



RUMINATIONS AND OBSERVATIONS A Periodic Overview January 2009

In the words of one of my more sympathetic correspondents, it has turned out to be an 'Annus Horribilis.' I suspect that I am not alone in thinking it so. Indeed, I suspect that there are very few people or institutions unaffected by these last months of worldwide turmoil and uncertainty.

Queen Elizabeth II, 1992 speech marking her 40th Anniversary as Queen of the United Kingdom

Market Review

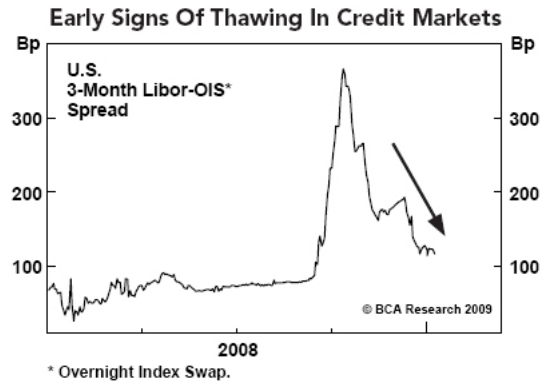
While Queen Elizabeth's 1992 speech referred to the travails concerning the Windsor Castle fire, royal family strife, and the first Gulf War, it quite aptly describes the tribulations faced by investors in 2008. Last year will go down in history as truly an "Annus Horribilis." When the New York Stock Exchange rang the final bell on December 31, it grimly tolled for everyone who invested in stocks. The Dow Jones Industrial Average plunged nearly 4,500 points in 12 months, or 34%, registering its worst annual loss since 1931. Over \$7 trillion of shareholders' wealth, or six years of market gains, evaporated in 2008. Equally staggering was the breadth of the decline. All but two stocks in the Dow Industrials—Wal-Mart and McDonald's—fell by more than 10%. And outside U.S. borders, major global stock markets suffered even greater losses.

For political leaders, government treasurers, and central bankers around the world, it was a period of unprecedented challenges. The global contagion of the collapse of collateralized debt (especially mortgage-backed securities), investment banks and other major financial institutions going bankrupt or forced into eleventh-hour mergers, and the Great Unwind of leverage culminated in a bond market frozen by fear and stock markets pummeled by panic selling.

What began as increasing defaults in the U.S. subprime mortgage market in mid-2007 eventually metastasized into a worldwide financial crisis by September 2008. Economic growth stalled and a recession was officially declared as having begun in December 2007. The recession is expected to continue as GDP for the United States is estimated to fall in the fourth quarter of 2008 and for at least the first half of 2009. The equity market collapsed over the past four months with unprecedented velocity and intensity. Incredibly, 90% of that decline occurred after Lehman Brothers declared bankruptcy on September 15. The old Wall Street investment banking stalwart was unplugged from life support. Yet other financial firms were triaged as "too big to fail" and revived via federally-brokered acquisitions or bailouts. History may judge the death of Lehman Brothers by neglect as being the spark that accelerated the global credit crunch, investor panic, and the resulting stock market freefall that ensued.

In the ensuing credit freeze, fixed income markets reeled, forcing the Treasury Department and Federal Reserve to flood failing financial institutions with massive infusions of cash and cuts in the Fed funds rate effectively to 0%. In the midst of the chaos, investors fled to the security of Treasury bonds and government-backed cash accounts. This stampede was exacerbated by highly leveraged hedge funds and investment banks that were forced to liquidate corporate and municipal bonds in order to meet margin calls on their sinking stock investments—mercilessly driving down these bonds' normally stable prices.

The U.S. stock market's third-worst year in more than a century left many investors angry and confused—angry at mortgage companies that wrote dubious loans; at Wall Street who packaged these loans and peddled them as “high-quality” investments as anointed by the credit rating agencies; and angry at the federal government whose lax oversight enabled the scheme, and whose response to the crisis was to dole out taxpayers' money to many of the same financial firms that caused the catastrophe. Investors are confused as to what to do with their investment portfolios during this uncharted economic and market course. They long for a turnaround in 2009, but considering the pain and disillusionment that has continued for more than a year, many are understandably sceptical.



