

# DecisionMaker

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*The most common cause of low prices is pessimism—sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer.*

— WARREN BUFFETT

Volumes will be written about the financial meltdown of 2008. Obviously, the current financial crisis is no ordinary crisis—it has all the hallmarks of an “extreme event” of a proportion that could ultimately transform the entire political, economic, and financial landscape for decades to come. Rather than focusing on the past, we want to take this opportunity to discuss the future and address what is on most investors’ minds: how to renew growth over the next few years. While the markets and the economy will not have a V-shaped recovery, we believe that substantial returns will be produced for those who look beyond current fears. In fact, for those with a time horizon of two to three years, today’s prices could provide one of the best buying opportunities of the past several decades.

Three key domino-linked events occurred in 2008, the effects of which are still being felt today. First, there was a simultaneous breakdown of both funding and market liquidity, which meant the prices of vast quantities of securitized credit assets were being set (and continue to be) by “fire sale” conditions. Second, financial institutions were subjected to severe pressure to mark all securitized assets to depressed market values. Now, on the heels of those markdowns, banks are being forced to mark down consumer and business loans on their already battered balanced sheets. Last, there was an implication that current capital injections would prove inadequate, helping explain why many banks are reluctant to fund each other or make adequate numbers of new loans. Throughout history, when the price of the key collateral in the financial system is falling, credit conditions spontaneously tighten when they need to ease. It is the magnitude of the fall in the market value of securitized collateral that makes this crisis unique.

Some of the key themes for 2009 are likely to be the ongoing struggle between counterparty distrust and deleveraging and the overwhelming policy responses designed to avert a depression-like scenario, escalating protectionism and worldwide political instability. The speed, scale, and global nature of the monetary and fiscal measures already announced are unique in peacetime. For fiscal and monetary policy to work, however, it must first stop the spiral of deleveraging. Once the circuit of value destruction has been broken, it should be possible to set up the conditions for a healing equilibrium that gradually restores the system of collateralized lending and borrowing within the financial system and, in turn, reopen the channels of private lending to firms and households.

In order to stabilize the financial system and create a more investor-friendly environment, five mutually reinforcing actions must be taken: 1) stabilize deposits in the banking systems (through government guarantees, etc.), 2) improve inter-bank funding conditions (much of this is being accomplished by the decline in LIBOR), 3) substantially increase

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capital to make it possible to deleverage without shrinking balance sheets, 4) address the mark-to-market distortions created by fire sale conditions, and 5) selectively underwrite the non-financial sector (e.g., U.S. automakers). The list is holistic; there is no magic bullet to turn the situation around, but measures to address all five areas simultaneously should have a very high probability of success. To date, substantial progress has been made in four of the five categories, but the missing link lies in addressing the mark-to-market distortions effectively. The lack of attention to this problem is in part due to the Troubled Assets Relief Program (TARP) being diverted from its original plan. Also, the question of whether to modify or suspend the mark-to-market accounting rule is very complex. Importantly, however, the rule was never designed to make financial institutions mark to a fire sale price. The end result, as we have seen, can be massively destructive to capital and systemically destabilizing if enough assets are affected. During a credit crisis, performing assets should be valued on a held-to-maturity basis, not as though they must be liquidated immediately at fire sale prices. Of course, nonperforming assets should always be



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devalued to reflect their impaired status. Such losses as well as actual losses due to defaults must be subtracted from earnings, and capital accounts should be reduced if the company is losing money. However, blowing huge holes in the capital accounts of financial institutions to reflect mark-to-market losses has grossly exacerbated the current credit crisis.

We now face a situation where panic has not completely waned. In fact, we have had at least three distinct, global, risk appetite panic episodes over the past twelve months—the SocGen/AIG equity panic, the Bear Stearns failure and, most monumental, the Lehman Brothers/hedge fund redemption panic. In each of these episodes, interest rate spreads on asset-backed credit instruments reached new levels and prices hit new lows.

