excesses of the past, especially those of the last decade or so.

The economic events of the past two years have been well chronicled. After a long period of global economic growth aided in no small way by financial engineering on

steroids, the asset bubbles of housing, commodities, and consumption collapsed. The derailing of global economic growth went into high gear when Lehman Brothers filed for bankruptcy on September 15, 2008, and in the aftermath, two days later, AIG was forced to seek a federal bailout that was tantamount to government nationalization. In the wake of these two events, credit markets that were already strained went into cardiac arrest. In the months that followed the demise of Lehman and AIG, the Federal Reserve, Treasury, Congress, and the Bush and Obama administrations were galvanized into engaging in an all out defense of the financial system and jump-starting the economy through a plethora of measures and programs. Central bankers and governments around the world have undertaken similar steps. While the degree of success of these efforts remains to be seen, some longer-range consequences of the global financial meltdown are clearer.

Perhaps the most significant outgrowth of the economic downturn is the massive deleveraging occurring around the globe that is accentuated by the transformation and decline of what has become known as the shadow banking system (SBS). The shadow banking system developed into a wide array of financial intermediaries that channeled funds from investors to entities seeking credit. Prior to 2008, typical members of the SBS included Bear Stearns, Lehman Brothers, and other investment banks such as Goldman Sachs and Merrill Lynch. Other institutions such as hedge funds, special investment vehicles (SIVs), conduits, money funds, monoline insurers, other investment banks, and non-bank financial institutions constituted some of the more familiar SBS participants. Importantly, these shadow institutions did not accept deposits like a depository bank and therefore were not subject to the same regulations and capital requirements as banks. As the SBS grew over the last twenty years, and especially in the last ten, it operated outside of the regulatory system that was controlled by the Federal Reserve and the FDIC. The mushrooming growth of the SBS during the last decade played an important role in the economic growth fueled by the leverage it was able to employ outside of traditional regulatory channels. For example, as regulators would preclude a typical bank from leveraging its equity capital by a ratio greater than 10:1, Bear Stearns and Lehman Brothers had leveraged their equity capital at ratios of 35:1 and 32:1, respectively.

The role the SBS played in providing credit to the economy can be seen in terms of its size relative to traditional banks. In June 2008, U.S. Secretary Timothy Geithner, then President and CEO of the Federal Reserve Bank of New York, outlined the importance of the SBS:

> *In early 2007, asset-backed commercial paper conduits, in structured investment vehicles, in auction-rate preferred securities, tender option bonds and variable rate demand notes, had a combined asset size of roughly $2.2 trillion. Assets financed overnight in triparty repo grew to $2.5 trillion. Assets held in hedge*

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> *funds grew to roughly $1.8 trillion. The combined balance sheets of the then five major investment banks totaled $4 trillion. In comparison, the total assets of the top five bank holding companies in the United States at that point were just over $6 trillion, and total assets of the entire banking system were about $10 trillion."*

Thus, and in retrospect, amazingly, lending through the SBS slightly exceeded lending via the traditional banking system based on outstanding balances!

Investment banks borrowed from investors in short-term, liquid markets such as money market and commercial paper markets. Consequently, they would have to frequently repay and borrow again and again from their investor constituency. However, they used the funds to lend to corporations or to invest in longer-term, less liquid assets, the most notable of the latter being mortgage-backed securities. Unfortunately, leverage did not extend to just mortgage-backed securities. Securitization of such assets as credit card loans, student loans, auto loans, equipment loans, and other asset-backed paper exploded over the decade prior to 2007. The SBS, spurred on by origination and underwriting fees, trading profits and fees, and the bonuses based on "profits" from the explosion of financial products birthed with other people's money, created a gusher of credit which financed asset bubbles and consumption around the world.