Global Market Performance

The U.S. stock market tumbled 23% in the last quarter, with most of the damage occurring in October and November, and ended the year sharply down 37% as measured by the broad Russell 3000 Index. The S&P 500 Index of large-cap equities dropped 22% over the last three months, and 37% for 2008. Small-cap stocks declined as well, with the Russell 2000 Index off 26% for the quarter, but outperformed large-cap stocks for the year as the Index fell 34%. The tech-heavy Nasdaq Composite Index also posted heavy losses, down by 25% in the last three months and 41% at year end.

The financial meltdown hit every major international market as investors withdrew funds from regions they once favored in search of safety. Ironically, although the United States was the epicenter of the financial crisis, foreign investors bought U.S. Treasury and cash securities, strengthening the dollar versus other major currencies. The broad MSCI EAFE Index of international developed countries plunged by 43% in dollar terms in 2008. A number of benchmark indices of developed European countries—including those in Germany, France, and the United Kingdom—all dropped by more than 40%. In Asia, Japan's Nikkei Stock Average recorded its worst year ever, tumbling 42%, based on local currency.

Formerly highflying emerging markets suffered the worst punishment as fearful investors redeemed their shares. The MSCI Emerging Markets Index dropped 53% by year end. Key indices in China and Russia tumbled more than 60% in 2008. China's Shanghai Composite experienced the worst performance of its 18-year history. The MSCI Asia-Pacific Index, an index that excludes Japan, fell 53%, wiping out about \$2 trillion in market capitalization. India's Sensex Index, which enjoyed three consecutive years of more than 40% gains, saw its value fall 52%. In Latin America, the MSCI Latin America Index sank 53% in U.S. dollar terms—a big reversal from 2007's 47% rise, which followed the 39% jump of 2006. In Brazil,

Latin America's largest economy, the benchmark Bovespa Index shed 55% in U.S. dollar terms. Brazil's economy was hit by a sharp devaluation of the real currency, while falling commodity prices decimated shares of its steel, oil, and minerals companies.

The battering of stocks worldwide put to rest the theory once popular among academia and analysts alike that stock markets in countries with good economic fundamentals could "decouple" from troubles in the U.S. and notch better performances. Instead, 2008 demonstrated that in times of immense volatility, global stock markets suffer the same fate. This proves that as cross-border trade barriers have fallen in the past decades, the world's economies are truly "flat" or interdependent during periods of strong growth or recession.

The turmoil in the credit markets pulled stocks and the U.S. economy down in 2008, setting records along the way as prices of corporate and mortgage bonds sank to new lows with yields soaring to sky-high levels. The chaos caught many investors off guard and sent them running to what many consider the safest investment in the world—U.S. Treasury securities. As prices of Treasuries rose, yields tumbled to record lows, and in some instances these securities earned practically no interest.

The past year was also marked by unprecedented moves by the Federal Reserve, the U.S. Treasury Department, and Congress, which committed billions of dollars in attempts to restore order to the credit markets. The government effectively backstopped short-term credit and bank deposits, increased its money supply to financial institutions, took steps to lower mortgage rates, and pressured lenders to provide consumers and corporations with access to capital. The full impact of many of these actions remains to be seen in 2009. However, it appears evident that the credit markets are slowly thawing and beginning to act in a more normal manner.



As investors flocked to Treasuries, prices skyrocketed, making these securities by far the best-performing asset class for the year, returning 14%. The Treasury-weighted Barclays Capital U.S. Aggregate Bond Index increased by 5% in 2008. Investment grade corporate bonds lost nearly 7%, and their yield spreads versus Treasuries tripled to 600 basis points (6%) at year end from 200 basis points (2%) in January. Investors in tax-exempt municipal bonds lost 4% as institutional investors were forced to sell these conservative securities to meet margin calls. The Merrill Lynch High Yield Master Index of non-investment grade corporate securities sank 26%, fueled by fears of increasing defaults. The Barclays Capital Global Bond Index returned 5% during the year. U.S. Treasuries accounted for the bulk of the gains, while foreign bond issues were hampered by a strengthened dollar.