At current levels, the debt markets are still in distress, although slightly improved from the worst levels. The markdown in credit values is most directly tied to the health of the housing market and significantly impacts bank balance sheets. As banks have been hunkering down to withstand the storm of markdowns (while waiting on the housing market to stabilize), lending has essentially been curtailed. Facing the prospect of a slow housing recovery, banks are hoarding their cash. However, the real value of extremely forceful monetary and

fiscal measures may lie in their ability to buy time for other complementary measures to restore a degree of financial confidence and to help coordinate investor response to the existence of extremely undervalued assets. Once enough investors recognize value in the marketplace and begin buying these inexpensive assets in significant quantity, the possibility arises for a virtuous cycle in which collateral values increase, write-downs stop, and counterparty confidence starts to improve, boosting collateral values further, resulting in confidence and the willingness to lend.

While unprecedented moves have been made around the world to shore up the global banking systems and credit logjams, one of the real issues is the gradual restoration of counterparty trust within the existing financial system. To achieve this, we need new technical innovations, such as new exchanges for credit derivatives, but also possibly a new vision of how governmental entities/regulators should intervene to correct or preempt market failures.

As the market waits for government and regulatory changes to unfold, stimulative steps continue to be implemented to turn the financial tides in the right direction. The Federal Reserve recently began purchasing mortgage-backed securities in the open market. This action has led to a substantial rally in the mortgage-backed bond market, driving 30-year fixed mortgage rates from 6.40% to below 5%. In fact, in early January, the average rate for a 30-year fixed rate mortgage was 5.01%, the lowest since record keeping began in 1972. The average rate paid on 30-year fixed rate mortgages was 6.10% over the past five years and 6.26% over the past three years. This means a substantial number of mortgages are ripe for refinancing, as it generally takes an incentive

of approximately 50 basis points to motivate homeowners to refinance their mortgages. Improvements in the mortgage realm are obviously extremely important to the financial markets.

The low interest rate environment should remain for quite some time. The Federal Reserve recently indicated its intent to keep rates low for the foreseeable future. In early January, three-month LIBOR fell 10 basis points to 1.25%, which was the largest daily drop since the 27 basis point decline on December 17; this move followed the Fed's larger-than-expected 75 basis point cut in the federal funds rate on December 16. Three-month LIBOR has now fallen approximately 85 basis points in about a month's time. This

