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Winter 2012

KING

DecisionMaker

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Volatility that reached twice the five-decade average left the S&P 500 with the smallest price change in 41 years.

The banner headline of a flat return of the S&P 500 for the year masks the turbulent nature of 2011. While the S&P 500 barely moved for the year, 2011 was one of the most volatile on record. Eighty-five companies dropped more than 20%, compared with 11 in 2010 and 15 in 2009. The Dow Jones Industrial Average alternated between gains and losses of more than 400 points over a four-day period for the first time ever in August, as Congress and the Obama administration struggled over budget cuts and Europe was forced to devise a plan to bail out Greece.

Also in August, daily swings in the S&P 500 averaged 2.2%, the most of any August since 1932. In fact, the S&P has moved on average 1.3% per day since April. This compares with a 50-year average of 0.6% and is greater than the monthly volatility recorded before the collapse of Lehman Brothers in 2008.

The relatively unchanged return of the S&P 500 also masks the carnage felt in many industries. For example, banks declined -20.64%, materials slid -9.75%, and energy producers fell -12.50% for the year. Investment managers of most equity strategies had a difficult year, as stocks were whipsawed and managers were not rewarded for taking a longer time horizon when putting capital to work. In fact, long-only managers had their worst year since 1998 and their second worst year since 1989 (versus the benchmarks). Hedge funds also had one of their worst years on record. As of December 16, the HFRX Global Hedge Fund Index was down 9.0% compared with -1.3% for the S&P 500. Fundamental Value Funds fell by 23.6% and Market Directional Funds (long and short) fell by 19.7%. Every single category of hedge fund returns underperformed the S&P 500.

With that said, trying periods often create opportunities. The highlight in performance last year was in the defensive industries. In fact, one of the major reasons the S&P 500 outperformed other markets around the world is because 30% of its market cap is concentrated in the Staples sectors, including Consumer Staples, Healthcare, Telecommunications, and Utilities. These stocks, which are the least tied to economic

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growth, returned 8.2x more than the Index. By comparison, the Cyclical sectors actually declined approximately 6% on the year. That is the largest performance gap between the two groups since 1989. The best performers of the year—Utilities, Consumer Goods, and large-cap Healthcare companies are now trading at their highest valuations since 2008. The large valuation divergence that currently exists between less economically-sensitive and more economically-sensitive stocks also preceded market-wide rallies in 2002, 2007, and 2009. For example, in November 2008, defensive stocks were 7.1% more expensive than the rest of the market. That was four months before global stocks bottomed and the S&P 500 doubled, sending shares of cyclical companies up, on average, 135%.

At KING, we are in the camp that believes current stock valuations are not accurately reflecting the improvements in the U.S. economy, nor are they reflecting any sort of stabilization in Europe. It is interesting to dissect the profile of the countries in Europe. Obviously, there is an excessive level of sovereign debt in some euro-area countries. However, in the case of Italy and Spain, two countries being punished by the markets, current general government net debt-to-GDP ratios are lower today than they were in the mid-1990s, while the ratios for Germany and France have both notably worsened since then. Spain's ratio is no higher than that of Germany. For the euro area as a whole, the debt-to-GDP ratio is slightly below that of the U.S. and far below that of Japan. As a result, we believe that stocks are reflecting somewhat unrealistic fears. In August, we began buying more economically-sensitive stocks, which we believe are very much undervalued and do not reflect realistic growth prospects for 2012. Consequently, the majority of our portfolios have under-performed the overall market over the short term, but projecting into 2012, we believe that we are very well positioned and the portfolios should reap nice rewards. Profits among stocks in defensive industries (Consumer Staples, Utilities, etc.) are forecasted to increase 3.8% in 2012, according to more than 7,000 analysts estimates compiled by Bloomberg. Earnings are poised to increase between 11% and 18% for more cyclical large-cap companies. For small- and mid-cap energy companies, earnings overall are expected to rise by 35% to 40% in 2012. Despite the higher forecasted growth, most of these stocks are trading at lower valuations than the more defensive companies; this represents a significant opportunity. In order to understand why we believe these stocks are so inexpensive, it is important to look at the current global economic situation as well as some key trends and data that are not receiving the same level of attention as the problems in Europe.

HOW DID WE GET HERE?

