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KING

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You pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values.

— Warren Buffett

Equity markets ended on a mixed note for 2005 with the Dow Jones Industrial Average up 1.7%, the S&P 500 up 4.9%, and the Nasdaq Composite up 1.4%. The advances for the major indices were largely driven by the returns in energy (+31.4%) and utility (+16.8%) stocks. Excluding these two industries, the S&P 500 would only have been up 2.15%. Despite an underweighting in both of these groups, KING's portfolios managed to deliver relatively solid performance in 2005, after an outstanding 2003 and 2004.

In December 2005, the Fed raised interest rates for the 13th time by 25 basis points. This was the first time we have seen a revision in the terminology that the Federal Open Market Committee (FOMC) used following the increase. The Fed omitted the words "removing accommodation," which was viewed as putting the Fed in the eighth inning of rate increases. It was the light at the end of the tunnel for many investors, even though the door was clearly left open for at least one, if not two more rate increases. When details of the meeting were released on January 3, 2006, equity investors were further comforted by the language, "…given the information now in hand, the number of additional firming steps required would not be large." The equity markets embraced this news and rallied substantially, reversing the downward trend seen in equity prices at year-end as the yield curve between the 2-year and 10-year U.S. Treasuries inverted. *(When shorter-term interest rates are higher than longer-term rates, the yield curve is said to be "inverted.")*

There have been eight Fed-tightening cycles in the past three decades; five of which saw the yield curve invert. In all five instances, the economy either

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slowed or fell into a recession. It is this history that has caused the recent nervousness in both the equity and fixed-income markets. However, it is important to take into consideration several factors. First, the curve was only fractionally inverted in early January and monetary policy is still accommodative, a situation which has not always been the case in the past. Also key is the magnitude and duration of the inversion. Today's inversion is a recent phenomenon, thus it is important not to read too much into what may be a short-lived situation. Finally, while yields on the short end of the curve look as though they are bound to go up under pressure from a few more rate hikes from the Fed, the long end of the curve should be range-bound under steady inflows from overseas. In fact, absent heavy overseas investments, the yield on the 10-year bond would be significantly higher. Essentially, the globalization of U.S. dollar debt has changed the interest rate market dynamic and the yield curve inversion may be a result of more technical issues as opposed to simply a prediction of future economic behavior. In fact, the yield curve narrowed sharply over the 1992-1994 period, even as the economy was entering the longest sustained expansion of the post-war period.

Pessimists say the worst-case scenario for 2006 would be that the housing bubble bursts, American consumers stop spending because they can no longer extract equity from their homes, inflation escalates, China's economy implodes as exports to the U.S. go from good to bad, and the Japanese bull market comes to an end as its exports to U.S. consumers also plunge. What is wrong with this grim picture? Plenty. Recently, gasoline prices have dropped to a national average of $2.30 a gallon. Also, consumer confidence is on the upswing along with payroll employment. Consumers will spend when they are offered incentives, as was the case during Thanksgiving and Christmas. While there is evidence that air is starting to come out of the so-called real estate bubble, it is unlikely that it will burst. Homeowners are extracting less equity from their homes. Are consumers drowning in debt? Actually, they are flush in liquid assets accumulated over the past few years as they extracted equity from their homes through refinancing cash-outs and capital gains. They now have $4.3 trillion parked in liquid assets— $1.7 trillion more than what they owe in consumer debt. While much media attention has been given to the U.S. consumer's negative savings rate, the net worth of households has risen $5 trillion over the past four quarters to a record high.

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Is inflation really a concern? Despite the increases in energy and commodity prices over the last year, core inflation has been more or less contained. The primary reason for this is globalization. Free trade means producers of goods and services have

broader access to more consumers around the world. It also means additional competition from other producers around the world. Increasing competitive pressures make it hard to raise prices in many industries. This forces companies to increase productivity, which is easier and cheaper to do as technology hardware, software, and services continue to get commoditized because of intense competition within this important industry. Interestingly, core (excluding food and energy) PPI finished goods prices are up only 1.7% year-over-year, which is less than the 2.1% increase in the core CPI. Consumer goods prices excluding food and energy are up 2.0% in the PPI and only 0.1% in the CPI. The difference is mostly attributable to cheap consumer imports, which are gaining market share in the U.S. If the U.S. dollar resumes strengthening in 2006, imports will continue to be a source of disinflation. Another interesting fact is that the core PPI finished goods rate dropped to a 13-month low of 1.7% in November after peaking at 2.9% in July. This is a good indicator that inflationary pressures are not building up in the pipeline.

