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Years of
Investment
Excellence

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Underlying most arguments against the free market is a lack of belief in freedom itself.

— Milton Friedman
Nobel Laureate, Economics, 1912-2006

For investors in the U.S. equity markets, the fourth quarter of 2006 was a rewarding three months that closed out a strong year in which each of the three major indices registered double-digit gains. Skepticism on the part of many investors regarding the health of the domestic economy and the inflation picture created the proverbial "wall of worry" for the equity markets during the final months of 2006. Concerns about a weakening housing market and a slowing domestic manufacturing sector slowly gave way to increased confidence that a recession would be avoided and the Federal Reserve Board would cut interest rates sometime in 2007. Consequently, those skeptical investors who had remained on the sidelines were drawn back into the market with each incremental advance, as these investors did not want to get left behind. This dynamic pushed the equity markets steadily higher as the fourth quarter progressed, with the Dow Jones Industrial Average hitting new all time highs several times before the year drew to a close.

Now that the stellar returns of 2006 are history, investor attentions have quickly shifted to the potential catalysts and impediments that will impact equity prices during 2007. Near the top of any list of items that will influence stock prices in the future is interest rates. Specifically, the direction and magnitude of rate movements inevitably move stock prices. Not surprisingly, the investment community is often focused on the Fed, especially during periods of Open Market Operations when members are raising or lowering rates. Obviously, the principal public face of the Fed is the Chairman. Current Chairman Ben Bernanke took over this position in early 2006, succeeding the esteemed Alan Greenspan.

On the topic of interest rates and their effect on stock prices, the most striking development of 2006 was the shift in investor attitudes towards the strength of

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Bernanke's commitment to stamping out inflation. After Bernanke was nominated to become the new head of the Federal Reserve Board in the fall of 2005, many pundits immediately warned that the equity markets could experience some turbulence given that he was thought of as "soft on inflation." Indeed, the incoming Fed Chairman was derided in some circles as "Helicopter Ben," in reference to a speech in which he stated that the U.S. could always avoid deflation by simply issuing more money— even potentially resorting to a "helicopter drop" of currency. Critics seized on the comment (even though the speech was made in 2002 during a period when deflation was briefly a concern) as evidence that Bernanke and his "printing press" would lead to higher inflation and lower stock prices. Many believed that the last thing Bernanke would do is aggressively attempt to wring inflation out of the system. One market strategist went so far as to write a paper entitled *"Helicopter Ben" is no Paul Volcker*. Volcker was Fed Chairman beginning in the late 1970s and helped bring down rampant inflation by fearlessly raising interest rates multiple times.

Bernanke officially began his tenure in February of 2006, and all of his "soft on inflation" critics confidently thought they had him pegged two months later when he hinted that the Fed may soon pause in its rate hike campaign. Many were surprised when he and his fellow Fed Governors began making constant headlines during the summer of 2006 in speeches across the country where they proclaimed that inflation was above the preferred comfort zone and further rate increases were likely needed. By that time, the criticism of Bernanke had transformed from worries about a Fed that would be soft on inflation to a monetary policy that was too restrictive. In yet another example of how quickly perceptions can change in the financial markets, "Helicopter Ben" was beginning to look more like Paul Volcker than someone who was

