The Decision Maker

KING

Spring 2005

…it is difficult to attribute the long-term interest rate declines of the last nine months to glacially increasing globalization. For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum.

— Alan Greenspan
testimony to the U.S. congress, february 16, 2005

After a strong 2004, the equity markets have experienced a round of profit taking thus far in 2005. All major equity indices were down for the first quarter of 2005, including the broad-based indices. The Dow Jones Industrial Average, S&P 500, and Russell 3000 showed quarterly returns of –2.6%, –2.6%, and –2.2%, respectively. Mid-cap stocks fared a little better, with the Russell Midcap suffering a decline of –0.6%, while small-cap stocks took it on the chin as the Russell 2000 had a quarterly loss of 5.3%. The most disappointing quarterly results came from the NASDAQ 100 Index, with a –8.6% return. Losses encompassed all economic sectors except energy stocks, with the Russell 3000 Energy Index rising 17.9% for the quarter. With U.S. economic growth in reasonably good shape, why have the markets been in a funk?

As always on Wall Street, broad declines are usually caused by fear of the future. Market participants are currently suffering from fear of rising energy prices, the federal deficit, the U.S. trade deficit, the falling dollar, and event risk arising from the Middle East or Asia. Even though wariness in each of these cases is justified, the primary factors causing the most difficulty for investors are rising interest rates, and—closely related—increasing inflation.

The headwinds caused by rising short-term interest rates have been steady and strong. On March 22, the Federal Open Market Committee (FOMC), chaired by Alan Greenspan, by unanimous vote, raised its Federal Funds target by 0.25% to 2.75%. With this move, the FOMC set a new record—seven consecutive increases at its regularly scheduled meetings. Moreover, the Fed is not through raising rates. Responding to a recent question by the CEO of Deutsche Bank, Alan Greenspan remarked, "Rising interest rates have been advertised for so long and in so many places that anyone who has not appropriately hedged this position by now obviously is desirous of losing money."

But the behavior of long-term interest rates has been perplexing. Most often, when economic growth is as strong as it is today and the FOMC raises its Fed Funds target, long-term interest rates will follow suit and also rise. However, as shown in Table I, the last nine months have been different as the spread between two-year and ten-year treasuries has narrowed significantly.

While the Federal Reserve has consistently been upping the ante, as shown in Graph I, yields on the ten-year bond have actually fallen instead of increased! This odd reaction to rising short-term rates elicited Alan Greenspan's now famous "conundrum" comment. Will Greenspan's "conundrum" become as infamous as his unforgettable 1996 "irrational exuberance" christening of the tech bubble?

Understanding the reasons behind this riddle is not only fascinating, but provides us a frame of

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TABLE I	SPREADS TIGHTEN			
	Fed Funds Target	2-Year Treasury Yield	10-Year Treasury Yield	2-10 Year Spread
May 30, 2004 (Before First Rate Target Increase)	1.00%	2.6%	4.7%	210 bps
September 30, 2004	1.75%	2.6%	4.1%	150 bps
December 31, 2004	2.25%	3.1%	4.2%	110 bps
March 31, 2005	2.75%	3.8%	4.5%	70 bps

reference as we peer into our crystal ball and look out over the next few quarters. Before we proceed, it is critical for one to understand the concept of the "yield curve" and the determinants of its shape. Read the insert, "Primer for Understanding the Yield Curve," to brush up on your bond lingo.

Expectations Call for Higher Interest Rates

The key driver of interest rates is usually the market's inflation expectations. While we recognize that we might be characterized as somewhat too optimistic, we are assuming inflation over the next year will continue at a rate of approximately 2.5% for the core Consumer Price Index (CPI), which excludes food and energy costs. Total CPI, including both food and energy costs, is much more volatile, but should range between 3.0% and 3.5%. We expect inflation in the out years to remain at approximately the same levels. Some of the key factors boosting and suppressing current inflation expectations include:

Fueling Inflation Fears

1. A Growing U.S. Economy: While economic statistics are still mixed, the U.S. economy is doing well. Real GDP grew at 3.8% year-over-year for the fourth quarter of 2004 and could do the same for the first quarter of 2005. By the fourth quarter of 2005, real GDP growth should slow to 3% to 3.5%, still a respectable increase, but strong enough to raise inflation expectations. One item causing recent concern is the low unemployment rate of 5.2%. At what point does continued demand for labor start driving up wages? (For you economists out there, we agree that in the long run inflation is a monetary problem of too much money chasing too few goods. However, in the short run, inflation expectations are often driven by other economic and emotional factors).