Market Outlook

“Never make predictions, especially about the future.”—Casey Stengel

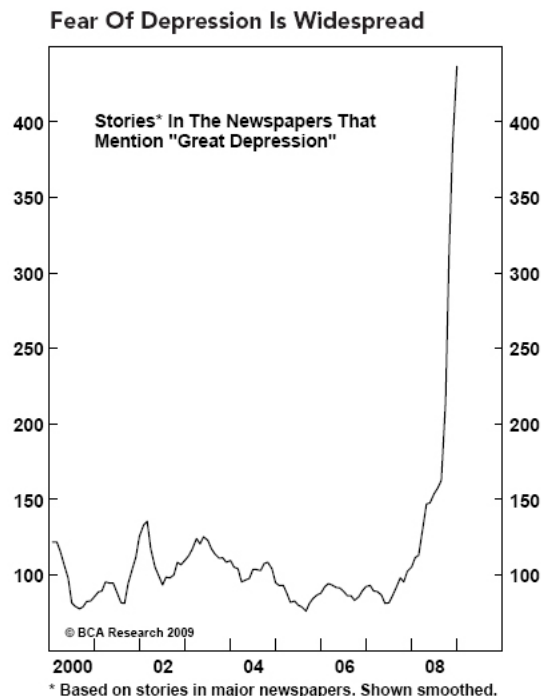
Some predictions are easily made and would require an act of God not to be fulfilled. One can easily predict that the sun will rise tomorrow, or that the financial markets will fluctuate. Less certain is the accuracy of predictions as to how long one will live beyond the next sunrise, or to what degree markets will fluctuate, in what direction, and when they might encounter major turning points. Nevertheless, we will forego Casey’s advice, and venture a few predictions about what may be in store for 2009 and beyond, with specific reference to the world of investing. We would add that looking at the distant and recent past sometimes best supports anticipating outcomes in markets.

The economy continues to face some significant headwinds. Credit conditions have begun to thaw from a virtual deep freeze, but financial institutions are clearly concerned about their capital reserve levels and loan delinquency rates. Thus, lending conditions are still tight, which puts downward pressure on economic growth. The counter-party risks associated with credit default swaps—insurance against bond defaults—raise questions about bankruptcy contagion risk. The important cyclical considerations of rising unemployment and reduced consumer spending for goods and services are likely to reduce aggregate demand and corporate earnings. The ongoing housing market decline and the general loss of investor wealth also dampen consumers’ propensity to buy.

Corporate earnings will decline further before they start to recover. We are still in the midst of a massive systemic financial deleveraging process (probably in the final stages). As such, it is unlikely that in some industries earnings will rebound as strongly as in past cycles, when easy access to capital was prevalent and the use of leverage contributed significantly to growth during the recovery phase. In contrast, there are a number of companies within certain industries that should continue to report higher earnings.

Policymakers have appeared prepared to do whatever they can to get the economy back on track—the nature of their questionable policies aside. The federal government is keenly aware of the systemic problems, having provided close to \$1.0 trillion in bailouts and other government guarantees—with more to come under the Obama administration. Despite President Obama’s pledge to rein in federal spending, the likely downside to increasing government intervention includes further ballooning federal deficits, eventual tax increases, inflationary pressures in future years, and regulatory changes that typically impose additional operating costs on companies (e.g., Sarbanes-Oxley).

Furthermore, stock prices and fundamentals have decoupled. However, clearly the traditional measures of valuation have little meaning in the current market environment, where fear and



liquidity demands trump underlying fundamentals. Our research reveals broad and diverse opportunities in several asset classes, yet we are cognizant of the need to tread carefully. We do not know when the turn will come, only that it has often made a sudden arrival during past recessions. The visibility of these opportunities should increase as the market finds its footing in 2009.

The talk of another Great Depression is tossed about with great regularity in the media. Such bantering is, if not foolish, certainly lacking perspective. Over the course of the last few months, a number of developments stand in marked contrast to actions taken or not taken during the Great Depression period. As well, a number of other barometers of investment valuations and market activity may well indicate that, indeed, contrary to the fear-mongering that permeates the headlines, one of the big surprises for certain markets in 2009 could be a meaningful increase in security prices.