The underlying problem for the equity market and global economy over the past several years is simple: too much debt. The current problems would not exist if such large financial imbalances had not been allowed to build in the first place. However, history cannot be undone so we are faced with a vulnerable and unbalanced economy and financial system. Excessive leverage always hits a ceiling where it is forced to self-correct. This is readily apparent in the private sector where there is a limit to how much debt a consumer or a business can carry. For the U.S. consumer, that limit was reached in 2007. Revolving credit (which includes credit cards) has fallen during every month except three since September 2008. After 3½ years of retrenching, consumer balance sheets are improving and spending is starting to strengthen. This point is illustrated by holiday sales, which were much stronger than anticipated. Black Friday sales grew 6.6%, to the largest amount ever as many U.S. consumers unleashed pent-up demand. The percentage increase over the previous year represents the largest gain since the 8.3% increase recorded between 2007 and 2006. In fact, sales were strong throughout the holiday season. During the week ended 12/24/11, consumers spent an estimated $44 billion, a 38% increase from the week before and a 15% jump over the same period of 2010. Consumers did not stop there. The day after Christmas, traffic rose by 26% over the same day of 2010, and spending grew an estimated $7.1 billion, a 25.5% increase over the same day a year earlier.

For countries, the overleveraged problem is different as governments can resort to increasing liquidity (i.e., "printing" money), delaying an adjustment, and digging the country into an ever-deepening pit of debt.

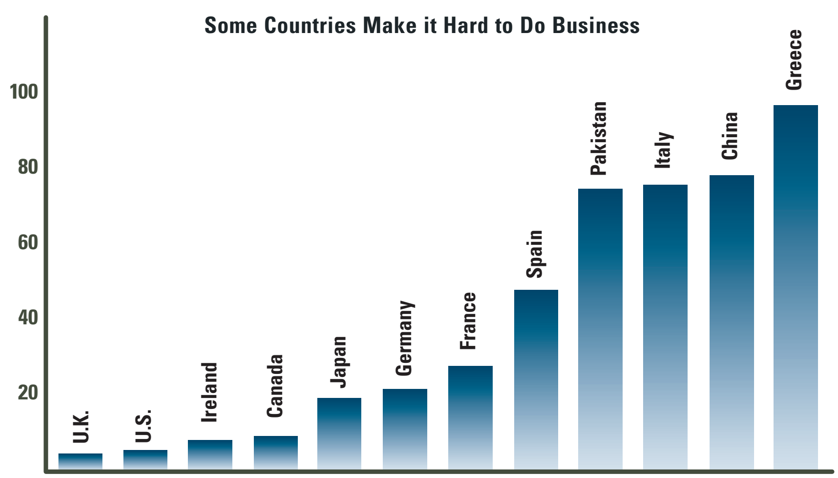
Eventually however, markets will riot and force a change in policy. The debt problems in both the U.S. and in Europe are solvable, but the solutions are not easy. A combination of supply-side policies to boost economic growth and major tax and spending reforms is needed to improve government finances over the long run. Simply focusing on short-term austerity could prove to be disastrous. There is no mystery about what needs to be done to turn global government finances around. Decades ago, governments initiated welfare programs that are no longer affordable. When pension systems were introduced, subsequent dramatic improvements in life expectancy and falling birth rates were not envisioned. Today, a growing number of retirees live for 30 years on a government pension, funded by a diminishing pool of taxpayers. Similarly, when these assistance programs were developed there was little understanding of how demographics and inflation would lead to unsustainable increases in healthcare spending. All of these programs need to be drastically reformed. As unpopular a decision as it is, any entitlement reform (such as raising retirement ages, etc.) would be a significant component of the solution to today's global debt problems.

In addition, changes need to be implemented in the regulatory environment to reduce burdens on companies. For example, in parts of Europe there are many opportunities to reduce the bureaucratic obstacles to starting a new business. All of these efforts, combined with changes in the tax code, could be highly stimulative to the economy and aid government balance sheets around the world.

The problems in Europe cannot be solved overnight; however, significant steps have been taken to address the debt crisis. While the next few months may continue to be rocky, a global safety net is being woven in the hope that it will avert any major collapse. Greece, Ireland, and most likely Portugal, are insolvent. Help from the IMF, ECB, and the EU should forestall a sovereign default for at least a few years, but additional debt restructuring will eventually need to occur. Central bank purchases of bonds cannot be the solution to a fiscal problem, but the ECB has the power to create a window of calm in the markets during which the European Union can implement some coordinated fiscal help and the peripheral economies can legislate policies to promote growth and bring budgets under better control. The problems faced by Spain and Italy are more manageable. In 2012, we believe that any significant concerns about the euro-area debt and the durability of the U.S. economic expansion should diminish somewhat, and the global economy will expand at a modest above-trend pace over the next year, propelled by growth in emerging markets and the U.S.