2. Rising Energy Prices: Oil prices recently exceeded $58 a barrel, and, while most analysts think prices will retreat to some extent, the days of cheap oil certainly appear to be history. While consumers already feel the drain on their wallets at the pump, they will also see price increases in consumer goods made of petroleum products as well as general price hikes due to rising transport and shipping costs. Personal and business travel costs will increase to some extent as rising fuel prices pressure the airlines to increase ticket prices. One thing to remember, even at today's prices, oil still trades below its peak 1980 price of $93 in today's inflation-adjusted dollars. Furthermore, America has significantly retooled its industrial base since the oil crises of the 1970s and early 1980s. According to the Department of Energy's Energy Information Administration, the amount of oil and gas needed to produce a dollar of economic growth fell by 55% between 1973 and 2003. In recent speeches, the Fed Chairman appeared pleased with the U.S. economy's ability to absorb these price increases and still maintain its stride.

3. A Host of Other Reasons: Commodity prices are at very high levels and, at some point, should get passed on to the consumer. Healthcare costs are also rising quickly, as are housing prices, although the latter is showing signs of a slowdown in a number of locations. With the devaluation of the U.S. dollar, imported goods have become more expensive and have given some domestic producers the opportunity to raise prices as well.

Alleviating Inflation Fears

1. Rising Energy Prices: While counterintuitive, rising energy costs could restrain consumer discretionary spending later in 2005, thus slowing economic growth. A slower economy should lead to lower inflation and hence lessen pressure on the Fed to raise short-term interest rates.

2. Productivity Increases: U.S. corporations are still increasing their productivity by finding new ways to use computers, software, telecommunication tools, and other technology in the workplace. While the bulk of these productivity improvements is behind us, continuing productivity enhancements still help restrain inflation without impeding economic growth.

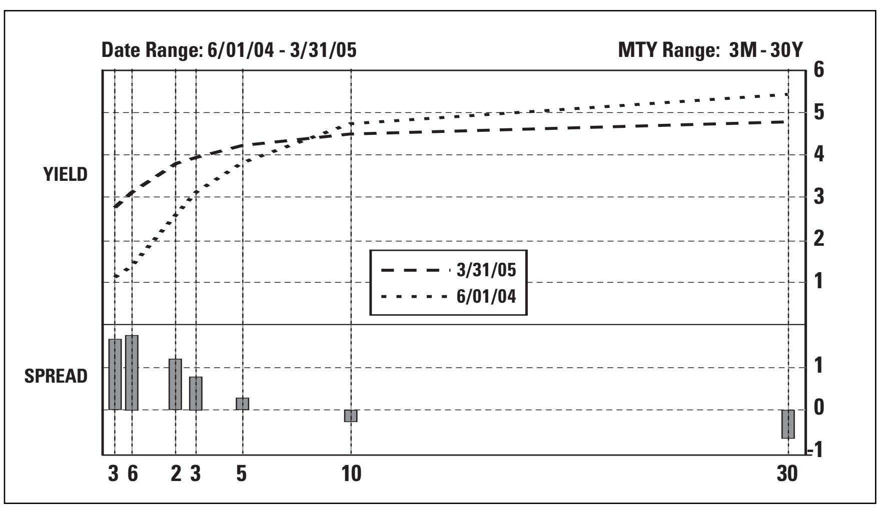
The dynamics of the U.S. economy over the past several quarters have led the Federal Reserve to tweak anew its economic levers. With the Fed's tightening of the money supply and ratcheting up of the fed funds rate, coupled with rising inflation expectations, short-term interest rates across the board have been moving upward. The mystery is why investors purchasing ten-year bonds are not demanding a higher coupon as they have traditionally done in comparable periods in the past.