- The actions of the Federal Reserve are the most striking contrast with measures taken during the Great Depression. The Fed has supplied an unprecedented level of monetary stimulus and is prepared to continue doing so. The shock to the economy arising out of the subprime mortgage collapse was the greatest threat to the viability of the financial system since the 1930s. However, in the thirties, the Fed refused to aid the banks, and actually *reduced* the money supply, further aggravating the severe economic decline. The Bernanke Fed has essentially guaranteed virtually all bank deposits and extended credit of over \$1.0 trillion. The Fed has engineered a rapid reduction in interest rates; short-term interest rates are close to zero, the prime rate is down to 3.25%, 10-year Treasuries are 2.25%, and 30-year fixed rate mortgage rates are below 5.0%. The Bank of Japan, facing a severe economic downturn in the early 1990s, took almost a decade to engineer the types of stimulus that the Fed has orchestrated over the last several months.
- The Obama administration will usher in a gigantic amount of fiscal stimulus aimed at bolstering an economic recovery. Still in its formative stages, the Obama plan calls for tax reductions, infrastructure spending, and other measures that should create significant demand for the products and services of a number of industries. Again, in contrast to the present, during the 1930s, policymakers called for increased taxes and a reduction in spending in order to cut deficits, measures which were further drags on the economy.
- The collapse in oil prices is tantamount to a huge tax cut for businesses and consumers alike. Talk of \$200 per barrel oil has given way to fears of a further decline in oil prices.
- Risk premiums on debt and equity prices recently reached all-time highs. It is as if investors across a broad spectrum are assuming almost nothing will go right. And although the debt markets have begun to thaw, the flood of capital into treasuries at rates approaching zero is a sign that pessimism and fear have trumped reality.
- The earnings yield of the S&P 500 (7.7%) relative to 10-year Treasuries has made equities the most compelling investment since the 1930s and 1950s.
- Since 1926, when tracking began, the annual 10-year return for large company stocks turned negative in December—this has occurred only twice, in 1938 and 1939.

- The amount of funds parked in cash equivalents has grown to an amount significantly greater than the total market value of U.S. stocks.
- Insider buying increased dramatically in the fourth quarter of 2008, reaching historically high levels that typically precede market recoveries.
- The forced selling from margin calls, hedge funds, and mutual funds probably reached its zenith during the fourth quarter of last year.
- The VIX, a measure of expected volatility and investor fear, reached an all-time high on October 24, 2008, and has receded dramatically from its October-November peaks.
- Prior to 2008, there were four prior periods in which value style stocks declined two years in a row: the Great Depression years of 1930-32, the early years of WWII in 1939-41, during the Arab oil embargo of 1973-74, and when the Internet dot.com bubble burst in 2001-02. Following all four periods, equities recovered by an average of 60% in the next 12 months.

All of the above points are significant signs that, despite the early-year hiccups in the equity markets, the equity markets have already discounted a very severe economic downturn. Corporate and municipal bonds, too, appeared to have carved out price levels and yields that offer investors potentially rewarding returns. Many of the companies in which we have invested have strong balance sheets, and a number are continuing to buy back stock, thus growing the intrinsic value of their shares that are already undervalued.

Fear may continue to dominate the psyche of investors, and a period of irrational and forced selling may persist somewhat longer. Nevertheless, the price levels at which a large universe of stocks are trading will soon begin to benefit from the positive forces previously mentioned. Warren Buffet's encouragement in October of last year to buy stocks is perhaps even more valid today. Businesses are on sale as never before over the last few decades. They will not remain on the bargain counter forever.

As always, we remain mindful of balancing the risk taken with the expected reward when constructing portfolios. Our employees and families also invest in many of the same securities as our clients, which should provide an additional level of confidence that we are monitoring portfolio investments closely. Finally, this uncertain and unprecedented time will certainly require more patience. Just as there is relief in knowing that the "Annus Horribilis" of 2008 has come to an end, investors can be hopeful that 2009 just may become "Annus Mirabilis"—year of wonders. As it is said, "This too shall pass." We add—and when it does, you will be well rewarded.

We are extremely grateful for the enduring relationships we have shared with our clients, and we look forward to providing you with "good news" as 2009 progresses.

King Investment Advisors