

# DecisionMaker

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*Individuals who cannot master their emotions are ill-suited to profit from the investment process.*

*Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope, fear and greed.*

— BENJAMIN GRAHAM

The U.S. stock market has been struggling with problems on numerous fronts. After rising to a new peak last fall on the premature notion that the Fed easing would quickly turn the housing and credit crisis around, the major averages suffered a substantial initial decline to a January bottom. This decline was followed by two rally attempts to develop a sustained recovery, but both failed with the market falling back to the January lows. The last relapse was large enough, however, for experts to finally declare an official bear market in early July in the wake of the worst June market since 1930. Investors have been responding to a variety of disturbing developments: the collapse of Bear Stearns, the rise in unemployment, the contraction in manufacturing, the severe stress in the housing and auto industries, and the struggles of the consumer. Along the way, oil prices managed to leap another 40% higher and pulled most commodity prices along for the ride. Rumors du jour circled about the health of various financial entities. However, thus far, we have not even had

a negative quarter of GDP growth. No wonder many investors are confused.

The last twelve months have proven to be a very difficult period for equity investors across the globe. The issues plaguing our markets are not a U.S. phenomenon alone; just take a look at the year-to-date returns of many foreign bourses.

## WORLD EQUITY INDICES

YEAR-TO-DATE RETURNS AS OF JULY 15, 2008

EXCHANGE	% DECLINES
DJ EURO STOXX 50 €Pr	-28.51
CAC 40 INDEX	-27.47
IBEX 35 INDEX	-26.58
AMSTERDAM EXCHANGES INDEX	-25.39
DAX INDEX	-24.61
HANG SENG INDEX	-23.87
FTSE 100 INDEX	-19.68

**WORLD SAMPLE OF U.S. STOCKS**  
YEAR-TO-DATE RETURNS AS OF JULY 15, 2008

STOCK	% DECLINES
WASHINGTON MUTUAL, INC.	-70.1
GENERAL MOTORS	-59.7
MOTOROLA, INC.	-57.7
CITIGROUP INC.	-46.1
SPRINT NEXTEL CORPORATION	-39.3
MORGAN STANLEY	-38.2
MERCK & CO., INC.	-35.8
J. C. PENNEY COMPANY, INC.	-32.4
DEERE & COMPANY	-28.9
THE BOEING COMPANY	-26.7
GENERAL ELECTRIC COMPANY	-25.7
GOOGLE INC.	-25.0
JP MORGAN	-23.5
HONEYWELL INTERNATIONAL INC.	-20.8
PFIZER INC.	-20.5
EXXON MOBIL CORPORATION	-9.7
CHEVRON CORPORATION	-1.2

Nor has the carnage in the U.S. been limited to small- and mid-cap stocks, as many large-cap companies in the U.S. have suffered significant losses.

Another interesting point is that most large-cap oil stocks have failed to keep pace with the move seen in crude itself.

Thus with all of this uncertainty and bloodletting, one may ask, should one invest in equities at all? The silver lining to these developments is that many stocks are trading at extremely attractive levels and, despite what one might hear from the media, positive signs are present. For

the patient and disciplined investor, we believe that significant gains can be made over the next 12 to 18 months and well beyond.

## REASONS TO BE OPTIMISTIC ABOUT THE NEXT 12 TO 18 MONTHS

### Sentiment

Sentiment currently is extremely negative. If you turn on the television, read a paper, or look at a news or financial website, very few positive headlines are present. While this may look like a negative factor at first glance, historically it has actually been a strong contrarian indicator as it usually indicates people have already sold.

Negative stories and headlines sell newspapers and attract viewers to websites. Reality, however, can prove to be a bit different. For example, coming out of the 2000-2003 bear market, investors in U.S. stocks had just witnessed their third successive year of negative market returns. An article from April 2003 stated the following about the overall market, "S&P believes operating trends are not likely to rebound in the near term, which could place pressure on debt protection measures over the next several quarters, and perhaps more immediately, threaten some issuers' ability to comfortably cover common stock dividend payouts." Another report from April 2003 stated: "Despite modest gains from the refinancing of debt-laden balance sheets, meaningful improvement in U.S. nonfinancial creditworthiness is still hindered by a weak corporate earnings outlook and reverberations from accounting and disclosure irregularities. Additionally, lingering concerns about the war's aftermath have the potential to cloud the outlook for oil prices, business sentiment, and consumer optimism." Does the tone sound familiar? In April of 2003, an investor faced with those headlines and in the face of a declining market might have had a difficult time investing capital into the market. It would have been difficult to predict that in the same year the S&P 500 would reverse its course and return 24.3%, and the battered Nasdaq would gain 50% by year-end. The point is, no one rings a bell at the bottom and the media and Wall

Street tend to be great at summarizing the past, but terrible about predicting the future.