Europe's debt crisis has slowed growth worldwide but has not interrupted it. Some of the major growth engines of the past (e.g., China and India)

EASE OF DOING BUSINESS



SOURCE: *WORLD BANK*

have slowed but are still growing at healthy rates. Importantly, the monetary cycle in China and the emerging world has turned. Monetary tightening was justified while on the back of rising inflation pressures and overheating growth, but that picture has changed significantly in the past few months. The main source of concern in China is the health of its housing sector. Home sales continue to contract and weakness is widespread. Although public housing construction has supported overall investment in the property sector, a decline in construction activity seems inevitable. The big question is whether the growth slowdown in China is the start of something worse or if it represents the long-hoped-for "soft-landing" scenario. The latter is likely, as authorities have been well aware of these risks and have had sufficient time to plan accordingly. Actions have already been taken to reverse excess weakness: reserve requirements have been cut, and further measures will be taken if economic conditions continue to worsen. Unlike the U.S. and Europe, China has ample fiscal and monetary ammunition to offset any decline in external demand.

POSITIVE ECONOMIC SIGNS IN THE U.S.

Despite all of the concerns around the globe, the U.S. economy is experiencing growth that is gaining momentum. GDP growth was 1.8% in the third quarter of 2011, and many expect that it could be close to 3% during the fourth quarter; that is very solid performance in the face of economic volatility around the globe. Other indicators give us some confidence going into 2012. The recent December Confidence Board report showed surprisingly high results. First, consumers' feelings about the economy surged to its highest reading in over two years. The "jobs hard to get" component softened to its lowest reading since January 2009, which continues to support the theory that the labor market is undergoing a healthy rebound. On December 29, the Institute for Supply Management (ISM) reported that the index of U.S. manufacturing surpassed expectations by posting a reading of 68.0 for new orders (any reading above 50.0 is consistent with an economic expansion). Apart from the November reading, the report remains the strongest in 10 months. In addition, the report also showed some encouraging news from the employment component where a rebound in manufacturers' intentions to hire reversed the decline witnessed in November. The overall message is to expect better employment conditions ahead.

An important piece of the recovery puzzle is an improving employment situation, something that the U.S. has struggled with for several years; however, positive signs continue to emerge. For example, the December 22 initial unemployment claims data was positive from every angle. The decline in the headline reading to 264,000 was better than forecasted. The four-week average reading for initial claims is now at its lowest level since June 2008, proving that firing is going out of vogue. In fact, the number of workers who lost their jobs over the past 12 months is now lower than before the recession. Hiring plans in small businesses are also improving.

> ✶ Another area for some optimism is corporate spending. In the near future we hope to begin seeing a traditional virtuous cycle where companies start spending more aggressively, thereby boosting employment and creating stronger growth. ✶

The housing market in the U.S. is also starting to see a slow increase in activity. On December 29, the pending home sales report showed that sales increased 7.3% in November, versus the expected increase of 1.5%. This is the largest increase in nearly two years. In November, housing starts rose to their highest pace since April 2010. Finally, the National Association of Homebuilder Confidence Index reached its highest reading since May 2010, but more importantly, a component measuring forward buyer traffic rose to its strongest reading since May 2008, suggesting a healthy pick-up in buyer interest.

Another area for some optimism is corporate spending. In the near future we hope to begin seeing a traditional virtuous cycle where companies start spending more aggressively, thereby boosting employment and creating stronger growth. This, in turn, further prompts additional capital investments. Currently, capital spending is less than 80% of internally-generated corporate funds, one of the lowest ratios on record. In addition, real capital stock is no higher now than in 2008, indicating that firms have undertaken only enough new investment to offset deprecation of existing capital. As a result, there is pent-up demand for new investment. What is missing is confidence.