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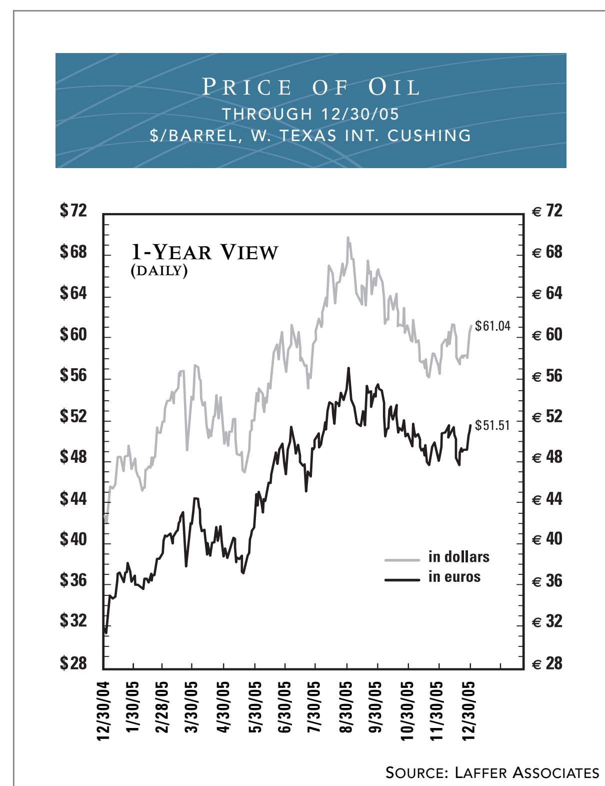
Contrary to popular opinion, high oil prices are not having a large impact on inflationary measures. While oil prices are high relative to recent years, the CPI deflated oil price is still 40% below and 50% below the oil price levels of the early 1980s in the U.S. and Europe, respectively. Today's oil prices would need to reach at least US$94 per barrel to get back to the real levels of 1980. It is also worth keeping in mind that underlying economic conditions were vastly different then. Recall that in 1980, core inflation in the U.S. was running above 12% and long bond yields were over 14%, very different from the current core inflation rate of only 2.1% and a bond yield of approximately 4.2%. Another



SOURCE: LAFFER ASSOCIATES

compelling argument for lower oil prices is that emerging economies have only recently reduced their subsidies for domestic users of petroleum products. Their demand should be much more price elastic than among higher-income users in the industrial economies. The fastest growing demand for crude oil for the past two years has been among emerging economies. Additionally, many believe that financial speculators have been playing a partial role in keeping oil prices elevated. Evidence shows that non-commercial players accounted for 43% of open interest New York Mercantile Exchange (NYMEX) crude oil futures in 2004, compared with only 24% in 2000. Many who fear inflation have also been concerned about the booming price of gold. Interestingly, gold prices are not as highly correlated with inflation as they are with global liquidity. While many developed countries, like the U.S., have been raising interest rates, the monetary policies of the major central banks actually remain very easy. Easy money continues to fuel a global boom, which is partially why several key industrial metal prices continue to soar. So, is gold predicting that inflation rates are likely to rise around the world? Perversely, no. Low consumer price inflation— caused by competitive forces unleashed by globalization— means that more of the central banks' liquidity is available to boost commodity and asset prices, which is partially why real estate, gold, and some other hard assets are all in major bull markets.

The increase in global competition not only helps keep a lid on inflation, but also forces companies to increase productivity. Productivity, in turn, boosts profits. Thus while the Fed is tightening, it is probable that it will not overshoot because inflation is not a serious problem. This should be a win/win for equity P/Es, which have been depressed mostly by rising oil prices and exaggerated fears about geopolitical risks (terrorism, anti-Americanism, imperial overstretch), structural imbalances (the Twin Deficits), and bubbles (home prices, housing finance, credit derivatives).