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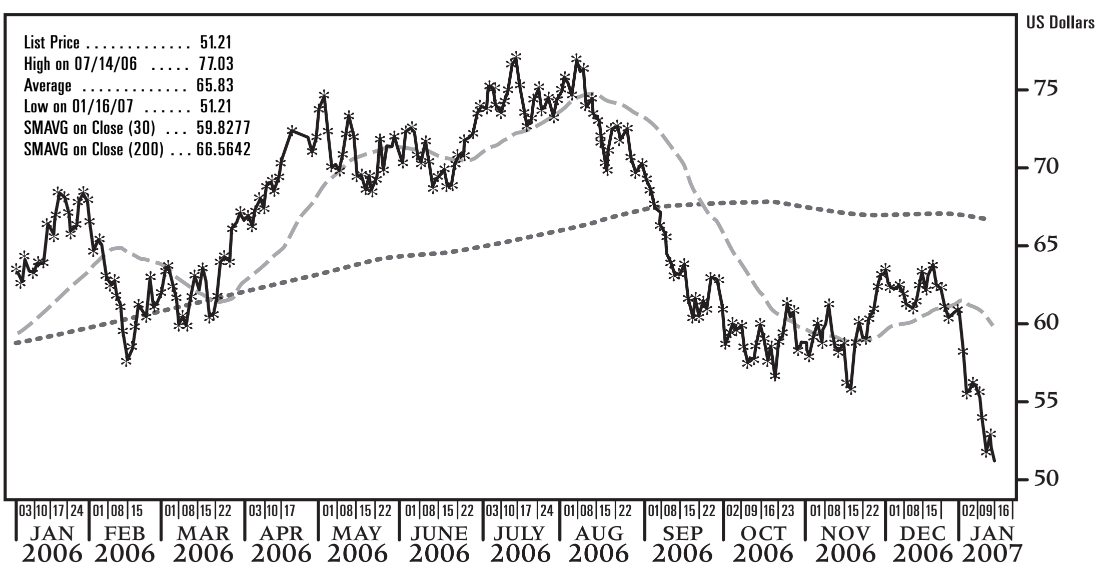
careless about inflation. More than a few pundits began worrying that the Fed Funds rate had reached a level that would cause indigestion for the U.S. equity markets. Why did the Fed keep hiking rates when it was clear that the housing market and the manufacturing sector, two important components of economic growth and stability, had begun to deteriorate? How can we currently have a Fed Funds rate of 5.25% when inflation expectations began to decline late in 2006 and the yield on the 10-year Treasury is now at 4.75%?

Looking back on Bernanke's first year, we would like to reiterate that, aside from a few early communication missteps, we believe he has performed admirably and that his actions were necessary.
As we have stated in prior publications, the most important task of any Fed Chairman during a period of rising inflation is to emphatically drive down inflation expectations. Though some myopic investors undoubtedly would have liked Bernanke to hold rates steady after he was sworn in, that action would have been the worst-case scenario for stocks since inflation expectations would have accelerated. When expectations of inflation spiral upward, the bond market sells off, interest rates shoot higher, and equity markets tumble. Bernanke

is now thought of as anything but soft on inflation, and the long-term benefits of taming future inflation expectations cannot be understated.

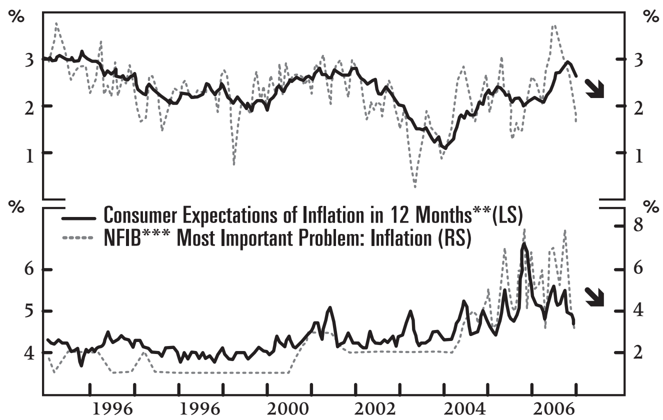
Considering the interest rate backdrop, weakening conditions in housing and manufacturing, and a strong equity rally that sent the Dow Jones to a record high in 2006, what are the prospects for equities in 2007? We believe 2007 will likely be another rewarding year for U.S. equity investors, though we acknowledge that it may be difficult to top the excellent returns posted by the major indices in 2006. Though many investors became increasingly convinced as 2006 drew to a close that Bernanke was poised to cut interest rates during the first quarter of 2007, we believe he could hold rates steady for a longer period than some market participants had originally hoped given his vigilance on inflation. The mild sell-off during the first week of 2007 was partly a reflection of a ratcheting down of rate cut expectations being discounted by the equity markets. Some commentators are even projecting another rate hike. Though we cannot completely dismiss this possibility, several indicators have been pointing to lower inflation in the near term. Though the core rate of inflation remains above the upper bound of the Fed's comfort range of 2%, recent core readings have been declining toward 2% for a few months. Also, the price of crude oil has fallen from a high of $77 on August 7 to a low of $50 on January 18, alleviating inflationary

Crude Oil Futures Price
January 3, 2006 — January 16, 2007



Source: Bloomberg L.P.