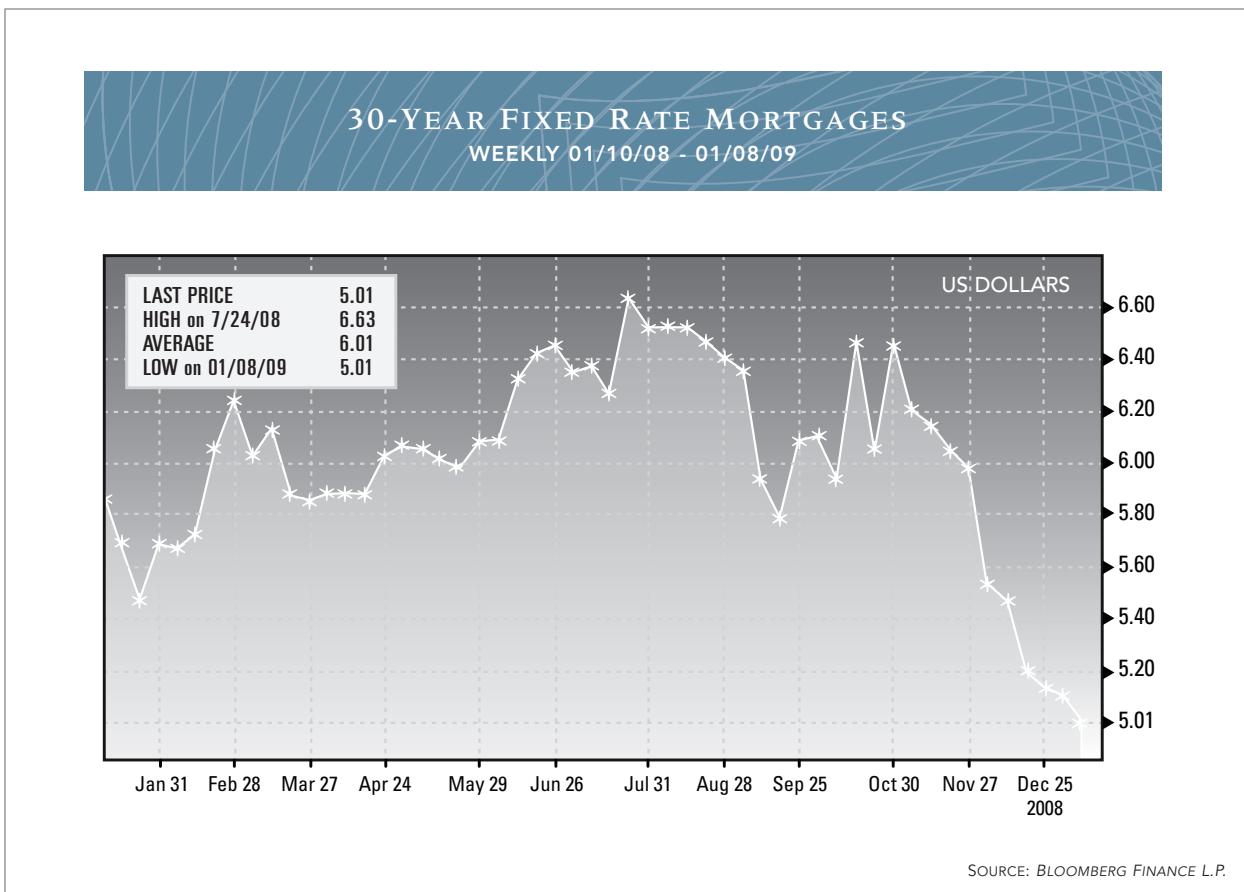
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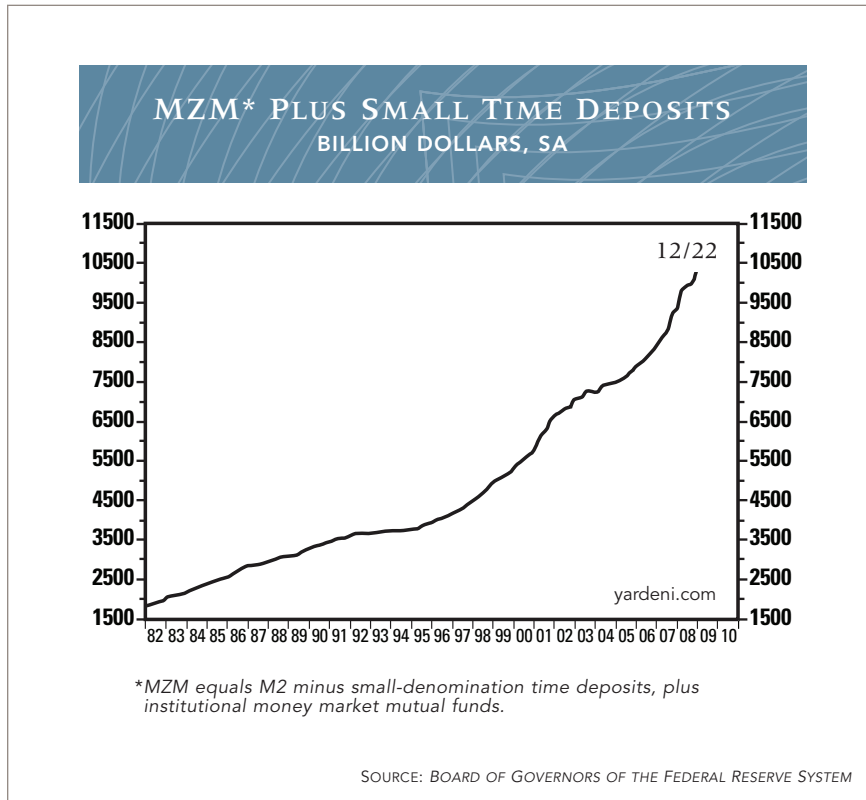
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