Despite the inversion of the yield curve, higher commodity prices, and inflationary concerns, our outlook for 2006 is cautiously positive for equities. The primary reason we at KING are somewhat sanguine is our adherence to a discipline that makes up one of the three prongs of our investment

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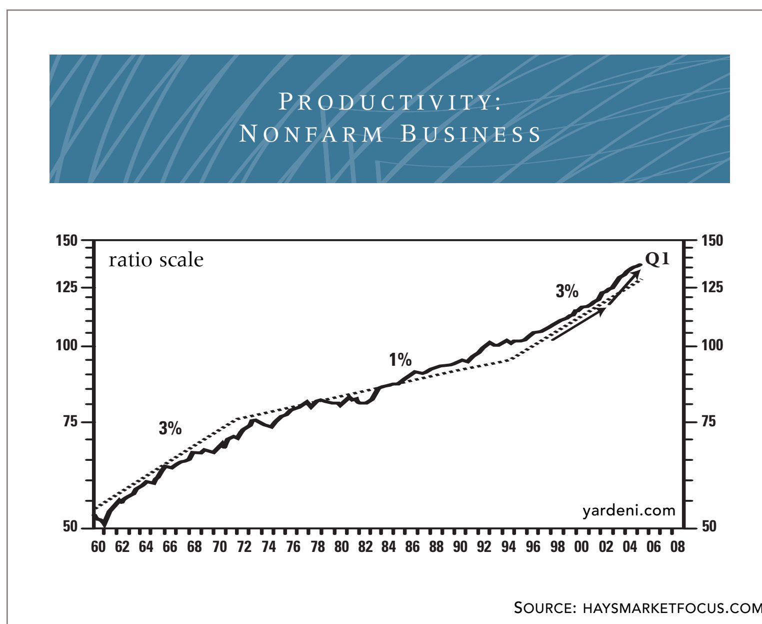
criteria, buying stocks that trade at a discount to their private-market value.

Private-market value is important because it tells you whether you are getting a bargain or if you are overpaying. Another investment manager whom we respect recently illustrated the concept of private-market value very well. Suppose you fall in love with a house and want to buy it. The owner is not a willing seller, so you have to bid him more than it is worth based on comparable lot values in the neighborhood and the current cost of construction. Although you may get the prettiest house on the block, it may be a money-losing investment. Conversely, suppose you hear of a house coming on the market whose owner is desperate for money, perhaps because of a risk of foreclosure. To make a quick sale, the owner is willing to offer you a discount if you can move quickly. Now you have a bargain. If you can market the house in a less desperate way, you can make a profit because the intrinsic value of the house is greater than your cost. The "value" of the house is determined by the prices at which comparable houses in the same neighborhood are sold.

Businesses are not much different from houses. There are many comparable sales of companies to smart buyers. The market consistently gives us these opportunities, as emotional sellers will pressure individual stock prices down due to temporary issues. The actions of stockholders and some investment managers are often driven by fear and greed, not logic. As investment managers, one of our jobs is to track corporate acquisitions in order to form a model of intrinsic value. The goal is to identify a company for which the sum of the parts is greater than the market capitalization of the shares outstanding and take advantage of this value discrepancy to make a profit. If



SOURCE: HAYSMARKETFOCUS.COM

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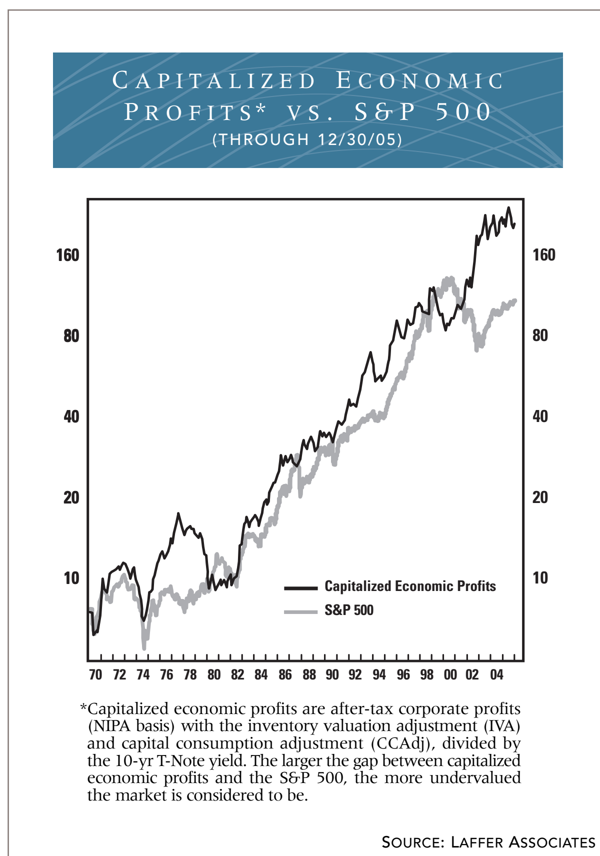
the company is worth more than the market capitalization of the shares, someone need only unlock that value to make a profit.