In addition, while the market has been declining, unlike last year at this time, corporate insiders are not selling shares. In fact, they are net buyers, which is a positive sign that selling has been overdone with many stocks.

### Rising Profits?

The focus of investors over the last several months has been on the downside and not the *upside*. What has been overlooked is the revision of earnings estimates on the upside, which has been occurring over the last several weeks. During the last week of June, forward earnings for the S&P MidCap 400 Index and the S&P SmallCap 600 Index rose to record highs! On the flip side, forward earnings for the S&P 500 have been falling since October 2007, led by Financials and Consumer Discretionary stocks. However, in recent weeks, estimates have stabilized.

During the first quarter of 2008, S&P 500 earnings fell sharply by 17.0% year-over-year. However, excluding Financials and Consumer Discretionary, they rose by a whopping 16.4%. As we move into the second quarter earnings season, analysts are estimating a 10.2% drop, which is an 11.5% increase without these two sectors. For the third and fourth quarters, analysts expect large, positive year-over-year comparisons of 11.7% and 52.9%, led by better comps for Financials. However, even excluding Financials, the estimated earnings growth rates are 16.6% and 16.0%.

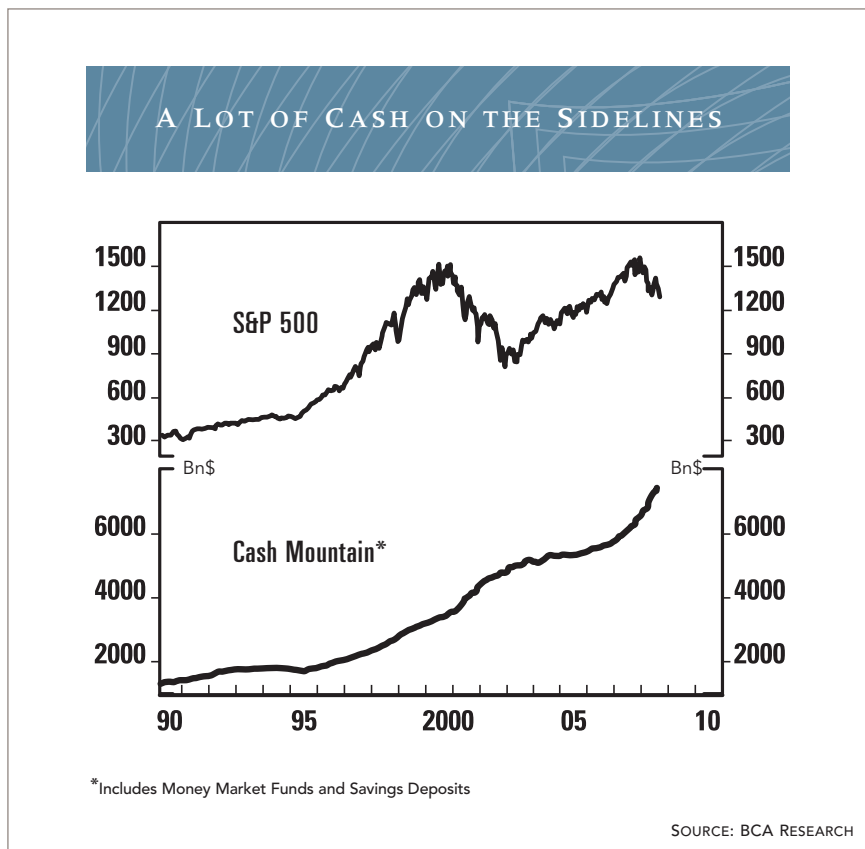
### Cash on the Sidelines

The silver lining in the overwhelming bearish sentiment of investors is that there is a massive amount of cash on the sidelines. In fact, the cash hoard in CDs, savings accounts, and money markets currently equates to approximately 60% of the total market cap of the S&P 500—this represents an enormous amount of potential buying power.

Money in liquid assets is hitting new highs every day and it is earning a miniscule return. Putting the cash to work in stocks at current levels should be profitable. The dividend yield of the S&P 500 is currently above the risk-free fed funds rate for the first time since the market lows earlier this decade, providing an attractive incentive to move more money into stocks.