As is painfully now known, the SBS began to unravel in 2007 and essentially imploded in 2008. The SBS was subject to market risk, credit risk, and especially liquidity risk since its liabilities were short-term while its assets were more long-term and illiquid. As nondepository institutions that were highly leveraged beyond all historical norms of sound banking principles and having no direct or indirect access to a lender of last resort, they became imperiled. Prominent firms that existed for decades became bankrupt; others such as Goldman Sachs and Morgan Stanley became banks, and are thus subject to a new set of regulatory oversight. Merrill Lynch was forced to rush to the arms of Bank of America. Hedge funds have been forced to liquidate assets in a whirlpool of deleveraging. Major banks such as Citigroup have had to acknowledge their exposure to

leveraged vehicles such as SIVs and grasp a lifeline from the U.S. Treasury, diluting their shareholders. The scythe of deleveraging has swept through the field of the SBS. After its growth of the past two decades, the SBS, as it has been known, has ceased to exist. The spectrum of non-bank financial institutions will be faced with a new set of regulations aimed at controlling their ability to put the financial system at systemic risk.

Bill Gross of PIMCO sums up the implications of the deleveraging process for the future of the economy and investing:

> *The prior… leveraging and the development of the amorphous shadow banking system was growth positive. Major G-10 economies became dominated by asset prices and asset-backed lending most clearly evidenced in housing markets. Excess consumption was promoted, and investment based on that consumption followed in turn. Savings rates in many countries including Japan, the U.K., and the U.S. fell towards zero as the reliance on rainy day thrift faded. Deleveraging of business and household balance sheets now means those trends must reverse, and as they do, growth itself will slow, bolstered primarily by government spending as opposed to the animal spirits of the private sector.*
>
> *…There is a near certain probability that the financially based global economy of the past half-century will not return, nor will we experience the steroid driven growth excesses that it facilitated.*

Gross also posits that global economic growth has benefited from the "adrenaline" push of international trade and fund flows into a multitude of developed and undeveloped markets. Yet the benefits of globalization may be at risk in the face of trade barriers, government support of domestic corporations, and "financial mercantilism." Such measures that are politically popular would undoubtedly be less positive for overall economic growth.

Greater government oversight and regulation of the financial markets will lead to less leveraged growth, which has been a hallmark of much of the asset growth of the past decade. A growing tension between the "haves and have-nots" has manifested itself in the recent election and in recent government legislation both at home and abroad. A recent Rasmussen poll found that only 53% of American adults believe capitalism is better than socialism. Not surprisingly, investors believe by a 5-to-1 margin capitalism is better. Opinion polls can fluctuate with the times, but without question, free markets are under at least a temporary siege. The spending unleashed in Washington and state capitols will inevitably lead to tax increases and a less efficient allocation of economic resources in future years. Again, these measures will also hamper growth.

Thus, a number of signs point to an emerging recovery from a very depressed economic state and one that offers very compelling risk/reward opportunities. However, beyond the prospect of a recovery from a period marked by high unemployment, sluggish

economic growth, and a decline in asset values, is the longer-term future a palate of gray? Although economic growth in a deleveraged, re-regulated world may not be characterized by optimum growth, growth will return.

Even if one were to look at such socialist economies as France, Germany, and the U.K., it is obvious that, however irregularly, economic growth has occurred in these countries over many decades, and sound investments have amply rewarded investors. Certainly, we are a long way from reaching the nanny-state economies that characterize these European models. Yes, taxes will go up, the government will extend its reach, and we will not experience a hyper-level of growth, but neither will we slip into a depression nor drift into a "lost decade." The late Paul Harvey was fond of saying, "And that's the rest of the story." So too, our thoughts and outlook for the very long term and the impact of the evolutionary and revolutionary changes on investing to which we briefly referred will be the rest of the story and one for another day, another report. The prospects for the near term are somewhat more visible and, we believe, more promising than they have been for some time.

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Improving economic data and positive reports from Wells Fargo and Goldman Sachs are further indications that the intensity of the global decline is waning. Yes, there will be more bad news ahead. GM and Chrysler are flirting with bankruptcy. Unemployment will keep rising, although probably at a slower rate of ascent. However, while credit markets are still ailing, they are showing marked improvement, and banks are earning their way out of their problems. They are paying very little for deposits, and their net interest income will provide a growing earnings stream against which they can write down bad loans. Risk spreads continue to narrow, and capital flows into riskier assets are growing. New corporate bond issuance is gaining momentum, and capital is returning to high-yield funds. As the credit crisis dissipates, the economy will quicken its pace of improvement. In short, the pulse of the economic patient is beating stronger.

