

Summer 2005

An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen.

— UNKNOWN

The first half of 2005 was an extremely frustrating period for investors in the U.S. equity markets. On March 7, the Dow Jones Industrial Average hit a four-year high, a level less than 7% below its all-time peak of 11,750. Bulls looking for a Dow advance above the psychologically significant 11,000 level were quickly humbled. Cautious investors led a sell-off that sent the Dow down approximately 8% over the next six weeks, with similar declines in the broad S&P 500 and the tech-heavy Nasdaq. Fear permeated the investment landscape as various media pundits began blaming the slide on a number of factors, including earnings warnings, weak economic data, Fed rate hikes, rising oil prices, and an expanding trade deficit. *New York Times* columnist Paul Krugman went so far as to unearth a term not heard since the 1970s when he wrote of “a whiff of stagflation.” Unfortunately, bad news sells. The litany of barbs against the U.S. economy has become so ingrained and ubiquitous that few

outside of Alan Greenspan questioned the spring “slowdown” and its potentially dire economic consequences. When the initial reading on first quarter GDP growth came in at a respectable 3.5%, headlines shifted to the troublesome level of adjustable-rate mortgages and the presence of a housing “bubble.”

We believe that this continued pessimism and search for trouble around every corner is misguided. The U.S. expansion has been impressive and steady despite repeated claims of impending doom. Domestic economic growth has averaged a strong 3.9% pace since the initial 7.4% tax-cut-related growth spurt in the third quarter of 2003. Due in large part to smaller businesses, the U.S. unemployment rate recently fell to 5%, the lowest since the terrorist attacks of September 2001. Wage gains are driving consumer spending at retailers and other service industries. According to the latest data from the Commerce Department,

wages and salaries were up 7% in May from the same time last year. Confirming this wage growth is the fact that individual income tax receipts for the first nine months of the current fiscal year have increased 18% relative to year-ago levels, a surge which will obviously lower the projected budget deficit. More than a few economists have been sounding the death knell of the American consumer for longer than we can remember. One of their main assertions of late is that household debt is at a record high. This statement is true; mortgage and credit card debt have reached record levels over the last year. This fact alone is too simplistic. A thorough examination of the domestic household balance sheet reveals a very important piece of information—total household liquid assets have increased more than total debt, helping to lessen the possibility of a meaningful decline in consumer spending.

Numerous economic data points released over the past several weeks have lent further support to our thesis that the U.S. economy remains on firm footing. The final revision of first quarter real GDP growth (nominal growth minus inflation) came in at 3.8%, equal to the real growth rate of the fourth quarter of 2004. The first quarter nominal growth rate of 6.7% actually exceeded the nominal rate of 6.2% recorded in the fourth quarter. It is quite remarkable that the domestic economy has weathered the stiff headwind of spiraling energy prices for multiple quarters while continuing to grow at a rate far better than most other countries. The U.S. services industry grew faster than forecast in June as companies from railroads to retailers boosted hiring. The Institute for Supply Management (ISM) reported that its index



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of non-manufacturing companies increased to 62.2 in June from 58.5 in May. Figures greater than 50 represent expansion, and the index covers approximately 87% of the U.S. economy. The index's hiring gauge increased to a four-month high in June. Even more noteworthy, the headline number of 62.2 is very close to the 62.4 average for all of 2004, a year when the economic growth rate of 4.4% was the fastest since 1999.

The manufacturing side of the economy also received positive news. The ISM factory index rose to 53.8 in June, the first increase in seven months. The index's gauge of manufacturing prices fell to its lowest point in more than three years, offering a benign view of inflation that matches recent tame readings of the Consumer Price Index (CPI). Speaking of consumers, the University of Michigan Consumer Sentiment Index in early June rose to its highest level since January on a marked

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improvement in consumer assessment of both current conditions and expectations. Not surprisingly, retailers from Wal-Mart to Nordstrom posted their biggest sales gain in 13 months in June. Finally, U.S. employers added 146,000 workers in June, and job growth in April and May was revised upward by 44,000. So far this year, job growth has averaged 181,000 per month, consistent with the 183,000 per month recorded in 2004.

