

DecisionMaker

Published Quarterly by King Investment Advisors, Inc.

“I know you believe you understand what you think I said, but I am not sure you realize that what you heard is not what I meant.”

“I guess I should warn you, if I turn out to be particularly clear, you’ve probably misunderstood what I’ve said.”

— ALAN GREENSPAN

Hopes of closing out the first half of 2006 with a continuation of market strength proved to be illusory for U.S. equity investors. The momentum that began in February and lifted the major equity indices to several new highs for the year amid a placid environment of low volatility quickly evaporated as a myriad of worries beset the investing landscape. Prior to the month of May, many complacent investors believed that the upward pressure on stock prices would continue unabated— it was only a matter of time before the Dow Jones Industrial Average eclipsed its previous record of 11,750. This complacency was disturbingly shattered in May, and not unlike the personality of the literary character Dr. Jekyll and his alter ego Mr. Hyde, the equity markets’ behavior shifted abruptly as investors ran for the exits.

Chief among the multiple worries on investors’ minds was the possibility that the new head of the Federal Reserve Board, Ben Bernanke, would raise interest rates higher than the markets had originally anticipated and tip the economy into a recession. Mr. Bernanke was sworn in as the fourteenth Fed Chairman in February of 2006, succeeding the esteemed Alan Greenspan, who served almost nineteen years as Chairman. To say that most investors were comfortable with Greenspan is obviously an understatement; the “maestro” guided interest rate policy for nearly two decades. Consequently, as soon as President Bush announced during the fall of 2005 that Bernanke would be the next Chairman, market pundits began reading the tea leaves of his prior publications and parsing his every word in an effort to get a sense of how the mindset of “the new guy” would shape the direction of the markets. Is he soft on inflation? Will he have to

raise rates higher than Greenspan would have simply because he is new and has to establish his inflation-fighting credentials? Will his stated policy of “transparency” improve communication or just unnerve the markets?

Investors thought they had Bernanke pegged in April when he hinted that the Fed may soon pause in its rate hike campaign. In late April, however, Bernanke learned a very important lesson about circumspection when he casually told CNBC financial correspondent Maria Bartiromo at the National Press Dinner that his position on interest rates was “misunderstood.” Equity markets sold off on the perception that the new Fed Chairman was sending mixed messages, leading to further skepticism about his ability to live up to the record of his widely admired predecessor. To make matters worse, in the weeks immediately following his verbal indiscretion, Bernanke and his fellow Fed Governors made headlines seemingly every day in speeches across the country. Their message was consistent, blunt, and crystal clear. Specifically, inflation is above the preferred comfort zone and further rate increases may be needed. Wall Street did not respond well to the supposed benefits of “transparency” as many investors yearned for the comforting, often indecipherable words of Alan Greenspan. Even though the affable Greenspan was famous for elevating cryptic statements to an art form, market participants were content just knowing that he was in charge.

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tightening around the globe sent stocks into a tailspin in May. Coming on the heels of a period of abnormally low volatility, the discomforting nature of the sell-off was amplified. Though the major U.S. equity indices fell less than 10%, the decline felt considerably worse after an extended period of relative stability. Further deepening the unease of U.S. equity investors, emerging markets around the world suffered staggering losses over a short period between late May and mid-June. Colombia’s stock market declined over 10% in one day alone, with the country’s index falling another 9% the next day. In India, the benchmark BSE index fell 10% one day in late May before trading was halted. Prior to this sell-off, emerging markets had experienced significant cash inflows as the sector posted spectacular returns of approximately 28% annualized for the three years ended June 30, 2006.

In the wake of this disturbing worldwide market swoon, investors were justifiably shaken. Where do the markets go from here? Is the global expansion history? Should I drastically lower my equity weighting? We believe that at times such as these, the best course of action is to step back and dispassionately analyze the situation. Making investment decisions based on the heightened emotions of the moment is rarely the best course of action. Upon closer examination, the market declines that began in May should not have been that surprising.

Global markets are currently fighting the headwind of declining liquidity. Central banks in the U.S. and abroad are draining excess liquidity from the system by raising short-term interest rates. The abnormally low interest rates that have prevailed for several years have encouraged a rash of speculation and risk-taking in areas such as the global commodities markets and the U.S. housing market (specifically on the East and West coasts), to cite two notable examples. This excess liquidity and speculation inevitably creates upward inflationary pressure. Consequently, while central bank tightening should not have been unexpected, the tough talk by Bernanke and other central bankers alarmed the risk takers that had been making such handsome profits. Their halcyon days of plentiful liquidity were coming to an end, and they responded accordingly. Risk aversion became the new market driver. With the liquidity-fueled party coming to an end, logically the hardest hit areas would be the most volatile markets. Framed in this context, the fact that emerging markets bore the brunt of the declines served as a textbook example of what happens to formerly high-flying, high

beta markets during a time of central bank tightening. In the U.S., previous market-leading sectors like the volatile metals and mining group that had led the market up sold off sharply. However, not surprisingly, the loss of market value as a whole for the lower beta, domestic equity indices was significantly less than the pain experienced by investors in multiple emerging markets.

