

Fourth Quarter 2009

■ Market Review

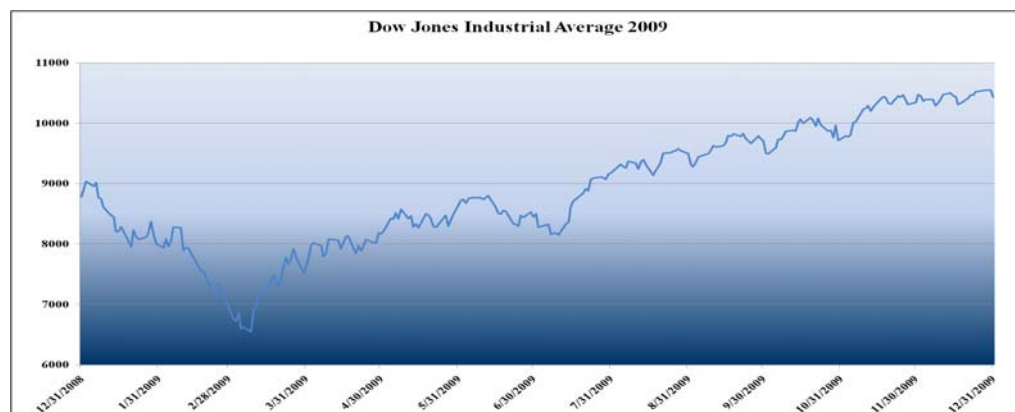
Equities

Financial markets orchestrated a remarkable recovery in 2009, thanks in large part to unprecedented rescue efforts by governments and central bankers around the globe. Encouraged by signs that the green shoots of economic recovery had taken hold, investors who had once fled stocks in fear of a worldwide financial meltdown now dove back into the most volatile sectors with confidence. After tumbling 25% to a 12-year low in March, the Dow Jones Industrial Average staged a stunning rebound to finish the year up 19% at 10,428. The Dow's low point on March 9, when it was down 54% from its all-time high in October 2007, turned out to be the start of a powerful rally. Although the gains slowed in December, the Dow finished 2009 up 59% from its March low, the highest climb since 1933.

The perplexing question now facing equity investors is how the economy and markets will perform in 2010 as the government and Federal Reserve begin to remove the training wheels of a near zero Fed funds rate, massive spending and money printing, and other historical stimulus efforts that have kept the economy upright. Investors will pay close attention to the Fed for signals of future interest rate hikes and other pull backs of monetary easing, and signs of whether the central bank's exit strategy is proving disruptive to an economy that has only recently come off of life support.

Fixed Income

With the dysfunctional credit markets having been the epicenter of the 2008 financial crisis that quickly spread to other investment securities, the stabilization of credit and the subsequent solid turnaround of the bond market in 2009 was a critical spark to the rise of the equity markets. Investors poured the cash they had on the sidelines into riskier credit assets, causing a once-in-a-lifetime opportunity for returns in junk bonds that exceeded 50%. In contrast, safe Treasury securities posted losses for the year after being one of the few investments in 2008 to record gains. In 2009, with bank savings and money market fund rates at microscopic levels, investors flooded the credit markets with approximately \$350 billion invested in higher-yielding bond mutual funds, far exceeding stock inflows.



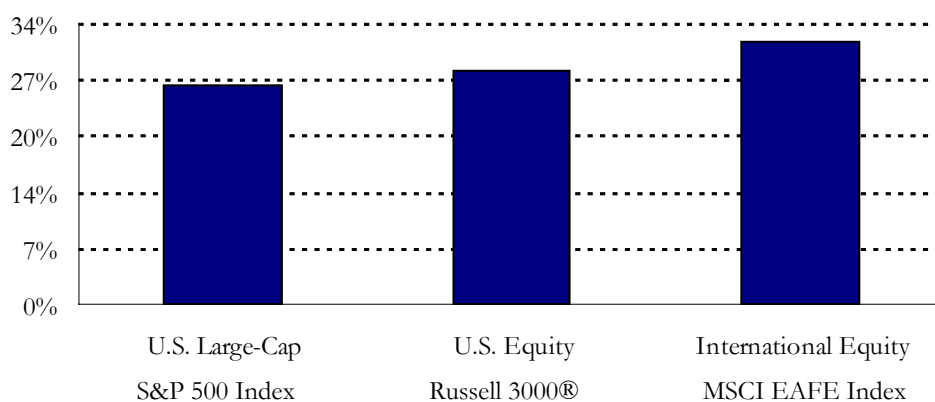
Global Market Performance

The U.S. stock market advanced 5.9% in the quarter and ended the year sharply up 28.3% as measured by the broad Russell 3000 Index. The S&P 500 Index of large-cap equities rose 6.0% over the last three months, and 26.5% for 2009. Small-cap stocks climbed as well, with the Russell 2000 Index up 3.9% for the quarter, and increased 27.2% for the year. The tech-heavy Nasdaq Composite Index also posted significant gains, advancing 6.9% in the last three months and soaring 43.9% by year end. As stocks rose from the rubble in 2009, investors bought into industries once thought to be on life support, such as financials, commodities, and technology. Traditionally safe industries, such as healthcare, utilities, and consumer staples, lagged other sectors.