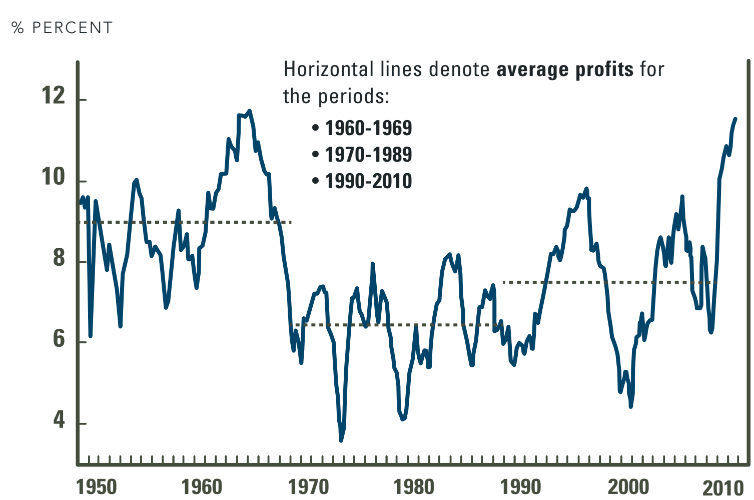
Throughout the recession and economic weakness of the past three years, corporate profits stood out as a major trend and have continued to surprise on the upside. The odds have been heavily stacked against this progression because of the persistently tough competitive climate. Many companies have faced sharp increases in input costs as a result of energy and commodity prices spiking during the past several years. More than anything, the earnings story has been about productivity. Companies have been able to find ways, such as making better use of technology, to progressively boost efficiency. In other words, this has not been a story about one-time aggressive cost cutting. This is an important distinction that indicates this trend is more sustainable and could actually accelerate as global demand starts to improve.

WHY CYCLICALS ARE AN AREA OF INTEREST

We thought we might take the time to comment on some areas where we have been seeing buying opportunities for stocks. Given the backdrop of an improving economy, we believe companies that are more economically-sensitive are trading at multiples that are far too low versus their growth prospects. For example, over the past several months we have purchased quite a few stocks in the Energy sector and have found numerous companies that we believe offer very attractive risk/reward profiles. In our opinion, the Energy industry is currently undergoing a major transformation in the U.S.

Ten or so years ago, conventional wisdom was that the United States, and North America by extension, had peaked as an Oil and Gas producer. It was thought that all of the hydrocarbons which were going to be found had been found and all known reserves in the region were being depleted without much hope of new discoveries. At the time, experts believed that natural gas would be the first to disappear. If this were to occur, a tremendous problem could result because natural gas, while not as critical as crude oil, was necessary to maintain the standard of living. With this in mind, industry practitioners have been extremely innovative and invented an ingenious new production technique that can unlock incredible amounts of energy and change the profile of the region.

U.S. Domestic Non-Financial Margins



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This new technology is hydraulic fracturing, which when combined with horizontal drilling, opens vast amounts of hydrocarbons that were previously thought to be economically unrecoverable. It is important to note that, independently of one another, horizontal drilling and hydraulic fracturing had been in use for many decades but had never been used in unison. Once they were married, certain resource formations became economical. The technology was first used on the Barnett Shale formation in North Central Texas to explore for and produce natural gas. What is colloquially known in the industry as the "Shale Gale" was born.

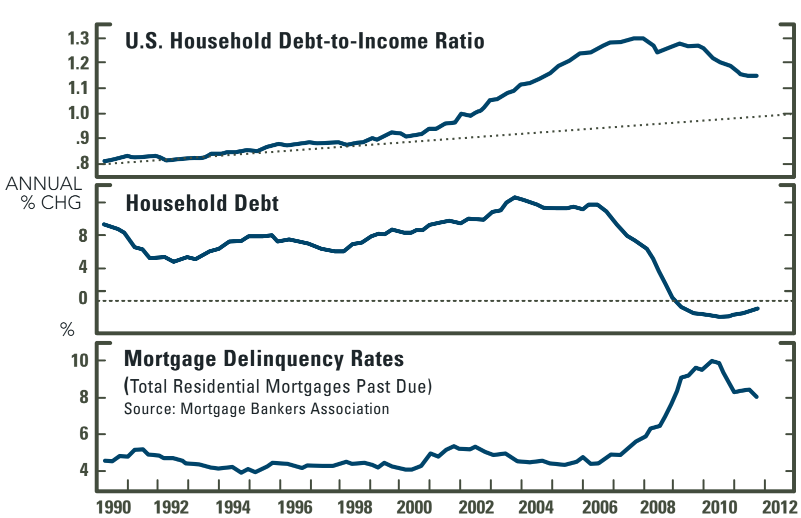
Shale gas exploration and production turned a feared natural gas dearth into an unimaginable glut that has pushed natural gas prices to very low levels. From the huge Marcellus Shale in the North East United States to the highly productive Haynesville Shale in Louisiana, many large shale formations have been discovered over the last 10 years.