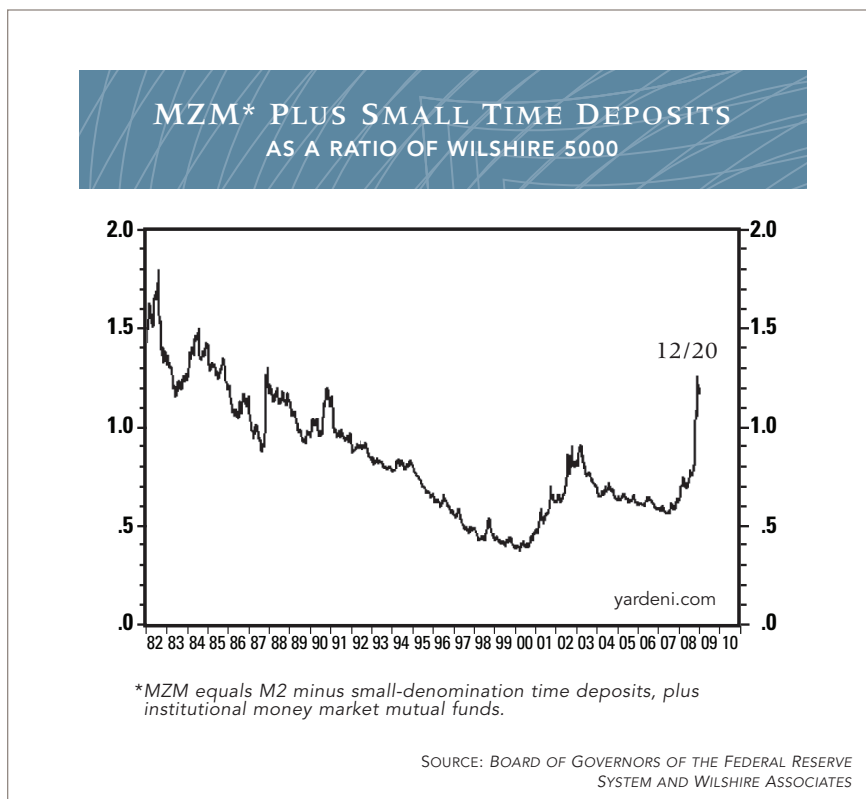
is a significant positive for anyone holding debt (consumers or businesses) linked to LIBOR.