U.S. CORE CPI
A RETURN TO DISINFLATION



* Annual Growth Rate ----- 3-Month Rate of Change
** Source: The Conference Board
*** NFIB: National Federation of Independent Business
Note: CORE = Excludes Food and Energy

SOURCE: BCA RESEARCH

forces throughout multiple sectors of the domestic economy. Crude oil is but one of a number of commodities that have swooned of late. Copper, a commodity that rose dramatically over the last several years and thus had exerted upward price pressure in several sectors (including the residential and commercial construction area), has sold off sharply, declining 37% from its record closing price reached last May. Also, the latest survey of smaller U.S. companies by the National Federation of Independent Business indicated that companies are losing pricing power, as the reported price changes index has decisively rolled over. These data points are clear signals of moderating inflation and logical manifestations of the recent slowdown in GDP growth.

Though we are optimistic about equity performance during 2007, we would be foolish not to acknowledge potential risks to our positive thesis. Slowing economic growth eases inflationary pressures, and lower inflation is obviously good for stocks. The other side of the coin, however, is a situation where economic growth slows so much that stocks fall in anticipation of a recession. To the disappointment of many investors, Chairman Bernanke has continued to focus on inflation and has given no hint that a rate cut is forthcoming. Given the slowdown in manufacturing and a housing market that is still trying to find a bottom, the fact that market participants desire a rate cut is perfectly logical. Bernanke, however, is forcing equity investors to consider a scenario in which he conceivably holds rates steady for the next two or three quarters. Considering the tug of war between investors who are most concerned about a slowing economy and a Fed Chairman who remains most concerned about inflation, the choppiness of the equity markets during the first two weeks of 2007 should not be surprising.

While we cannot predict the future direction of the equity markets with certainty, we do not see a high risk of a recession in 2007. We are confident that any economic slowdown sharp enough to cause a real correction in U.S. stocks will be relatively short-lived, as a slowdown of this magnitude would likely be met with at least one interest rate cut by the Fed. Despite the strong equity advance of 2006, valuations of many domestic equities remain attractive. The cash flows and balance sheets of a multitude of domestic corporations improved yet again in 2006 as earnings growth has remained healthy. One of the more important equity market themes we foresee in 2007 that will serve to put a floor under and exert upward pressure on the equities of many corporations in multiple industries is the continuation of merger and acquisition activity.

The year 2006 could be termed "the year of the buyout," and we have little reason to think that this trend will stop just because the calendar has shifted to 2007. Around the globe last year, corporations and financial firms went on a shopping spree that broke the full-year record for announced acquisitions a month and a half before December 31, 2006. The numbers are truly staggering. Approximately $3.5 trillion in global transactions took place in 2006, besting the previous mark of $3.3 trillion set in 2000. On one "Mergers Monday" in late November 2006, $50 billion in transactions were announced that day alone. Private equity firm Blackstone Group's announced plan to purchase Equity Office Properties Trust for $36 billion (including assumed debt) last fall set a new record for the largest buyout in history. This figure surpassed the previous mark of the leveraged buyout of HCA for $33 billion announced in July of 2006, which in turn topped the mythical $31 billion buyout of RJR by Kohlberg Kravis Roberts & Co. (KKR) in 1988, chronicled in the well-known *Barbarians at the Gate*. Amazingly, nine of the world's top ten leveraged buyouts (LBOs) have occurred over the last 18 months.

Private equity firms have made the biggest push on the deal front. Private equity buyout firms acquired companies valued at approximately $740 billion in 2006, more than double the total figure from 2005. The private equity sector has been raising buyout funds over the past year in amounts that were unheard of even a few years ago. As a group, private equity firms raised

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$320 billion in new equity in 2006, swelling the total cash balance that buyout shops are sitting on to a mind-boggling $750 billion. The buyout shops are desperate to put this money to work in chunks of $10 billion or more, and lenders are eager to facilitate these transactions. Factoring in the usual amount of debt that is included in a typical buyout, these firms have several trillion dollars to spend on acquisitions!

Given this firepower coupled with the fact that many transactions are now "club deals" where more than one private equity firm is involved, almost nothing is off limits. Buyout firms have moved on the country's largest casino operator, Harrah's Entertainment, and they have their eyes on a multitude of companies and assets, even the toll roads that crisscross New Jersey. Anheuser-Busch and Home Depot have been mentioned recently as possible private equity targets, companies that are so large that a buyout would previously have been unthinkable. Anheuser-Busch has a market capitalization approaching $40 billion, while Home Depot's is north of $80 billion. With the control premium added to any Home Depot takeover, any transaction would approach $100 billion! These numbers indicate that all but the top thirty or so companies in the S&P 500 could conceivably be an acquisition target.