While gas directed drilling has waned somewhat due to low gas prices, it is a completely different story with crude oil directed drilling. As it turns out, the new technology is also appropriate for crude oil production. The Eagle Ford Shale in South Texas is a rich crude oil formation that is producing impressive well results. In fact, for the week ended December 22, 2011, the rig count in the Eagle Ford Shale hit a new high. Even traditional basins, such as the famous Permian Basin, are experiencing a renaissance. The recent technology is bringing so much new production to the mature play, it is speculated that producers can equal the total cumulative production from the Basin to date in the next 40 or 50 years.

Because of these developments, we believe the Energy group (in particular, the oil services industry) is poised to perform very well in 2012. Oil prices have remained persistently high throughout 2011, despite the uncertain economic environment. The primary reason for this support is the low inventory of global crude oil. In fact, during December, U.S. inventories sank to their lowest level since 2009. It is unusual for crude oil inventory to fall during an economic slump, thus underscoring the fact that global oil markets remain tight. As a by-product of this situation, healthy global rig utilization rates will continue to support pricing power gains, especially since the latter are still in the early stages of a rebound. Industry profit margins are tightly linked to pricing power, implying that near-term margin expansion is probable. In addition, Energy should prove to be a nice hedge against potential turmoil in the Middle East where uncertainty in the region is on the rise.

The strength in the ISM Manufacturing Index is very supportive of a rebound in economically-sensitive companies. The November and December reports were

U.S. Consumer Health



Source: ©BCA Research 2012

✶ Despite the negativity in the headlines, positive signs are emerging behind the scenes. ✶

robust, especially the component that shows the strength in new orders. These readings are consistent with the notion that the economy is starting to perk up. An improvement in the ISM Manufacturing Index is positively correlated with improving stock performance in the Industrial, Energy, Material, and Technology sectors. We have found attractive investment opportunities in most of these industries over the last several months. Aside from Energy, Technology has been an area of particular interest for us, as many companies sport attractive balance sheets and have unique growth prospects, yet trade at very reasonable valuations. Despite the disruption in the supply chain created by the floods in Thailand, tech sales are expected to accelerate over the next several quarters. Also, Technology continues to evolve and grow as a percentage of the world's overall spending (both with consumers and corporations). We have found some intriguing investment opportunities in this group over the last several months and have invested accordingly.

Unique niches within Healthcare are another area where we see tremendous potential for returns. Overall, small- and mid-cap Healthcare stocks are expected to see a 13% rise in revenues and a 20%-25% rise in earnings in 2012. Several of the Healthcare companies that KING holds in client portfolios have stepped up hiring and have seen a nice pick-up in their backlogs for business over the past few months. This should translate into increased earnings in 2012, and subsequently, rising stocks prices. Rarely can investors buy a company with a unique technology, a strong product portfolio, future earnings growth of 30% or more, operating in an industry with high barriers to entry for less than 15x earnings. Our client portfolios hold several companies that meet this description. Sooner, rather than later, this value should be unlocked, leading to significant appreciation for many of these stocks. Healthcare, Technology, and Energy are also industries where we see the potential for increased merger and acquisition activity that could benefit our client portfolios as well.

SUMMARY

We have discussed this subject at length in the past, but corporations in the U.S. have the strongest balance sheets recorded since the 1950s, with close to record levels of cash. What are they doing with all of that cash earning next to 0% and in the face of economic uncertainty created by Europe? Instead of preserving cash, CEOs and Boards are buying back the most stock ever over a four-year period, taking advantage of their healthy balance sheets and low interest rates to purchase equities at valuations 15% cheaper than when the credit crisis began. As of November 14, 2011, corporations have authorized more than $453 billion in repurchases, putting 2011 on track for the third-highest annual total ever. U.S. companies spent 70% more on their stock in the third quarter of 2011 than they did one year ago, according to filings. This behavior indicates that executives have confidence in their companies as well as in the economy. If 2011 valuations are compared with those of 2006, the second highest year of share repurchases, companies are now generating three times as much cash. In addition, P/E ratios are lower and 10-year Treasury yields are approximately 2%.

While 2011 was a volatile and difficult year for the markets, we believe that 2012 will be a rewarding one. Despite the negativity in the headlines, positive signs are emerging behind the scenes. This is a choice investment time with similarities to the reversal of the market that occurred in early 2009. Many stocks offer 50% to 100% upside; we believe that patience will ultimately be rewarded as the year unfolds.

Leah R. Bennett, CFA
Managing Director

The year 2012 marks KING's Thirty-First 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.

For over 30 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.

OTHER CONTRIBUTORS

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SOURCES FOR THIS ISSUE

BCA RESEARCH; Bloomberg L.P.; Furey Research Partners, LLC; *MarketWatch.com*;
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