Foreign stock markets came roaring back to life in 2009 as investors armed with cash roamed the globe in search of rewarding returns. Thanks to investors' risk appetite along with a declining dollar, international markets overall outperformed those of the United States. The Dow Jones World Index, excluding the U.S., jumped nearly 40% for the year in U.S. dollar terms, compared with a 19% gain by the Dow Jones Industrial Average. The worst performance by a major international market in 2009 was Japan, where the Nikkei Stock Average of 225 companies finished the year up 19%.

Western European markets also climbed from their bear-market lows, aided by anticipation of a global recovery, low interest rates, and ample liquidity from European central banks. The Dow Jones Stoxx Index of Europe's 600 largest companies rose 29% in 2009. In local currency terms, France's CAC-40 and the U.K.'s FTSE 100 ended up 22%, and Germany's DAX rose 24%.

Emerging markets were the global leaders in 2009 as investors sought stocks in developing countries that demonstrated continued growth in the face of a global economic recession. Russia's RTS Index exploded by 129%, India's Sensex by 81%, and China's Shanghai Composite by 80%. Nevertheless, all remain significantly off their all-time highs reached in 2008 or 2007. Brazil's Bovespa gained 83% by year end, which placed its market within 7% of its 2008 record.

GLOBAL EQUITY MARKETS**2009 Returns*

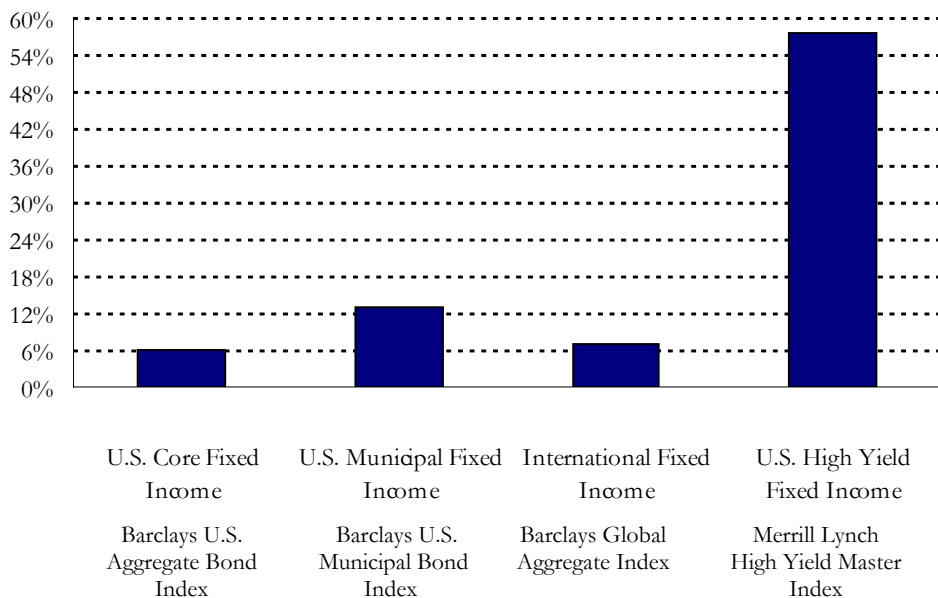
*Index information is for illustrative purposes only and does not represent any particular investment.

Prices of corporate bonds, mortgage-backed securities, and leveraged loans soared back to levels seen before the credit collapse in September 2008 as bond investors regained increasing confidence that a financial crisis had been avoided. Also benefiting bond market returns was the implicit guarantee by the Federal Reserve to hold rates at historically low levels for an extended period of time.

Fixed income securities performed well as the Barclays Capital U.S. Aggregate Bond Index advanced 5.9% for 2009. The Merrill Lynch High Yield Master Index of non-investment grade corporate securities soared 57.5% for the year, fueled by historic investor inflows. The Barclays Capital Global Bond Index returned 6.9%, aided by stabilization of foreign economies and a weakened dollar. Tax-exempt municipal bonds rose 12.9% in 2009 as investors took advantage of after-tax yields that remained higher than comparable Treasuries.