After digesting this list of economic superlatives, readers may conclude that we are being overly optimistic about U.S. economic prospects. To be perfectly clear, we readily acknowledge that the economy will slow from its current 3.8% real growth rate. Record oil and gasoline prices cannot be ignored; they represent an unquestionable drag on economic growth. The Federal Reserve Board's yearlong campaign of interest rate increases is also slowing the economy, though Alan Greenspan is closer to the end than the beginning of his fight against

inflation. Rates are still low by historical and even recent standards—the real fed-funds rate in the late 1990s averaged 3%, today it is close to 0%. Given the headwinds of elevated commodity prices and central bank tightening, we would not be surprised to see a slowing of economic growth to the 3.3% or even the 3% level over the next several quarters. It is important to remember that this slowing will be relative to a very robust growth rate just slightly under 4%, and an economy growing at 3% has historically been viewed as a healthy economy, certainly a far cry from the “stagflation” days of the 1970s.

Any discussion regarding the future performance of the U.S. equity markets must include the subject of corporate profits. The recent strength in corporate profit growth is another positive item that has been given less attention than the many perceived perils facing the economy. For more than half a century, the Bureau of Economic Analysis of the Department of Commerce has been assembling and recording a measure of corporate profits called the National Income and Product Accounts (NIPA). The NIPA profit figures are derived from tax returns filed by all U.S. corporate taxpayers. This data is ideal for sound analysis because corporations do not artificially inflate these figures for obvious reasons, unlike the often “pro-forma” profit numbers reported by companies on a quarterly basis. The growth in NIPA profits has been astounding and unprecedented; 2005 is likely to be the fourth consecutive year of double-digit corporate profit growth. The first quarter pre-tax profit growth rate was recently revised upward to 15%, well ahead of the fourth quarter 2004 growth rate of 12%.

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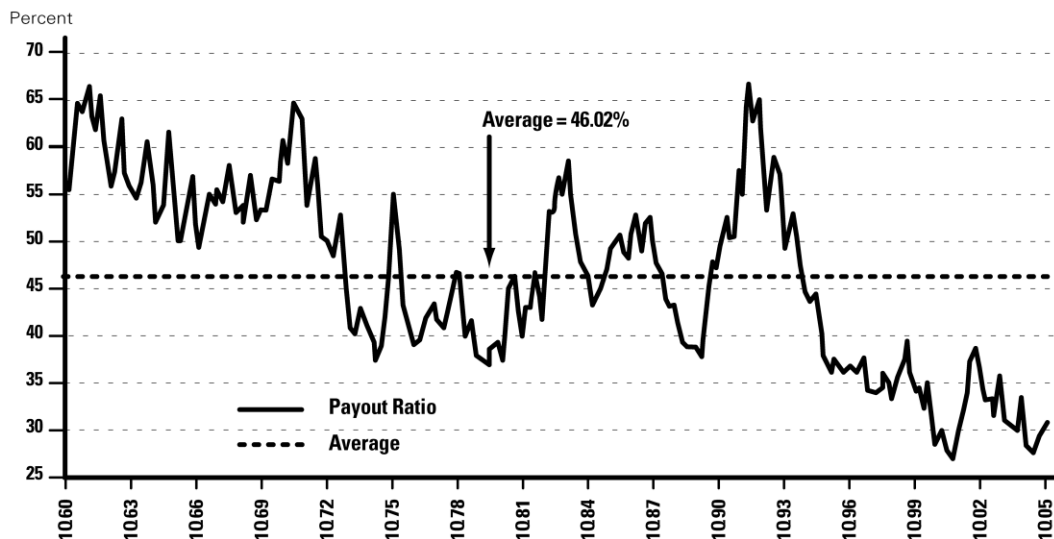
While we recognize that corporate profits cannot advance at this level indefinitely, the trend in the NIPA numbers usually changes slowly after considerable fluctuations in the economic environment.