Several factors are likely to continue this downward pressure on LIBOR. Banks are holding massive amounts of excess reserves to the tune of \$1 trillion versus the normal \$300 billion.





The Fed is supporting the commercial paper market through programs that reduce companies' reliance on bank credit lines, leaving more money available for the inter-bank market. Additionally, the Fed is committed to maintaining lower short-term interest rates for the foreseeable future, and through its currency-swap arrangements is providing unlimited supplies of U.S. dollars to foreign central banks. All of these factors coupled with a reduction in risk aversion should lead to a lower LIBOR.



A functioning money market is obviously vital to any recovery scenario, both from the standpoint of lowering borrowing costs and from the standpoint of credit availability. The continued decline in LIBOR is very good news. This is a significant positive as it allows over-leveraged consumers and businesses the opportunity to refinance their respective balance sheets and emerge from today's recession in a much stronger position.

Another positive is that consumers have already

received one of the largest consumer “tax cuts” in history via the decline in oil prices. For the U.S. consumer alone, the plunge in energy costs is equivalent to approximately 3% of disposable income.

Several technical indicators are also signaling that the worst might be over for most equities. The VIX volatility index, which hit a record high in November, has declined to the 40-range from a historically high intraday spike of 90. Valuation ranges are also very compelling. Equities in both the U.S. and Europe are one standard deviation below their long-term real return trend and over five standard deviations cheaper versus bonds. At the end of 2008, the credit markets were arguably discounting a depression scenario. In other words, if anything goes right, stocks and corporate bonds should perform fairly well.

Historic market reactions to big down years also favor long-term investors. Evidence indicates that statistically a historic market sell-off is usually followed by a recovery, often a significant one, as illustrated by the Miller Tabak chart (above).

Even so, a year is a long time and can include many ups and downs. As an example, in 1987, the market rose 40% in the year’s first six months and gave it all back in the latter half. The following two years after the crash of 1987 were quite good; the market returned

17% in 1988 and 33% in 1989. While we do not know what 2009 will bring, at least the odds are in investors’ favor.

Approximately \$10.5 trillion is currently held in cash by investors, the largest amount since the early 1980s. In fact, the total amount parked on the sidelines in cash is larger than the total market value of the Wilshire 5000, which represents all publicly-traded companies registered in the U.S. This ballooning of “mattress cash” was a result of the flight to safety from the tumultuous capital markets in 2008. Investor risk appetite has plunged this deeply into the panic zone only twice before in the past twenty years: in August 1982 and October 2002, periods which proved to be major buying opportunities. At today’s interest rates, assets parked in cash instruments are earning close to zero, a pitiful return when many need to grow their wealth. As the

## REBOUNDS AFTER HISTORIC DECLINES 1721- 2002

YEAR	HISTORIC DECLINE	ONE YEAR AFTER DECLINE	2ND YEAR AFTER DECLINE	COMBINED AFTER 2 YEARS
1721	↓58%	↑4%	↑4%	↑8%
1801	↓38%	↑12%	↑12%	↑25%
1807	↓46%	↑54%	↓16%	↑45%
1893	↓36%	↑1%	↓3%	↓2%
1907	↓38%	↑47%	↑15%	↑69%
1920	↓33%	↑12%	↑22%	↑36%
1931	↓47%	↓23%	↑64%	↑26%
1937	↓39%	↑28%	↓3%	↑24%
1974	↓30%	↑32%	↑19%	↑57%
2002	↓24%	↑26%	↑9%	↑37%

SOURCE: PHILIP ROTH, MILLER TABAK + CO., LLC

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markets stabilize and panic begins to recede, cash will find its way back into the capital markets. As it does, asset values will once again be bid higher.

The silver lining to the brutal sell-off which occurred during the latter half of 2008, is the opportunity it provides to purchase some high quality companies, with solid franchises, and significant cash flow generation capabilities at historically low valuations. Despite today's recessionary environment, many of these companies possess the ability to generate 15%+ earnings growth over the next several years. We believe many of these investments will produce very rewarding results for our clients. We also believe we are well positioned for 2009. The recession will probably linger through at least the first half of the year, but historically, the market is an effective discounting mechanism, thus it will begin to recover before the economy does.

The economy may begin to recover in the second half of 2009. One industry whose securities should perform relatively well in coming quarters is healthcare, which should benefit from merger and acquisition activity. As the year unfolds, technology and energy should also perform well in anticipation of an economic recovery. We believe this is a good

balance and should prove to be a rewarding mix as the year unfolds. Regardless of industry classification, the majority of our holdings possess strong balance sheets, solid cash flow generation capabilities, excellent franchises, and trade at sharp discounts to their intrinsic values. While the scars from the last eighteen months are still fresh on investors' minds, we believe many forces have been put into place which, with time, will heal our financial system and create an environment which will eventually amply reward investors.

Leah R. Bennett, CFA  
Managing Director

Pat H. Swanson, CFA  
Managing Director

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 Finance L.P.; Credit Suisse; Dr. Ed Yardeni; Miller Tabak + Co., LLC

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