In Greenspan We Trust

There are plenty of critics who love to hurl barbs at the Chairman, particularly with the benefit of hind-sight. Yet, for the most part, Alan Greenspan has done a remarkable job as the Fed's chairman for the past seventeen years. Alas, all good things must come to an end; Greenspan has announced he will leave the post at the end of his term in January 2006. It is hoped that he will have significant input into picking his successor and that Mr. Greenspan will want his heir-apparent to inherit his full kit of monetary tools, including setting short-term rate targets. Several members of the Fed have addressed the idea that the neutral range for the fed funds rate in the eyes of the FOMC members is between 3% and 5%. In order for a new Fed Chairman to have the room to cut rates to avert an economic downturn, the fed funds rate needs to be higher than the present 2.75%.

Keeping this neutral range in mind, the FOMC will probably

GRAPH I
HISTORICAL YIELD CURVE



Source: Bloomberg L.P.

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The newest hedge fund party is the attempt to front run pension funds' potential purchase of longer U.S. Treasuries.

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continue to raise the fed funds target by 25 basis points at its scheduled meetings through the early fall. With the target rate then at 3.50% to 3.75%, the FOMC can reassess its stance before the next meeting in November. Unless inflation picks up significantly, it is unlikely the FOMC will raise the target rate above 4.0%. Unlike some pundits who believe several 50 basis point hikes are in the making, we believe Greenspan and the FOMC realize the U.S. economy, while in good shape, is not capable of bearing too much burden or shock.

Our expectation of the fed funds rate increases is a fairly moderate one. Almost all economists project continued Fed tightening for at least the next few months. Thus, knowing these expectations are built into the market, why are so many fixed income investors committed to purchasing ten-year bonds yielding a mere 4.5%—with their attendant and potentially significant price volatility—when they could simply invest in very stable, short-term instruments which would probably be yielding approximately 4.0% within six months?

Market Segments, Indifferent or Irrational, Keep Long Rates Down

Since neither the liquidity preference nor the expectations hypothesis can explain the flatness of the current yield curve, there must be fixed income buyers who are purchasing longer-term bonds more aggressively than the shorter maturities. (See the Primer insert for a further discussion.) There are at least two interesting suspects who loom as willing buyers.

Different Priorities — Asian Central Banks

Three Deutsche Bank economists have developed a theory coined "Bretton Woods Two," in reference to the original system birthed in 1945 under which foreign central banks maintained fixed exchange rates between their currency and the U.S. dollar. Before 1971, the dollar was the global standard and convertible into gold until this exchange standard was eliminated by President Richard Nixon. Fast-forward to the new millennium. Many countries, but particularly Asian governments, have informally pegged their currency to the U.S. dollar. More specifically, China's neighbors have to "toe the pegged line" since China has officially tied its currency to the dollar. If a competitor's currency appreciates too much against the pegged Chinese Renminbi, the competitor loses market share to China. In order to cheapen their currency against the U.S. dollar and thus maintain their relative competitive position, central banks step in and buy U.S. securities.

Asian countries have traditionally purchased U.S. Treasuries, U.S. agencies, and corporate bonds in their efforts to support a falling U.S. dollar. In recent years, however, the purchase of U.S. Treasuries has increased rapidly, as shown in Table II.

Moreover, a recent UBS Financial Services Inc. (UBS) report states that the influence of Japan's Ministry of Finance on the U.S. Treasury market is far larger than any other foreign buyer. Japan accounted for 50% of the total net acquisitions of U.S. Treasuries by foreign accounts in the last two years. UBS also found some evidence that U.S. Treasuries fell in months when Japan's central bank was making strong currency interventions in the market; however, statistical significance is not conclusive. UBS estimates that the intervention of Asian central banks has lowered the yield on U.S. Treasuries by 50 basis points. It is reasonable to assume that foreign buyers have the greatest impact on the U.S. Treasury issue least affected by the Federal Reserve actions—namely, the ten-year bonds.