### Short Interest

Pessimism has dominated. While the natural trend in short interest is up thanks to the proliferation of hedge funds, short positions have soared from last summer's reasonably complacent levels. The surge in short interest



reflects the massive swing in sentiment from greed to fear, and is contrarily positive. To illustrate the rise, short interest on the New York Stock Exchange has risen more than 55% this year to a record 3.6% of listed shares. A record 36% of the companies in the S&P 500 have at least 5% of their shares sold short. Eighteen percent have more than 10%! The 55% jump in short interest since October 2007 exceeds all other gains since 2000. One likely reason for this development is the elimination of the uptick rule (eliminated in mid-2007), which now permits speculators to relentlessly drive down the price of a stock. The point of the rule originally was to maintain order in the markets and to avoid a bear run on a stock (where traders take on large short positions, with the large volume of selling causing the price to fall, making the strategy self-perpetuating). In the universe of companies with a market cap under \$18 billion, with below average trading volume (before the elimination of the rule), 78% declined and 21% lost more than 50% of their market cap since the rule was eliminated. Of the companies with above average trading volume, only 3% lost more than 50% of their market capitalization. Without an impediment such as the uptick rule, it is very difficult to slow down the pace of the short sellers and their ability to devalue companies at will.

The positive aspect of the shorting trend is two-fold. First, these investors must cover at some point. Given the extreme levels of short interest, the emergence of any positive catalysts for the market could trigger a substantial short-covering rally. Second, it illustrates the extreme level of pessimism that exists in the market, a good contrarian indicator.

### Peak Oil? Inflation of the 1970s?

Crude prices hit a high of \$147 per barrel (up 58% since the start of the year) in early July. Are oil supplies dwindling or is something else afoot? In addition to global demand, three key factors influencing today's energy market are speculators, government subsidies around the world, and global policies which make it difficult to take oil out of the ground. The good news is that near-term supply issues are not the problem and that

all of these factors can be resolved. Additionally, though the rise in commodity prices has certainly added to inflationary pressures, we do not believe that inflation will be as much of a problem as it was in the 1970s, the last time the U.S. experienced a commodity price spike. Given the lack of bargaining power of today's employees relative to the strong influence of labor unions in the 1970s, the chances of a wage-price spiral occurring are considerably less today.

Much discussion has been bantered around about the recent astronomic rise in oil prices and the impact of speculation. Certainly there are geopolitical concerns that emerge frequently in such places as Nigeria, Israel, and Iran. However, one cannot overlook the role that traders are playing in the futures market. Hedge funds, pension funds, and other speculators today account for approximately 70% of today's trading volume. In addition, the recent rise in crude prices has been suspect. With the prevalence of hedge funds today, they can get a lot of bang for their buck in a market where you can leverage 15 to 1, such as the oil futures market. A loophole instituted in 2000 at the behest of Enron opened the door for potential abusive trading practices in markets that are not policed by U.S. authorities (such as the commodities markets). For example, speculative investors can buy and sell futures contracts on millions of barrels of U.S.-destined oil and other energy products every day in the U.K. and Dubai, but are not made subject to the transparency and accountability laws that govern exchanges here in the U.S. The potential closing of the loophole should help prevent this market from being exploited by speculators and may result in a steep pullback in crude prices.

Government subsidies outside of the U.S. are also a significant factor, which have made foreign consumers less sensitive to rising prices. In June, the *Financial Times* reported: "This year's entire world oil demand growth, estimated at about one million barrels per day, is expected to occur in countries that have used subsidies to shield their citizens from the recent rise in oil prices. Half the world's population benefits from subsidized fuel..." However, these policies are already shifting. Much of Asia has subsidized oil prices to their consumers. That is changing, as Indonesia,

Sri Lanka, and Taiwan have announced they are decreasing their subsidies, as the cost is simply too high. Malaysia now spends 25% of its budget on oil subsidies, and must either raise prices or cut other services—or watch inflation get worse. India is now contemplating how to cut its subsidies. Even China is likely to lower subsidies after the Olympics. These countries are going to go through their own oil shocks. All of this should reduce world demand for oil.

Another catalyst to lower oil prices is a potential change in tax rates. Russia is the second largest producer of oil, yet production has tapered off over the last several years. Is this due to peak oil? Most likely, no. The marginal tax rate on a barrel of oil in Russia today is actually 90%! This is a rate that certainly does not incentivize global oil production. The potential for tax reform in Russia could be significant, and political officials in Russia are currently discussing rate cuts. An announcement would reflect the fact that the world's second largest producer of oil had just made an important move to free up supplies, and investors would look for companies that would capitalize. Though it will take a few years to access and harness new supply, Russia's reserves are much easier to access than the reserves lying in deep water off the coast of Brazil and in the Alberta oil sands.