A stockholder can realize a positive return through growth in earnings, expansion in the price-to-earnings multiple, and the payment of dividends. Even if the growth in corporate profits slows over the next several quarters, investors can still be optimistic about the potential total return of U.S. equities because another avenue of appreciation is re-asserting itself—dividends paid by S&P 500 companies are accelerating. Dividend-paying stocks have commanded investors' attention in the wake of the tech bubble collapse in 2000, but interest in dividend payers understandably increased when the federal government cut taxes on qualified corporate dividends in 2003 to 15% from as high as 38.6%.

Despite increased investor appetites, dividend growth only started to pick up speed at the end of 2003. More importantly, 2005 marks the first year that dividends started to grow faster than profits. During the first three months of the year, dividends grew by 16%, while corporate profits based on the NIPA figures grew 15%. Dividends have typically grown faster than earnings only in economic downturns, and typically it is not a case of dividends increasing but rather of earnings slowing faster than dividends. The fact that investors are being paid more to hold stocks at a rate exceeding earnings growth in the midst of an economic upswing is a rare occurrence. This phenomenon is extremely important because dividends are becoming a larger part of the total return equation as the heady days of the 20+% annual market returns of the 1990s recede from memory. For those who scoff at the idea of wealth creation through dividends, the following numbers are illuminating. From 1995 to 2004, a period of declining focus on dividends, the S&P 500 rose 164% based on price appreciation. By reinvesting small but growing dividends, however, investors earned 212% in total returns. The current low level of government bond yields makes an equity security offering a reasonable dividend even more attractive. The encouraging news for investors is that despite the recent pickup in dividend growth, the actual payout ratio (the percentage of a company's profits paid in dividends) is still near historical lows.

Investors should feel confident in the ability of companies to raise their dividends given the enormous amounts of cash that have been accumulating on corporate balance

S&P 500 DIVIDEND PAYOUT RATIO 1ST QUARTER 1960 TO 1ST QUARTER 2005

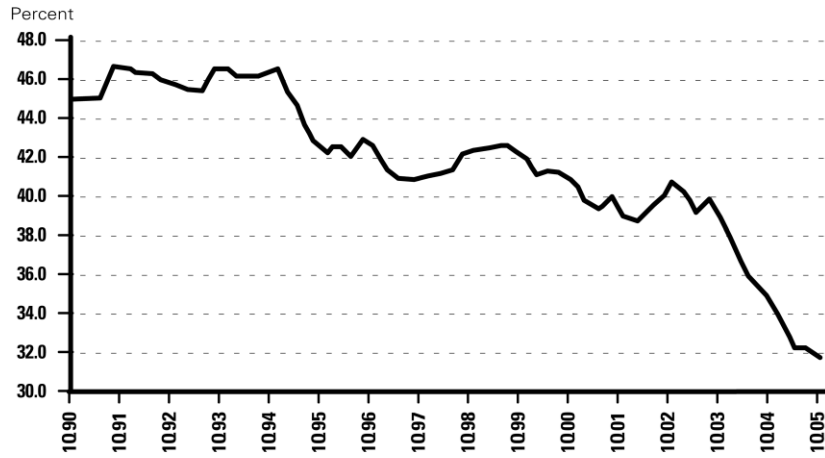


Source: Smith Barney U.S. Equity Strategy

sheets. The mountain of cash is indeed impressive. The S&P 500 (ex-financials) net debt (debt minus cash) to capital ratio is at a fifteen-year low, and the S&P 500 cash to market cap ratio is near a nineteen-year high. This cash hoard is supportive of equity prices in several ways. In addition to facilitating dividend increases, the cash has allowed corporations to greatly increase their stock repurchase activity. According to Standard & Poor's, company buybacks increased by 91% for the first quarter of 2005 compared with the same period a year ago, and grew by 64% for the twelve months ended March