The Bretton Woods Two concept is substantial and relevant. As Paul McCulley, of the gargantuan, fixed-income management firm, PIMCO, explains, "unless this effect is taken into account, one will systematically overestimate the level and slope of the U.S. Yield Curve." While some naysayers believe this informal arrangement may last only a couple of years, other very savvy economists such as McCulley believe Bretton Woods Two could benefit the U.S. for years to come.

Risky Business — Hedge Fund Strategies

There is little reliable data concerning hedge fund activity due to their secretive strategies and inaccessible portfolio holdings in the U.S. Treasury markets. Even so, we believe their influence has been substantial in the Treasury markets during the last few years. Now that the spread between short- and long-term rates has fallen to 70 basis points, one would think most of these funds involved in the "carry-trade" have closed their positions. (See the Primer insert for a further discussion of the "carry-trade.") In a classic carry-trade strategy, one borrows short-term at low interest rates and invests the borrowed funds into longer-term bonds paying higher interest rates. The spread between the short-term rates and long-term rates is your profit. Surprisingly, CNBC recently reported that rather than unwinding their positions, some desperate hedge funds are increasing their leverage (i.e., increasing their borrowing) on the carry-trade to squeeze more juice out of this increasingly barren strategy. These remaining players are disasters waiting to happen, since it is likely that such funds will play the game too long and will get squeezed themselves if the ten-year bond takes an unexpected nosedive in value. If not the "carry-trade," there will be other funds that add to market volatility as they pursue risky strategies such as the one discussed below.

The newest hedge fund party is the attempt to front run pension funds' potential purchase of longer U.S. Treasuries. In January 2005, the U.S. Secretary of Labor, Elaine Chao, announced President Bush's proposal for reforming the country's pension plan system. One of the proposal's primary aims is to reform the funding rules. The administration signaled its intent by sending up a trial balloon recommending the defeasance (essentially, defeasance allows an issuer to collateralize outstanding debt with a portfolio of "risk-free government securities," thereby instantly removing the debt from the issuer's balance sheet) of the pension liabilities of the plans that the Pension Benefit Guaranty Corporation inherits from bankrupt companies. In addition, the government would encourage companies to match plan assets and

TABLE II Asian Purchases of U.S. Fixed Income Securities (in U.S. $Bs)

	2001	2002	2003	2004(E)	3-Yr CAGR
U.S. Treasuries	$36	$56	$183	$209	79.7%
U.S. Corporates	$28	$26	$28	$28	0%
U.S. Agency & Mortgage-Backs	$81	$97	$83	$88	2.8%
Total	$145	$179	$294	$325	30.9%

Source: UBS Investment Research

liabilities to minimize volatility. Since pension liabilities are long-term obligations, sizeable purchases of long-term Treasuries will be needed to properly defease these plans. Within days of the Labor Department's overture, numerous hedge funds jumped at the idea of buying long-term U.S. Treasuries in anticipation of selling them to the pension funds in the future at an enviable profit.

We are skeptical of such a strategy, particularly since it is only a proposal at this time and is also fraught with structural problems. In the end, such a strategy will be a loser's game for the hedge funds should they naively try to embrace such a gimmick.

Looking Ahead

We believe long-term rates will rise to 5.0%-5.25% by the end of 2005. Continued signs of inflation will finally force investors to expect more for their ten-year money than the current rate of 4.5%. This upward pressure on rates will be assisted by the hedge funds winding down their carry-trade and other risk strategies. The yield curve will still have a positive slope, although somewhat flatter than average. Even so, yields will be lower than many economists would normally forecast due to

"And please let Alan Greenspan accept the things he cannot change, give him the courage to change the things he can and the wisdom to know the difference."