GLOBAL FIXED INCOME MARKETS*

2009 Returns



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■ Portfolio Review

Investment Overview and Strategy

KING WMS reviewed its investment strategy in the aftermath of the highly volatile markets from the fall of 2008 through the spring of 2009. This supposed “black swan” or “one-hundred-year-flood” event has now occurred twice in the past decade, providing evidence that extreme market declines are not so rare. In fact, the U.S. stock market has wrapped up its worst decade ever. Since the end of 1999, stocks traded on the New York Stock Exchange have lost an average of 0.5% a year thanks to the twin bear markets of this decade. In nearly 200 years of recorded stock-market history, no calendar decade has seen such a dismal performance as the 2000s.

Lessons Learned

We have maintained a flexible tactical focus in under- or overweighting asset classes in managing client portfolios. However, due to short-term periods of sharp stock movements of late (and with other volatile asset classes), it has become even more important to monitor market indicators for such events. This is especially significant in this high-tech, mega-information, and fast-trading era. In the past, we have monitored economic and fundamental indicators with general success when making adjustments to client portfolios—as evidenced by our favorable long-term track record. ** Still, we have analyzed how we could improve our performance during bear markets, such as the recent event. Our analysis showed that despite our correct call to underweight stocks prior to the crisis, there are technical indicators that perhaps we could use to act as the canary in the coal mine, warning of danger ahead.

One of the technical indicators is the Chicago Board of Exchange Volatility Index or VIX, often referred to as the *fear index*. This Index measures investors' expectations of near-term market volatility. The higher the number, the higher the expected volatility of the market, which typically does not bode well for stock prices. Historically, in normal markets, the VIX has hovered around ten. In the beginning of 2007, the VIX began at ten and reached twenty by mid-2008. While a rise to twenty is not normally worrisome, during this period the VIX spiked to near forty on a few occasions. This was an indicator that investors were becoming nervous. In mid-September 2008, at the beginning of the financial crisis, the VIX soared from around forty to near ninety by October. The Index remained elevated throughout the summer of 2009, and only recently has seemed to have stabilized around twenty.

Another technical indicator is the slope of the bond yield curve, typically measured by the interest rate yield of Treasury securities of short to long maturities. A normal yield curve is upward sloping, with short-term Treasuries having the lowest yield and the long-term Treasuries the highest yield, as bond investors want more interest paid to them for holding longer-maturity bonds. In 2007, the yield curve was flat and even became inverted at one point. Based on past history, when the yield curve is abnormally sloped, the bond market is signaling that something may be amiss with the economy.

Finally, “moving averages” of the stock market (typically 60 to 200 days) provide a trend of stock market price levels. An indicator that stocks are showing weakness is when levels of the market fall consistently below the moving average trend line. At the beginning of 2008, the 90-day moving average of the S&P 500 Index began a pattern of falling below the trend line. It briefly rose above the trend line, but by mid-2008—a few months before the market crash—the moving average began falling continuously until March 2009. From then, the 90-day average climbed above the trend line and has remained there since.

Alternative Investments

Another adjustment to our strategy that began in 2007, and has become a more important component of clients' portfolios, is the use of alternative investments. Alternative investments are securities that act unlike the traditional asset classes of stocks, bonds, and cash. There are multiple alternative investments for clients from which KING WMS can choose, but we typically utilize defensive options such as structured notes along with market-neutral and short funds that add stability to a portfolio by “hedging” against the risk of a large decline in the stock market.

Strategy Modifications

So how has our investment strategy changed and what can clients expect in the future? While none of the technical indicators mentioned above can accurately predict the direction of markets, by analyzing them KING WMS has the ability to potentially improve returns given a client's risk/reward profile. We can accomplish this by evaluating economic and technical indicators taken together with fundamental indicators—such as asset class valuations, cash flows, etc. As a result of our adjustments in strategy, clients have and will continue to experience more proactive portfolio changes. Second, the use of alternative investments should add stability to portfolios. As a majority of our clients are nearing or are in retirement, our first goal is to preserve hard-earned client capital as best as possible in the short term, while providing portfolio growth over a full market cycle to assist them in meeting their goals.

As a result of these strategy modifications, our clients can expect our portfolios to underperform versus a weighted benchmark in strong bull markets (such as the one that began in March 2009), and outperform during bear markets. The net result over a five-year+ market cycle should be favorable performance that is geared toward “absolute” return instead of “relative” return. In other words, we are now managing portfolios that are expected to provide a more consistent (absolute) return in the long run instead of attempting to beat a (relative) benchmark return in the short term.

Looking forward, this does not mean we will begin to make “calls” on when to get in and out of the stock market, or market timing, since this strategy almost always fails (as evidenced by investors who were all in cash during the recent market rally). At the other end of the spectrum, this also does not mean we adhere to a “buy and hold” strategy, as doing so over the past decade has proven to be counterproductive for investors holding stocks. Instead, we will focus on a more defensive strategy that utilizes traditional asset classes as well as alternative investments; with portfolios that are more carefully monitored and adjusted using economic, fundamental, and new technical analysis, with the goal of more stable short-term portfolio performance.