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Until recently, shareholders of buyout targets have been happy to take their cash and run. The era of the 1980s "hostile takeover" and gaudy movie characters such as *Wall Street*'s Gordon Gekko are a thing of the past. Indeed, in most of the acquisitions that have taken place over the last few years, if there has been a large shareholder of the target, that shareholder was already cooperating with the buyout firm before the deal was announced. Often, management has also cooperated and been amply rewarded. This complacency on the part of shareholders may not last, however. Resistance to buyouts has started to appear in Europe. In the U.S., shareholders are increasingly frustrated by the money they have left on the table in multiple transactions. Shareholders of struggling Ford Motor have watched as three private equity firms bought Hertz from Ford only a year ago and have already wrung $2.5 billion in profit out of the car-rental unit. Shareholders of the media conglomerate Vivendi sold publisher Houghton Mifflin to a group of buyout firms in 2002 and watched the group triple its money in four short years.

These examples of course beg the question, Why does it take a group of outside investors to come in and boost returns? The bottom line is that many corporate boards act like sycophants, and shareholders often fail to act like real business owners. Companies must focus more on boosting share prices by not hoarding cash and modifying inefficient capital structures to boost returns on equity. For the average person, it is undoubtedly hard to imagine having too much cash. Numerous corporations, however, shaken by the post-2000 stock market swoon, have had an aversion to debt and have thus let cash inefficiently build on their balance sheets instead of investing it in high-growth businesses or returning it to shareholders in the form of dividends and share buybacks. As Morgan Stanley strategist Henry McVey states, "They (companies) are running with high cash balances and not taking risks, while the private equity firms are taking the risks."

Encouragingly, several recent developments could be a harbinger of more productive things to come from both shareholders and management teams. In November of 2006, when Blackstone announced its offer to take over Equity Office Properties, Jim Corl, chief investment officer of Cohen Steers, Equity Office's largest shareholder, fired back that the offer "didn't even approach what the company is worth." (Interestingly, as this publication went to print, news broke that Equity Office Properties may receive a higher bid from another group of private equity firms, violating the unwritten "club rules" of limited competitive bidding that have prevailed among buyout firms over the last few years.) John Linehan of T. Rowe Price was even more blunt than Corl, saying in an October interview that he was "tired of management and private equity firms trying to steal companies from underneath our noses." Speaking of Home Depot, Relational Advisors, a shareholder that owned less than 1% of the stock and was frustrated by several years of stock price underperformance, helped play a role in the recent ouster of CEO Robert Nardelli. On the management front, Anheuser-Busch, the cash-rich beverage company which traces its roots back to the nineteenth century, suddenly sounded like a cutting edge buyout firm itself last month when it announced that it was moving toward a "new, more aggressive leverage target to enhance shareholder value." Anheuser's stock advanced on the news, and we hope its announcement spurs other companies to take similar shareholder-friendly actions in the near future.

Thinking about the prospect of equity market performance in 2007 given this huge war chest of buyout money at the ready, we believe that our holdings are well-positioned to benefit from our Private-Market Valuation Approach. As we have stated in past publications, we often purchase companies that are trading at a discount to what a buyer would pay to take control of the company—we like to buy a dollar for fifty cents, so to speak. In light of the recent dissatisfaction on the part of shareholders in various buyouts combined with probable increased competition for deals, we would not be surprised to see private equity buyers forking over higher premiums for their targets. Further, if more companies follow Anheuser's lead in focusing on more efficient capital structures, the share prices of multiple companies should advance even in the absence of a buyout. These developments would obviously put upward pressure on stock prices. We could not be happier about these nascent signs of increased shareholder vigilance and the push for increased management accountability.

In closing, we believe any significant economic slowdown will be short in duration. Although we cannot predict unforeseen events on the geopolitical stage, we are confident that our investment approach should continue to reward the patient investor. On behalf of all of us at King Investment Advisors, thank you very much for your support. Best wishes for a year filled with happiness and good health.

Ryan C. McCleary, CFA
Vice President

The year 2007 marks KING's Twenty-Sixth 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-six 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 TO THIS ISSUE

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SOURCES FOR THIS ISSUE

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Peter Schiff, Market Strategist; *The Wall Street Journal*

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