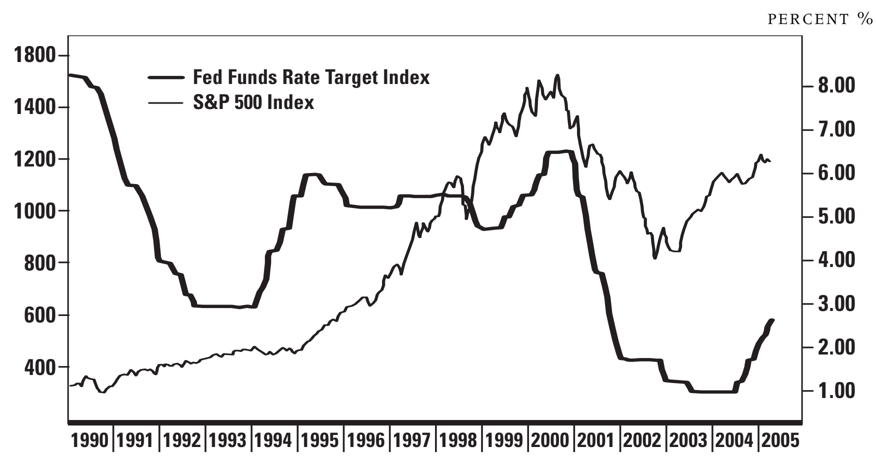
One should not assume future hikes in the fed funds rate will necessarily cause continued losses in the equity markets.

the continued purchase of U.S. Treasuries by the Asian Central Banks.

Given our expectation that rates will rise across the yield curve, our fixed income strategy has centered on purchasing short-term bonds and/or preferred stock instruments which track increasing rates: examples of the latter would be issues whose interest rates float with the CPI or LIBOR rates. In addition, cash has been a good, temporary, parking place. Taxable money market funds are currently earning around 2.2%, up nicely from the less than 1% money market returns earned two years ago. Should the FOMC continue to lift its fed funds target as we expect, money market rates should exceed 3.5% by next fall—just like the good old days.

One should not assume future hikes in the fed funds rate will necessarily cause continued losses in the equity markets. As Graph II reveals, there is no perfect correlation between movements in the fed funds rate targets and the U.S. equity market. One reason for this apparent lack of causality is that the broad movements in the stock market are due to the combined movements of a number of economic variables. The desired effect on the economy of raising or lowering short-term rates takes some time, often around six months. Even when attempting to account for this delayed impact, a

Graph II
S&P 500 versus Fed Funds rate target



Source: Bloomberg L.P.

significant correlation between interest rates and the equity markets is not always so clear-cut. Some would argue that history shows that Fed tightening leads to a bear market. The late Edson Gould's "three steps and a stumble rule," postulated that three successive steps by the Fed to tighten money led to a bear market.

In some respects, one could maintain that the Fed's actions over the past few quarters have already been discounted to a significant degree by a number of industry groups. The nature of the markets today is such that they discount adverse news within shorter time horizons. As the markets are forward looking mechanisms, and since the discounting process occurs quickly, if the Fed begins to slow its tightening by the fall, the markets could well begin to look beyond the horizon into 2006.

Without question, more often than not, it is the direction of interest rates that investors anticipate. And, arguably, more important in some cases is the market's fear of uncertainty. At this point in time, no one knows when the Fed will stop raising short-term rates or by how much—including the Fed. At the point Wall Street anticipates the end of the rate hikes is in sight and corporate America can adjust to a new stabilization of rates, the equity markets should again start rising in earnest.

Predicting when such a sea change will occur is impossible. We believe it is futile to attempt to time short-term wiggles in the market based on interest rate predictions, economic forecasts, or technical charts. Instead, we spend our time unearthing, analyzing, and investing in good companies that are undervalued by the market. By taking the same long-term view as a business owner, we set aside the noise of Wall Street and the media, and focus on deriving the intrinsic values of lasting and growing enterprises. If we are patient and can purchase such jewels at a discount, our past successes are a good indication that we can earn healthy profits for our clients when the market realizes the values of these companies. If such undiscovered gems are not available, we find that cash is also a worthy investment. By engaging in this process again and again, with a focused portfolio of companies, we are confident that we can continue to earn attractive returns for our clients over long periods of time in the future.