Portfolio Performance

At quarter end, client portfolios continued to post gains, and were in solid positive territory for 2009 on an absolute basis. Portfolio returns collectively for the year, however, lagged their relative benchmarks during the recent stunning stock market rally as a result of the implementation of the more defensive strategy outlined above. Still, KING WMS's long-term performance over multiple years compares favorably with the appropriate benchmarks.** At times, our modified strategy will be out of step with the market, but chasing a “hot” market in the near term on many occasions only leads to losses and disappointing long-term returns. As such, either under- or overperforming in the short term is not our focus. Assisting clients reach their goals by protecting and growing wealth in the long run is.

For equities, international, U.S. mid-/small-cap, and natural resource stock positions added significant gains in portfolios in 2009 with returns exceeding 30%—all outperforming the S&P 500 Index. For fixed income, core bond holdings posted double-digit returns and the multi-sector bond fund recorded a 37% profit for 2009. Overall, our alternative investments detracted from performance as they underperformed stocks. (Stock positions were lowered to purchase most alternative investments.) However, an alternative investment purchased in March, the partially protected structured rebate note linked to the S&P 500 Index, has steadily advanced with the rise in

the stock market. TFS Market Neutral Fund, a long/short alternative investment purchased during the past quarter using excess portfolio cash positions, provided a slight profit by year end. TFS Market Neutral Fund holds both long and short positions in stocks, primarily in the U.S. small-cap market universe, and to a lesser extent, closed-end mutual funds. We have been impressed with the Fund's long-term track record through both bull and bear market cycles, and view it as a good conservative alternative investment. The alternative investment that "shorts" the S&P 500 Index (which is inversely correlated to the Index's returns) detracted from performance in 2009 as stocks rallied over the past three quarters.

Obviously we are pleased that the stock market has rebounded since March and that client portfolios have recorded solid gains for 2009. However, our enthusiasm is tempered with concerns that a significant stock advance is usually followed by a correction. And there are several economic and geopolitical factors that could trigger a decline. As such, our near-term strategy is to continue to be judicious by underweighting stocks versus neutral targets and maintaining higher positions in bonds and alternative investments that reduce portfolio swings. More of our thoughts are discussed in the following Market Outlook section.



■ Market Outlook

I should have assumed that Wall Street's tendency toward reckless myopia—ingrained over the past decade—would return at the first sign of even temporary stability. The eagerness of investors to chase prevailing trends, and their unwillingness to concern themselves with predictable longer-term risks, drove a successive series of speculative advances and crashes during the past decade—the dot-com bubble, the tech bubble, the mortgage bubble, the private-equity bubble, and the commodities bubble. And here we are again.

—John P. Hussman, Ph.D.; Hussman Funds

Our outlook is unchanged from last quarter. We have been relieved that our economy avoided a meltdown in 2009, and pleasantly surprised to have witnessed a solid rally in the global equity and fixed income markets. Our relief, however, is tempered by caution in understanding that the recovery has primarily been government-stimulus driven, and the stock market's advance has been fueled by the cost-cutting measures of corporations and investors searching for higher-yielding securities rather than their savings accounts. Headwinds remain for a sustained recovery as the federal government begins reducing its multi-program support in 2010. Debt level reduction along with sizable wealth destruction over the past two years (due to declining home values and stocks), high unemployment, and uncertainty about the economic future will keep wary investors on the sidelines. Consumers and corporations are still in the process of shedding debt while increasing cash accounts. And then there are the inevitable longer-term consequences of the unprecedented acceleration of government (taxpayer) debt: higher inflation and taxes, the devaluation of the dollar—all becoming a heavy burden upon future generations.

We maintain our belief that under current Fed policies, the market can continue to climb in the near term. Currently, the fundamental and technical indicators we follow are favorable for stocks. But with each passing month—with stocks becoming fairly-valued to over-valued, and as the Federal Reserve and Congress begin exiting from monetary easing and fiscal stimulus—the economic recovery's unstable foundation may eventually be exposed. And if exposed, this could cause stocks to decline precipitously, sparked by the burst of another asset bubble. Because of this uncertainty, our strategy is to remain cautious in positioning our clients' portfolios, and overweight alternatives to stocks at the expense of fully participating in the rally. Since our economy is truly at a crossroads in 2010, it is very important to follow economic, fundamental, and technical indicators—in the U.S. and abroad—and execute tactical portfolio adjustments quickly. As such, we will continue to work diligently on our clients' behalf by monitoring market and economic events and construct portfolios that appropriately balance risk with potential rewards.

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Sources: *AdvisorIntelligence*, *Hussman Funds*, John Mauldin's *Outside the Box*, *The Wall Street Journal*

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