This nascent decoupling of the U.S. market from the riskier emerging markets has been long overdue. One of the oldest rules of investing is to reduce risk by diversifying holdings across sectors that do not move in lockstep with one another. Over the past few years, this rule has been difficult to follow. The MSCI EAFE index, which measures emerging markets, has

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recently exhibited a 90+% correlation to the S&P 500. As recently as six years ago, this figure was only 62%. The main reason for this abnormally high correlation has most likely been low interest rates globally, which has made it easier for more and more people to borrow money inexpensively. Once again, we are back to excess liquidity. This borrowing

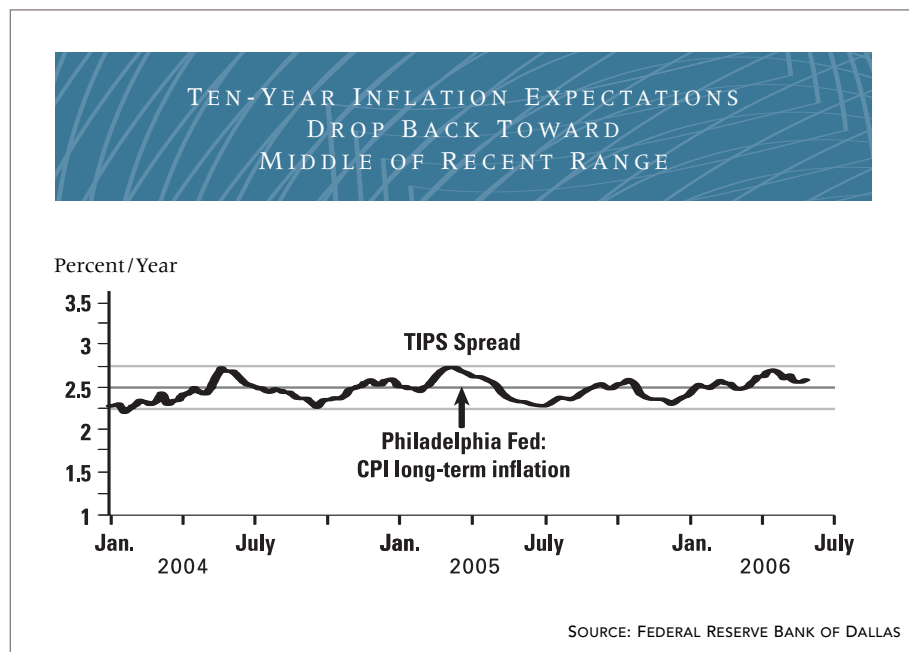
power has sent crowds of investors looking for new ways to invest the borrowed funds, simultaneously driving up prices for many types of investments. With risk aversion reasserting itself into the marketplace after a protracted absence, liquidity drying up, and borrowing costs rising, emerging markets are looking like a less and less attractive place to invest, especially given the sharp run-up in the sector over the last several years. We firmly believe that this confluence of events makes the U.S. equity market that much more attractive as a global destination of capital seeking a lower risk return amidst a more challenging macro-economic backdrop.

Despite the many criticisms of Bernanke, we believe that his actions have been absolutely necessary. The most important task of any Fed Chairman during a period of rising inflation is to ruthlessly drive down inflation expectations.

No one performs his or her job perfectly from day one, but Bernanke is a quick study. The early misstep of the careless comment to Ms. Bartiromo will not be repeated—the markets delivered a swift and jarring lesson on the perils of verbal indiscretions. Ever since this incident, the Fed Chairman and his fellow Fed members have been perfectly consistent with their message. Bernanke is now thought of as anything but soft on inflation, a far cry from the dovish perceptions that were held by many at the outset of his tenure. The fact that Bernanke is now a “hawk” is very important for the long-term health of the U.S. equity markets. Though some shortsighted investors undoubtedly would have liked Bernanke to not raise rates at all after he was sworn in, this action would have been the worst-case scenario for stocks as 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’s tough talk may have caused some short-term pain for equities, but the long-term benefits of taming future inflation expectations cannot be understated.