Pat H. Swanson, CFA

A Primer For Understanding the Yield Curve

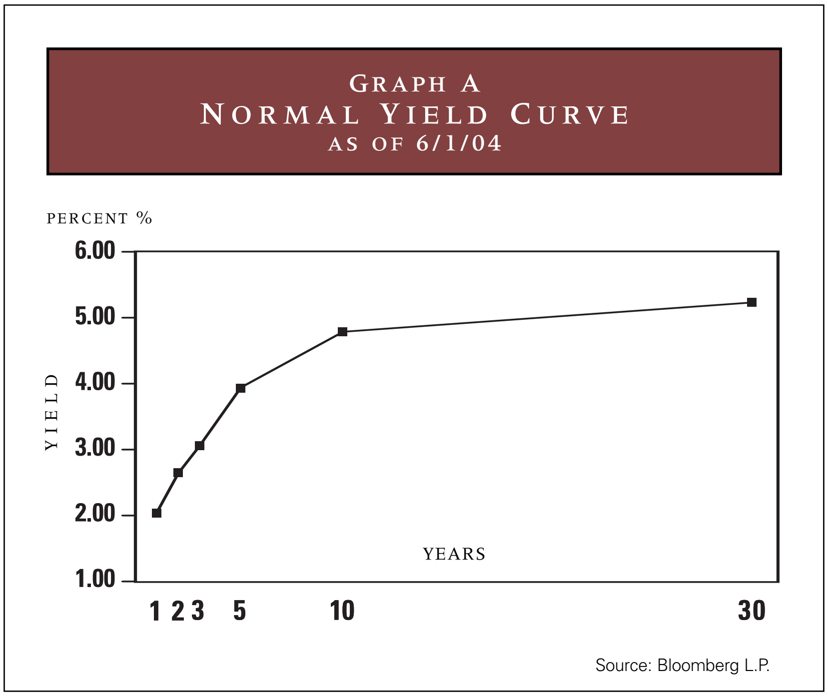
Grasping the concept of the yield curve is an essential building block for any equity or fixed-income investor. If you are new to the concept or just need to revive some sleeping memory cells, we encourage you to read this insert. We've attempted to boil the yield curve down to its essentials and to simplify the terms and principles used to explain its actions. The bible for fixed-income investing is Dr. Frank J. Fabozzi's *The Handbook of Fixed Income Analysis*, which is required reading for all serious financial analysts. So, many of the following technical explanations are ascribed directly to his collaboration with Dr. Frank J. Jones and Dr. Benjamin Wolkowitz in their chapter, "The Determinates of Interest Rates on Fixed Income Securities."

