

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

King Investment Advisors, Inc.



ROGER E. KING, President of King Investment Advisors, Inc., has been with the firm 20 years and has 31 years of experience in investment management. He earned a BA in Business Administration from Lipscomb University and an MA in Political Science from Middle Tennessee State University. Mr. King, a CFA and Chartered Investment Counselor, was also a National Science Fellow at Cornell University. King Investment Advisors, Inc., was founded in 1981; Mr. King has served as President since 1986. Prior to starting the firm, he was Senior Vice President with Sun Life Group/Sun Insurance Services in Atlanta, Georgia. He served in a similar capacity with GULFCO Capital Management (Gulf Life Holding Company). He began his investment career with the American General Companies. Mr. King served two years as President of the Jacksonville, Florida, Financial Analysts' Society. He is Chairman of the Investment Advisory Group, Chief Investment Officer, a senior portfolio manager, and a securities analyst. Mr. King is also a member of the Houston Society of Financial Analysts.



PAT H. SWANSON is Managing Director, Portfolio Manager and Securities Analyst for King Investment Advisors, Inc. Mr. Swanson, a CFA and Chartered Investment Counselor, has been with the firm eight years and has 21 years of experience in the investment business. He is a graduate of the United States Air Force Academy with a BS in Economics. He also has an MBA from Pepperdine University. Mr. Swanson's business experience includes four years as an Acquisition-Financing Specialist at First RepublicBank in Dallas, where he managed a fixed-income portfolio of senior secured private placements. His professional career includes five years as a Contract Negotiator/Financial Analyst at Hughes Aircraft. Prior to joining the firm, Mr. Swanson served as a Fixed-Income Portfolio Manager for US WEST Financial Services for three years. He is Director and past-President of the Houston Society of Financial Analysts, and serves on the Continuing Education Task Force for AIMR.

SECTOR – GENERAL INVESTING

(MAY501) **TWST: Would you begin by telling us about King Investment Advisors, Inc. and your responsibilities there?**

Mr. King: King Investment Advisors, Inc., was founded in 1981. We manage approximately \$1 billion in equities and fixed income, in both equity and balanced accounts. We are value investors with a growth overlay, and our objective is to maximize our clients' wealth over a long period of time.

We have six investment professionals and a technical and administrative staff of 15. I am the Chairman, President, and Chief Investment Officer of the Company. Pat Swanson, who is with me today, is a Managing Director and a Portfolio Manager. I've been with the firm since its inception; Mr. Swanson has been here eight years.

Most of the accounts the firm manages are in the equity area. In addition to separately managed accounts, we also manage two mutual funds: Fountainhead Special Value Fund (under the symbol KINGX), a mid-cap fund started on 12/30/96, and Foun-

tainhead Kaleidoscope Fund (KALEX), a small-cap fund with an inception date of 11/1/99. Like the rest of our equity portfolios, both have outstanding long-term track records.

Of the \$1 billion in assets under management, approximately 60% of that is with institutional accounts and 40% is with individuals. We have a nationwide clientele that includes foundations, endowments, corporate pension plans, and high net worth individuals. We have clients in nearly every state, as well as Europe, Latin America, and Asia.

We adhere to an approach that we call the "Business Valuation Approach" whereby we seek to identify attractive investment opportunities and, using a broad definition of value, uncover securities often overlooked by other investors. As previously mentioned, we incorporate within this approach some elements of growth. We view growth as a desirable element in our investment process; we are just particular about the amount we are willing to pay for it.

TWST: Can you describe your investment process for us?

Mr. King: The ultimate decisions regarding additions or subtractions to the portfolios are driven by our four-member Investment Advisory Group, consisting of myself, Pat, Leah Friday, and Doug Cannon. All four are Chartered Financial Analysts and Chartered Investment Counselors.

Basically — and again, I'm couching my comments primarily with regard to equities — the Business Valuation Approach utilizes a broad bottom-up approach that seeks to identify companies that meet at least one of three criteria. We look for companies that sell at a significant discount to their private-market value or enterprise value — we essentially seek to buy a dollar for fifty cents. Secondly, we look for companies whose prices are presently at the lower end of their historical valuation range as measured in terms of traditional fundamental benchmarks such as price/earnings, price/sales, price/cash-flow, and price/book. Finally, we try to uncover growth at a reasonable price. We are, as I said earlier, value investors. But we think value, in many cases, can be found in companies that some would characterize as growth, as long as you're not paying an excessive premium for that growth. The p/e to growth rate (PEG) ratio is used by a number of people within the analyst community, and anytime you can find a company whose PEG ratio is below 1, it could potentially offer an attractive opportunity for substantial price appreciation.

So essentially, there are three parts to our approach: discount to private-market value, discount to historical valuation parameters, and growth at a reasonable price.

In terms of market capitalization, we manage small-cap portfolios, mid-cap portfolios, and some multi-cap portfolios. Essentially, we are able to work with any number of clients who have different market capitalization requirements.

TWST: What is your performance benchmark, and how are you doing in the small and mid-cap value arenas these days?

H I G H L I G H T S

Roger E. King and Pat H. Swanson are value investors with King Investment Advisors; the majority of the company's accounts are in equities. They also manage two mutual funds, Fountainhead Special Value Fund and Fountainhead Kaleidoscope Fund. As a bottom-up stock-selecting firm, they can identify a number of very attractive, undervalued companies of varying sizes and are thus able to work with any number of clients who have different market capitalization requirements. Both emphasize an adherence to discipline in investing with a three part approach: discount to private market value, discount to historical valuation parameters and growth at a reasonable price.