Though Bernanke has performed admirably thus far, he must find the right balance between growth and inflation. The U.S. equity markets are



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currently experiencing a tug-of-war between the two. Is economic growth still too strong and thus inflationary or have interest rates risen so far that growth will decline below potential and cause a slowdown? Answering this question in today’s environment is obviously not easy. On the one hand, recent readings on inflation have been above the Fed’s comfort zone. On the other hand, the red-hot housing market, an important driver of economic growth, has shown clear signs of cooling. Housing prices are now falling in some of the formerly strongest markets, the number of housing permits peaked in September 2005, and the share prices of the publicly traded homebuilding companies have declined 40% on average this year. We have believed that Bernanke would not stop raising rates before the housing market cooled; one of his main goals in our mind has been to halt the unsustainable and inflationary speculation in this

area. While we do not subscribe to the theory that the overall housing market is a “bubble” poised to burst painfully across the country, we do believe that a slowing of the speculative excesses will be beneficial to the economy going forward.

Turning to the question of rising inflation, it is important to remember that inflation is a lagging indicator. In other words, inflation can be peaking during a period when the economy has already started to slow. The full effects of the Fed’s seventeen quarter point hikes have yet to be fully felt by the economy. We believe that economic growth is certainly slowing from the torrid first quarter 2006 pace of 5+% GDP growth toward a growth rate in the 3% range. While a 3% GDP growth rate may be disappointing to some, historically, growth in this range has been a sign of a healthy economy expanding at a non-inflationary pace. Given the lagged effects of prior rate hikes combined with a slowing GDP growth rate, the vast majority of the Fed’s work has been done. Helping to restrain inflation going forward is the combination of low compensation growth and high productivity growth, resulting in nearly constant unit labor costs. While we are not ready at this point to declare an end to the rate tightening cycle, the equity markets should have more clarity on this issue sooner rather than later, removing a large obstacle to stock price appreciation.

We would be remiss not to address the violence between Israel, Hezbollah, and Hamas that has recently exploded onto the global stage. Just as the equity markets were finding a bottom and turning up at the end of the second quarter,

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the conflict between Israel and Hezbollah militants in Lebanon has led to renewed selling. Media pundits are outlining various doomsday

scenarios involving the conflict spreading to Syria and Iran, adding yet another item to fret over for investors concerned by geopolitical risk. Terrorism in India, violence in Israel and Lebanon, an Iranian government bent on developing nuclear weapons, and a North Korean regime that already possesses nuclear weapons are not even a complete inventory of the worries on investors' minds as we move into the latter part of July.

Though the current climate is a daunting one for U.S. equity investors, once again we believe it is imperative to step back from the emotional headlines and undertake a rational analysis of the many factors exerting their influence on stock prices. While we certainly do not claim to have a crystal ball, in our experience the most



likely outcome of geopolitical crises is something short of the doomsday theory du jour. The U.S. economy and the U.S. equity markets have proven to be very resilient during trying times; one has to look no further than the quick recovery made by the major U.S. indices after

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the worst terrorist attack in American history on 9/11. The despicable attacks on the World Trade Center had a considerably greater adverse effect on the U.S. economy than the current violence in the Middle East is likely to have, yet our country was able to recover and move forward after 9/11 without falling into a deep, prolonged economic recession.

Looking through the angst that has rattled the U.S. equity markets, we see clear opportunities for the investor with a time horizon longer than a monthly news cycle. Earnings growth of U.S. corporations has expanded at a double-digit pace for sixteen quarters in a row while the

major indices have traded sideways or declined this year, resulting in P/E ratio compression that has made valuations more attractive by the day. Corporations flush with cash are returning a portion of this hoard to shareholders in the form of sustained dividend increases and significant share repurchases. This cash on corporate balance sheets coupled with the mountain of cash that private equity firms control has led to frequent merger and acquisition activity this year. The total dollar volume of U.S. acquisitions in the first half of 2006 increased almost 40% relative to last year's number. Merger and acquisition activity helps put a floor under stocks and is a clear sign that the entities doing the acquiring see considerable value at today's prices among selected domestic equities. Though it is obviously painful for the markets to digest in the short run, the campaign of rate hikes will ensure that the worst-case outcome of inflation expectations spiking out of control does not occur. As worries about the Fed's actions recede from the front-page headlines over the next several weeks or months, investors will be able to focus more of their attention on the enduring strength of the U.S. economy and the attractive valuations that the market offers. We do not overly concern ourselves with the daily roller coaster of emotional rhetoric and sensational headlines. The concept of a given company's intrinsic value does not usually change no matter what geopolitical flashpoints are in the news, and our strict, dispassionate adherence to identifying value will continue to reward the patient investor.

Ryan C. McCleary, CFA
Vice President

The year 2006 marks KING's Twenty-Fifth 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-five 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.; *The Wall Street Journal*

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