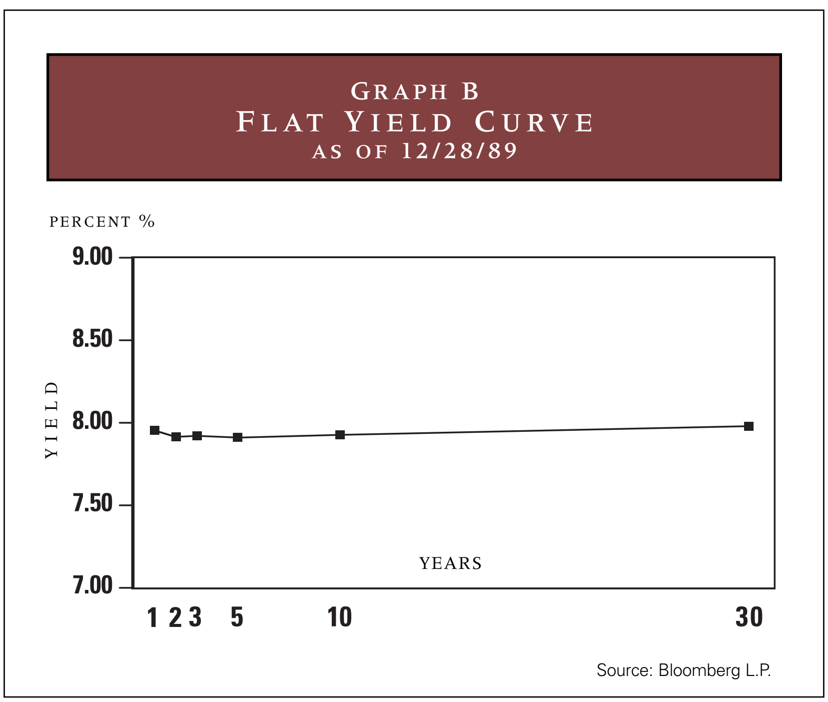
A Yield Curve Is…

A yield curve is simply a graph showing the interest rate or *yield* available for any future maturity date for bonds with similar credit risk and taxation characteristics. There are thousands of yield curves available to study and compare on any given day; to name only a few, yield curves exist for municipal bonds, investment-grade corporate debt, junk bonds, and foreign government obligations. Even so, when residing in the United States, there is only one "The" yield curve. *The* yield curve relies only on the most liquid of U.S. Treasury debt obligations to populate its graph over a three-month to thirty-year time horizon.

Yield Curves Assume Three Shapes

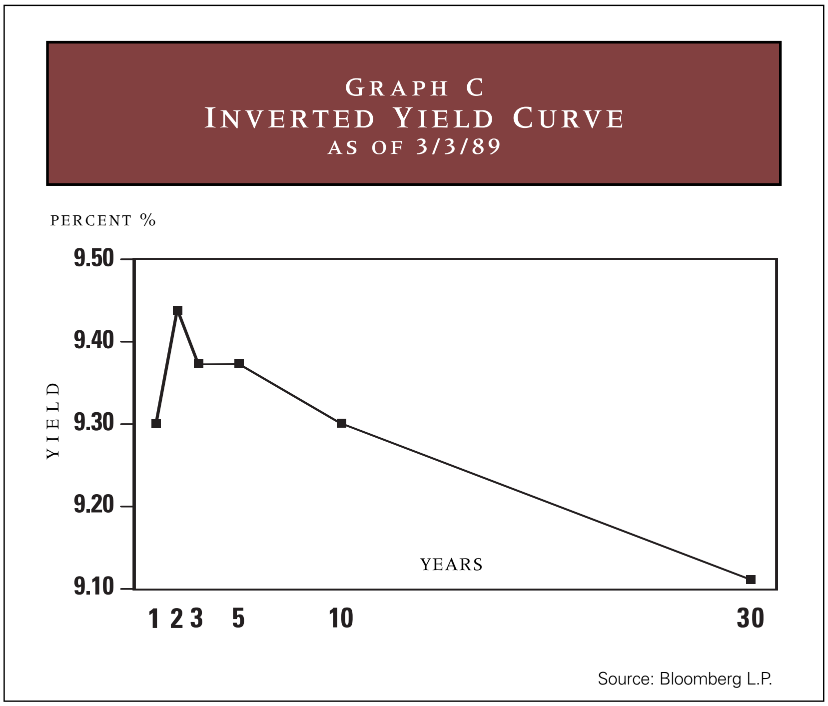
Normal or Positively Sloped Yield Curves: In these curves, as shown in Graph A, interest rates increase as the maturity dates grow longer (or in bond-speak, you "*move out the curve*"). These curves describe the usual state of economic affairs and are intuitively easy for investors to understand. You would usually expect to earn far less from a three-month Treasury bill than you would from a thirty-year bond. The difference between short-term interest rates and long-term interest rates describes the "steepness" of the yield curve. In spring 2004, short-term rates were very low and ten-year rates were relatively high, resulting in a very steep yield curve. This allowed risk-oriented investors such as hedge funds to benefit from the *carry-trade*; by borrowing capital at historically low short-term rates and investing these borrowings in long-term bonds, such investors can profit from the *spread* or the difference between short- and long-term rates. The risk in the carry-trade is calculating when to *unwind* your trade so that a rapid rise in rates does not destroy the value of your bonds with long maturities while simultaneously increasing your borrowing costs.





Flat Yield Curves: Rather rare, a flat yield curve, as shown in Graph B, has the same yield regardless of the maturity of a debt instrument. Investors who rely on the carry-trade to make profits, including many banks and thrifts, watch their profits dry up in a flat yield curve environment. Just as importantly, Wall Street goes haywire in a flat yield curve environment as economists and strategists try to determine whether this yield curve will revert to a normal yield curve or transform into the dreaded *inverted yield curve* discussed next.