Finally, rising energy prices lead to a reduction in usage, as seen in the 1970s. Already, SUV sales in the U.S. have plummeted, with lines such as General Motors' Hummer being discontinued. Consumers are opting for more fuel-efficient cars. Carpooling and mass transit commuting are up across the country. In addition, the trend toward global outsourcing is starting to reverse as more companies are reevaluating these decisions due to higher transport costs, and many are opting to build new manufacturing plants and distribution centers closer to their end-consumer (which means more jobs will be coming back to the U.S.). Combined with the decline in global subsidies, demand is on the decline, regardless of the debate about near-term supply issues. The Department of Energy announced in early July that its projection of domestic energy usage had declined for the year and was not expected to be higher than its 2003 level.

## The return of Merger & Acquisition (M&A) Activity

While M&A activity was strong in the first half of 2007, it was driven almost entirely by financial engineering (leveraged buyouts, private equity, etc.). Because of the tight conditions in the credit markets and the financial stress at the broker-dealer firms, we do not anticipate a return in this type of activity for quite some time. However, we do believe that we will continue to witness activity by natural/strategic buyers in the market. Many mega-cap companies such as Microsoft, Pfizer, and Merck are carrying solid balance sheets with significant cash positions and little to no debt. However, many of these mega-cap companies are also facing slow growth prospects over the next several years. The combination of these factors should lead to a significant pick up in M&A activity in the near-term as many large-cap companies look to acquire growth, niche products, unique technologies, and footholds into new markets.

Many transactions are likely to be cash based, because many acquirers have sizable cash balances, which have been generating negative real returns given the low interest rate environment in the U.S. In the healthcare space, many large-cap pharmaceutical companies are cash rich and product poor. They are also facing intensified generic competition over the next several years and further potential pricing pressure under either an Obama or McCain administration. Most likely, many of these firms will attempt to replace, through acquisition, what they have not otherwise been able to generate from their own internal R&D efforts.

In addition, in today's market, raising capital at attractive prices is very difficult. This further provides an incentive for some cash-strapped, small- and mid-cap companies to sell out to larger firms when they would not otherwise have the incentive to do so.

Finally, the sharp decline in the value of the dollar has made the purchase of U.S.-based assets increasingly attractive to European and Japanese acquirers. Given today's high transportation costs, it also potentially gives a foreign firm a greater footprint and better access to the U.S., the world's largest consumer.

## Economic Diversity and Resilience

The resilience of the U.S. economy has been impressive. The housing industry has been in a severe recession since late 2005. Motor vehicle sales have declined during five of the last six months through June. Airlines are cutting their capacity and payrolls. Financial firms are laying off and cutting back; some have gone out of business. Several retailers have also gone out of business. Yet real GDP rose 2.6% year-over-year during the first quarter of 2008, and 3.6% excluding residential investment. Retail sales were recently revised higher during March/April from no change to plus 0.9% over the two-month period. The question is why? Some of the resilience in consumer spending is attributable to real pay per worker, which was at a record high in April. That is remarkable given the increase in consumer prices. Robust productivity gains are driving inflation-adjusted wages, salaries, and benefits to record highs.

While housing, airlines, auto, and financial firms continue to struggle, companies that export have done extremely well (in fact, exports have offset two-thirds of the decline in GDP caused by the housing industry). Exports, of course, have been buoyed by a weak dollar, which has made our goods cheaper, on a relative basis, and more competitive overseas. Companies and individuals in agriculture and fertilizers have done remarkably well over the last two years. Those individuals in the energy industries have prospered. The end result is that the U.S. can absorb multiple shocks and remain fairly resilient given our strong economic diversity.

## The Resurrection of the U.S. Dollar

The U.S. dollar versus the euro in the mid-2000 through mid-2002 period was approximately \$0.85—that was when the dollar was its strongest. Today, the U.S. dollar price of the euro is hovering around \$1.55. That is an incredible increase in the dollar price of a key foreign currency. So, what is going on here? Currencies are cyclical and tend to go in and out of favor over multi-year periods. What has occurred over the last six or seven years is that the U.S. has become less attractive

to global investors. There are several reasons for this, but a primary factor is that foreign countries have been increasing their attractiveness dramatically. Tax cuts are occurring around the world and supply-side economics is being embraced with enormous success. As a result, global

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★ The resilience of the U.S. economy has been impressive. ★

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investors have been trying to increase their exposure to these markets. As their exposure to these markets is increased, they must reduce their exposure to the U.S.