Despite the fact that intrinsic value is such an important and reliable benchmark of value, most Wall Street research reports are not focused on true cash flows or intrinsic value, but instead on short-term earnings projections. As a result, many opportunities are frequently created in the marketplace as a company might miss Wall Street's consensus on earnings by a few pennies one quarter due to various temporary issues (such as building out a sales force, a large contract being signed a few weeks late and falling into the next quarter, etc.). As Wall Street starts downgrading the stock, the marketplace might overreact and push the share price of the company down to a level that is oversold and extremely attractive to value-oriented investors like KING. Often, despite the earnings miss, the fundamentals of the company might be intact and cash flows might even be largely unaffected, thus the private-market value of the company may be virtually unchanged despite the significant move on to downside in the stock. Benjamin Graham summed it up best when he stated that, "If we assume that it is the habit of the market to overvalue common stocks which have been showing excellent growth or are glamorous for some other reason, it is logical to expect that it will undervalue— relatively, at least— companies that are out of favor because of unsatisfactory developments of a temporary nature. This may be set down as a fundamental law of the stock market…" It is this type of inefficiency for which we hunger and which enables us to create value for our clients over the long term. Ideally, we look for situations where a stock is trading at least at a 50% discount to its private-market value.

The adherence to a private-market value discipline has proven to be rewarding over the long term, and allows us the flexibility to find value in all market cycles. However, market inefficiencies across asset classes ebb and flow, and not in a smooth and predictable fashion. For KING, this often leads to our performance not correlating well with various market benchmarks, especially on a quarter-to-quarter basis. Successfully exploiting opportunities requires variable risk management— that is, varying a portfolio's normal risk appetite to be in alignment with opportunities. Substantial value can be added by active management strategies over time as managers are provided the opportunity to capture market abnormalities as they present themselves. Interestingly, most individual investors and many institutional investors avoid this type of strategy, as this type of management style is uncomfortable for many. Ironically, the avoidance of this type of investment style often makes investments in

individual stocks even more inefficient, and hence, investors who are willing to take well-measured risks are rewarded handsomely over the long term.

Once we identify a stock trading at a steep discount to its private-market value, there are several catalysts that might drive the stock closer to its intrinsic value. One catalyst would be the acquisition of a company. Today, corporations are sitting on huge cash balances (approximately $1 trillion in liquid assets with an equivalent amount being generated in cash flow each year) that have resulted from strong earnings and a reluctance to spend capital over the last few years. Many of these companies are ripe for being acquired by private equity firms. Interestingly, borrowing costs have been lower than the earnings yield on stocks for the longest period in over 25 years. This is a huge shock absorber for stocks and a tremendous stimulus for private equity buyouts, corporate buybacks, and cash mergers. The headlines were packed with stories of huge private equity deals and corporations issuing bonds to buy back stock throughout 2005. In fact, private equity firms now have enough clout to potentially take 5% of the U.S. stock market private. Cash holdings in the S&P 500 are over $2 trillion; Microsoft has 15% of its market value in cash. In fact, non-financial corporate assets are at a record high as U.S. corporations have repatriated billions of their foreign earnings formerly held abroad. Corporate liquidity and debt ratios are at the best levels in at least four decades. While a few large mergers were announced in 2005, we believe that more will come in 2006 and that our current portfolios are poised to benefit from this type of activity.



*Capitalized economic profits are after-tax corporate profits (NIPA basis) with the inventory valuation adjustment (IVA) and capital consumption adjustment (CCAdj), divided by the 10-yr T-Note yield. The larger the gap between capitalized economic profits and the S&P 500, the more undervalued the market is considered to be.

Source: Laffer Associates

While 2005 was a lackluster year for U.S. equity markets in general, we believe that 2006 will prove to be a very rewarding one for our clients. We have a high degree of conviction in our portfolio holdings and believe that increased merger and acquisition activity over the course of the year will serve as one of the potential catalysts to unlock value. As always, we appreciate your support and welcome any questions.

Leah R. Friday, CFA
Senior 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

Bear, Stearns & Co.; Cantor Fitzgerald; Citigroup; Ed Yardeni; *Financial Analyst Journal*; *haysmarketfocus.com*; Laffer Associates; Merrill Lynch; *Tweedy, Browne Fund Semi-Annual Report*

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