Inverted or Negatively Sloped Yield Curves: For the curve shown in Graph C, the relationship between maturities and yields is such that the longer the maturity, the lower the yield. Luckily, it is quite rare. This curve usually indicates that the buyers of bonds with ten- to thirty-year maturities are so pessimistic about the U.S. economy that they are willing to accept a lower yield on a long-term bond today because they fear interest rates will be less a year from now. An inverted yield curve is an uncanny predictor of future economic activity. In 1996, the New York Federal Reserve released a study which concluded that it is the most reliable indicator of a coming recession. This curve is a catalyst to spark a bear equity market and an excellent contrarian indicator to purchase long-term Treasury bonds.



You should now be asking, Why is it that the yield curve is always changing shapes? Or, in other words, why doesn't the relationship between short-term and long-term rates remain somewhat constant? The answers lie in the *term structure of interest rates*.

TERM STRUCTURES OF INTEREST RATES

A term structure describes the relationship between a security's interest rate and its term-to-maturity. There are three distinct hypotheses or explanations determining a bond's term structure, all three struggling together to create the yield curve.

Liquidity Preference Hypothesis: The major determinate of a treasury bond's market risk is its maturity, because the longer the security's maturity the greater the price change for a given change in interest rates. Because a security with a longer maturity has greater market risk, and therefore, less liquidity, interest rates should increase with maturity as compensation for investors. This explanation is very powerful and is the primary reason that a normal yield-curve has a positive slope.

Expectations Hypothesis: When purchasing bonds, investors predict where they expect future interest rates are going to be. These future expectations drive the shape of the yield curve today. This hypothesis is best explained through an example. Let us say you have a sum of cash you want to invest for exactly two years, and you do not care about the liquidity preference described above. You have the choice of purchasing a one-year note today and another one-year note in a year, or purchasing a two-year note today. Presently, you can earn 3% on a one-year note. In deciding the best option, you will expect one of three following interest rate scenarios.

a) If you expect interest rates to be the same in the second year, you are indifferent about buying a one-year 3% note today and reinvesting in a second one-year 3% note next year or just purchasing a two-year 3% note today. You just created a flat two-year yield curve.

b) If you expect interest rates to rise to 5% in the second year, you will not be satisfied with only a 3% coupon on a two-year note. Instead, you would require a yield of approximately 4% on a two-year note in order to be indifferent to earning 3% the first year and 5% the second year. You just created a normal or positive-shaped yield curve.

c) If you and other market participants expect interest rates to fall to 1% in the second year, you would be overjoyed to earn 3% on a two-year note, but unfortunately no borrower will pay you that much. Instead, they are willing to give you an approximate 2% return on your two-year investment. Again, you are indifferent since you could have earned 3% on a one-year note but expected to only earn 1% in the second year. Now you have created an inverted yield curve.

While this is a simple example, investors apply this expectations hypothesis out thirty years. It is this explanation that incorporates budget surpluses and deficits, political changes and world events, currency fluctuations, and most importantly, inflation forecasts—the true demon of the fixed-income markets.

Market Segmentation Hypothesis: This explanation assumes that investors are not a homogeneous group and, instead, like to stay within certain ranges of term-to-maturities. Constraints might include regulatory reasons, investment mandates, liability-matching objectives, or political reasons. These sometimes irrational participants can overpower the liquidity and expectations hypothesis. The reason we know this is because there is no strong empirical evidence proving the predictive powers of the other two theories.

Summary

It is critical to note that the elements of each of these hypotheses are constantly pulling and pushing interest rates up and down. On any given day, one of these explanations is going to be more powerful than the others. With little notice, the balance of influence between these hypotheses will shift and result in changes in the yield curve. Moreover, it is impossible to quantify the impact of the conflicting hypothesis at any point in time in order to forecast interest rates in the future. This is why Wall Street economists have such a thankless job; the sheer number of moving parts and their ever-changing relationships make it impossible to accurately forecast interest rates. The best one can really hope to do is to predict the general direction of interest rates across maturities.

ABOUT KING INVESTMENT ADVISORS, INC.

KING is in its twenty-fifth year of operation. 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-four 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.

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