First quarter earnings reports will be anemic, but isn't that already known and discounted? Second quarter earnings will show an improvement, especially for financial companies when compared with the comparable quarter of 2008. The positive impact of fiscal

stimulus, mortgage refinancing, inventory restocking, and stable to improving balance sheets should give a boost to GDP.

Improving credit markets will lead to an improving economy. And, although the recovery may not be as strong as previous recoveries, it will be a recovery nonetheless. Over the last several quarters, market rallies were greeted with continued and often violent selling, as the implosion of leverage and its negative fallout ravaged the economy and corporate profits. Looking ahead, periods of market weakness, which are inevitable, will be increasingly viewed as opportunities to put money to work. It should be noted that approximately $13.8 trillion are parked in the mattresses of money funds, CDs, Treasury bills and other safe havens. The sums thus parked are greater than the market value of the Wilshire 5000, which consists of all stock issues on the NYSE, Amex, and the most active issues on the over-the-counter market. Much of that cash is essentially saying there is little or no opportunity in any sector of any market anywhere in the world. It has fled stocks, bonds, commodities, real estate, and any other viable investment option.

While it is possible the worst fears regarding the global economy may occur, we doubt

" And until you feel that banks are safe - - "

they will. Rather, we believe there is growing evidence that the prospect of an improving economy in the not-too-distant future will lead to a better environment for U.S. and global equity markets. The longer-term issues that will arise from central bank and government actions taken to avoid an even more severe downturn and to jump-start economic activity will draw increasing investor attention further down the road. At present, bond investors should recognize today's very low interest rates across the maturity curve call for investments in short to intermediate bonds as inflation will put downward pricing pressure on longer-term maturities in future years.

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On the other hand, given the depressed market valuations of a wide array of companies when compared to their intrinsic value and long-term, fundamental prospects, there appear to be ample and compelling opportunities for investors to benefit from well-selected equity investments which should produce significant returns over the next nine to twelve months. As mentioned, merger and acquisition activity has picked up since December 2008, especially if one excludes the forced marriages of many financial institutions at fire sale prices in the fall of 2008 from the baseline. In 2006, the average premium paid in an acquisition was 19% for the year. Over the past five months, the average premium paid rose to 60%, indicating while many stocks are trading at low valuations, their respective private-market values are still significantly higher than indicated by today's prices. The acceleration in M&A activity also begs the question, if corporations believe many companies can be purchased on Wall Street for less than the amount it would take to build or create the same equity, shouldn't individuals be buying as well? We believe stock selection remains key in today's market, but for those who are willing to take an investment horizon of at least six to twelve months, healthy returns could be realized faster than most naysayers believe.

Roger E. King, CFA
Chairman and President

The year 2009 marks KING's Twenty-Eighth Anniversary. Our professional staff includes investment managers, security analysts, and other specialists qualified to meet the needs of our individual and institutional clients. We are committed to creating wealth for our clients in the long term.

Over the past twenty-eight years, we have successfully navigated through both good and challenging markets by adhering to a discipline of value investing geared to evaluating ever-changing data and markets.

Our philosophy focuses on the valuation of businesses and their economic worth as measured through cash flow and not accounting artifice. Our work in equity and balanced accounts, which includes fixed income instruments, helps each type of account. Many excellent fixed income opportunities develop as a result of our research in equities, and vice versa.

We eschew "market timing" as theoretical nonsense divorced from the real world of investment decision-making and investing. Cash will accumulate in client portfolios when we do not find stocks that meet our selective criteria.

We are confident that the knowledge, experience, and dedication of our investment team, and the application of a disciplined process which has worked successfully over long periods of time, will continue to reward our clients in the years to come.

SOURCES FOR THIS ISSUE

Bloomberg L.P., Federal Reserve Bank of New York, PIMCO, Rasmussen Reports, *The New York Times*, *The Wall Street Journal*, Yardeni Research, Inc.

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