Some observers currently perceive an unattractive investment problem in the U.S., which has resulted from unfavorable policy changes in fiscal policy, trade policy, and income policies. Many changes in U.S. legislation are being proposed, such as minimum wage hikes and increased regulation. In addition, many politicians have become more supportive of protectionism policies (they dislike the Chinese, the Middle East, Mexican cross border trucking, etc.). This is another reason that investors have been trying to reduce their exposure to the U.S. and increase their exposure abroad.

How is this reversed? As the U.S. has become less attractive to global investors relative to foreign countries, U.S. goods have become progressively cheaper and cheaper, and the U.S. has become far more competitive. The next stage will be a major reduction in the trade deficit. When this occurs, the flow of capital into foreign currencies will dry up, and the U.S. dollar will trough and begin to appreciate. This shift should begin within the year. The dollar should bounce back and global portfolios will rebalance once again.

In addition, major currencies will eventually reach a level that is too tempting for global investors.

We are close to reaching this point as foreign demand for U.S. financial assets has been accelerating lately. Investment inflows jumped to \$115.1 billion in April 2008 from \$79.6 billion in March, a positive for the dollar.

Further, historically most countries follow the U.S. in terms of economic developments. Thus while Europe, Japan, and Australia currently have higher real rates of return than the U.S., the scale in the future should tip in favor of the U.S. For example, the European Central Bank (ECB) recently hinted that there may be no further interest rate increases between now and the end of the year. Also, the monetary base in Europe is growing much faster than in the U.S., a factor which should undermine the euro. Japan is also almost entirely dependent on imported oil and other industrial materials, the high cost of which is currently depressing corporate profits and consumer finances, even more so than in the U.S.

The most significant development near-term that could help turn the dollar around, and provide at least some temporary relief from high oil and commodity prices, is the clear shift in Fed focus in May to an inflation bias with at least some heavy jaw-boning in support of the dollar. The Fed again confirmed the shift after its June Federal Open Market Committee meeting and in a number of speeches by Mr. Bernanke. While it may not appear that way with prices still rising, the Fed is fairly far along in the shift where it counts. As discussed earlier, longer-term inflation is basically a monetary phenomenon and there is a lag between money and prices. The Fed has already succeeded in lowering the M2 money supply growth rate from above a 15% rate for the majority of the first quarter to nearly a 1% rate over the past two months, according to the St. Louis Fed. This is a primary reason why short-term rates have been falling and the yield curve has steepened significantly. Although many analysts were betting that the Fed will soon start to raise interest rates, we believe that this is not likely in the near term because the Fed will not want to run the risk of worsening the current economic downturn and will wait until at least the fourth quarter of this year.

## OUR OUTLOOK

In today's environment, patience is a virtue that will be rewarded greatly if one stays the course. Opportunities abound in this market. While one may not be rewarded two or three months down the road, we believe that significant rewards can be reaped by those with a one- to two-year time frame. As outlined above, current conditions are not as bad as many perceive.

We believe that client portfolios are well positioned to capitalize on future developments. Many of our stocks have company-specific catalysts which, once realized, should result in strong stock price appreciation. For instance, we own many healthcare companies which possess unique technologies and that continue to grow their earnings at a healthy pace. In addition, demand for a large part of healthcare products and services is not economically sensitive. As the market has sold off, we have also had the opportunity to buy shares in several cash-rich technology companies that we believe are trading at attractive valuation multiples and have positive outlooks for the future. We reduced our exposure to the financial industry earlier this year, but continue to closely evaluate opportunities here. While problems certainly exist at numerous companies, most financial entities will survive. Many of the survivors will emerge stronger and will prosper greatly in the future as the financial system begins to normalize. We also continue to evaluate opportunities in strong companies which may benefit from a retracement in oil prices. Thus despite the difficult path investors have traveled over the last year, it is time to open one's eyes to the prospects beyond today's gloom and doom headlines. We believe that prices of many stocks a year from today will seem like great values.

Leah R. Bennett, CFA  
Managing Director

The year 2008 marks KING's Twenty-Seventh 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-seven 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

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#### SOURCES FOR THIS ISSUE

Barrington Research Associates, Inc.; BCA Research; Bloomberg L.P.; Cowan and Company, LLC; Credit Suisse Securities (USA) LLC; Hays Advisory; *Market Intelligence Report*; Jeffries & Company, Inc.; John Mauldin's "Outside The Box"; Laffer & Associates; Miller Tabak + Co., LLC; Raymond James & Associates, Inc.; Seeking Alpha; Standard & Poor's; Stanford Group Company; Yardeni Research, Inc.



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