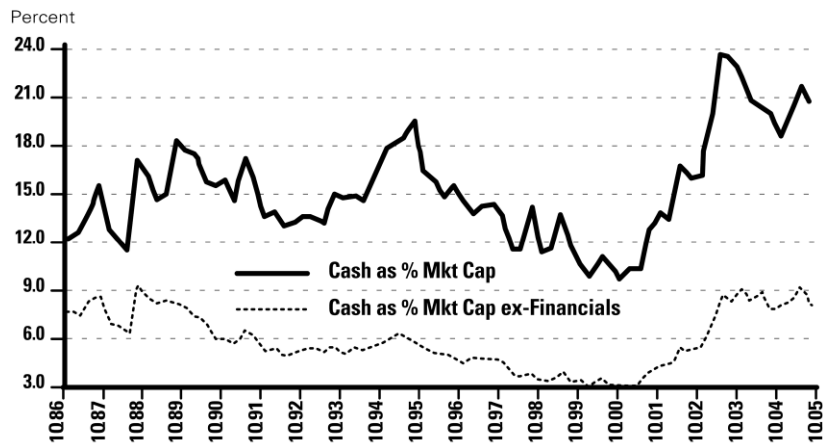
2005. Finally, the cash build-up has driven a substantial increase in mergers and acquisitions, activities that are a sign of business confidence and certainly beneficial to stock prices. The past three months of merger and acquisition activity has produced the most active period since the end of 2000, with corporations and investors spending \$666 billion for deals around the world, 53% more than the comparable 2004 period. Assuming continued earnings gains and cash accumulation, there is no reason to expect a pronounced slowdown in deals in the near future.

S&P 500 (EX-FINANCIALS) NET DEBT TO CAPITAL 1ST QUARTER 1990 TO 1ST QUARTER 2005



Source: FactSet and Smith Barney U.S. Equity Strategy

S&P 500 CASH TO MARKET CAP 1ST QUARTER 1986 TO 1ST QUARTER 2005



Based on current S&P 500 Constituents

Source: FactSet and Smith Barney U.S. Equity Strategy



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We at KING would like to take a moment to reflect on the recent tragedy in London. Our thoughts and prayers go out to the victims and their families who were the targets of yet another cowardly act of terrorism. The war on terror is unfortunately a non-traditional conflict with an indeterminate conclusion. While any loss of life is undeniably of utmost concern, we are also fiduciaries who must consider the financial market repercussions of acts of terror. From a market impact perspective, investors are gradually becoming inured to terrorism. The S&P 500 dropped 1.5% on March 11, 2004, the day that synchronized bombs shook the city of Madrid. The market recovered most, but not all, of its decline the next day. On the morning of the London bombings, Dow futures were down 220 points before the opening bell sounded. In an impressive reversal, the major indices recovered from their morning malaise and actually showed a positive return for the day, demonstrating yet another example of the pitfalls of making investment decisions based on emotional, knee-jerk reactions.

We are optimistic about the outlook for equities given our conviction regarding the underlying strength of the economy. While the recent pace of GDP growth must moderate in the quarters ahead, the economy will most likely grow quickly enough to boost equity prices. Solid economic growth coupled with healthy corporate profit growth and corporate balance sheets flush with cash should convince even skeptical investors of the opportunity cost of not investing a portion of their assets in the U.S. equity market. The impediments of ever-increasing energy prices and a tightening Fed will not last forever. While we are the first to admit that challenges lie ahead, we believe that our Business Valuation Approach will continue to reward patient investors over the full economic cycle.

Ryan C. McCleary
Vice President

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.

SOURCES FOR THIS ISSUE:

Bloomberg L.P., Citigroup, *New York Times*, *The Wall Street Journal*, Standard & Poor's.