Companies include: Broadwing (BRW); Dobson Communications (DCEL); Leap Wireless (LWIN); Alparma (ALO); St. Jude Medical (STJ); VISX (EYE); Boston Scientific (BSX); Elan (ELN)

Mr. Swanson: Our small-cap accounts are up about 2.5% compared to the benchmark, the Russell 2000, which is up about 0.5% for the 12 months ended June 30, 2001. For the three-year period, we have returned 21.6% compounded annually versus 5.3%.

On the mid-cap side, again, for the 12 months ended June 30, we're up about 2.2% versus the Russell MidCap, which is up about 0.9%. Our three-year number is 12.9% compounded annually versus 8.2%.

TWST: I note that you use bottom-up analysis. But do you ever identify value sectors and buy companies from within?

Mr. King: Not per se. We are not a firm that focuses on sectors or uses a top-down approach to sector analysis. However, it is not unusual for us to overweight, or in some cases underweight, certain economic sectors. Typically, a number of companies within any particular sector will tend to become overvalued

or undervalued at the same time, reflecting the fundamentals and circumstances of that particular sector. So as a bottom-up stock-selecting firm, it is not unusual for us to identify a number of very attractive, undervalued companies in the same sector that meet our criteria. The resulting sector weightings are essentially a byproduct of our bottom-up process.

However, we do diversify our holdings across companies and try to limit any sector weightings to no more than 25% (at cost) at one time.

Mr. Swanson: Along that line, too, it's not a priority of ours to try to mimic an index. Many times, if we do not find attractive companies within a certain economic sector, we will not have any investments there. As Roger said, if we find enough companies in one sector such as health care, then we might have an overweighting in that area at a given time.

TWST: Let's move on, then, to your holdings. What stocks have you held on to the longest?

Mr. King: Let me mention **Elan Corporation (ELN)**, which is also the largest holding of the firm. It's an Ireland-based pharmaceutical company. We came into our **Elan** position by virtue of the fact that we had purchased shares in Dura Pharmaceu-

“Broadwing is doing very well on the fiber-optic side at a time when other companies are falling apart. They are adding a lot of customers, and there are two reasons why. Some of Broadwing’s competitors are offering cheaper services, but in an industry rife with players in financial difficulty, potential customers are willing to pay Broadwing more to get a financially stable partner.”

1-Year Daily Chart of Broadwing



Chart provided by www.BigCharts.com

ticals. Dura Pharmaceuticals was a company we started buying, oh, three or so years ago. It was a pharmaceutical company based out in California. One of the assets that Dura had was a very strong marketing force, and they had a number of drugs that were doing reasonably well. Dura would buy small, overlooked drug lines from major pharmaceutical companies, lines that were small enough in size to no longer matter to a large company but were of adequate size to make a large impact on the revenues of a smaller firm like Dura. The company's excellent marketing staff would essentially reglvanize these drugs so that their market penetration would begin ramping back up. And **Elan**, while a leader in the drug delivery technology area with a very rapidly growing franchise in neurology and pain management, did not have a particularly strong marketing force in the US and obviously saw in Dura a company that would make a good, synergistic fit.

When we began buying Dura, we liked it in terms of where it was trading versus its private market value. We also liked it on a historical valuation basis and thought it was undervalued in terms of its p/e to long-term growth rate. We began accumulating the stock when it had a market cap of approximately \$500 million and was

considered a small-cap stock. Last year, **Elan** acquired Dura at a healthy premium, and we have continued to hold **Elan** because we think that it is an outstanding company with excellent long-range prospects, a company that itself could be on the radar screen of some major pharmaceutical companies, especially in Europe. We have doubled, in some cases tripled, our money on that particular investment over the course of the last few years. Although it is now considered a large-cap company, we have retained it in most of the accounts where we started buying it as a small-cap stock.

Importantly, in our small-cap and mid-cap accounts, we limit the size of the market cap that can be purchased in the portfolios initially, but we do not penalize our clients by then selling those stocks that appreciate and consequently jump into a larger market cap category. We will not usually purchase those stocks for new clients, but we do not sell them in existing accounts.

TWST: What are some of the recent buys that you have made and the reasons for them?

Mr. King: Let me mention an area where we have a number of investments, and we can mention some individual companies and weave it into a reason why we think this particular area is attractive.

We have been buying three stocks in the telecommunications industry: **Broadwing** (BRW), **Dobson Communications** (DCEL), and **Leap Wireless** (LWIN).

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Similar to the situation with Dura and **Elan**, we used to own a small-cap company called IXC Communications. IXC was acquired by Cincinnati Bell, and the company then changed its name to **Broadwing**. **Broadwing** is in the broadband services area, which is doing an excellent job in terms of execution. We’ve continued to hold **Broadwing**, adding to it in our mid- and multi-cap accounts. The latter two companies I mentioned, **Dobson** and **Leap Wireless**, are engaged in the business of providing wireless telecommunications services. I’m going to let Pat expand a little more on **Broadwing**, **Dobson**, and **Leap Wireless**.

Mr. Swanson: Obviously, as everyone knows, there have been a lot of disasters in the telecommunications service and telecom equipment stocks over the last year. However, it is our feeling that if you are diligent and thorough in your research, you can pick some winners. We believe that there are certainly going to be some survivors in this area, and these companies will be great long-term

investment opportunities given the greatly reduced number of competitors resulting from the industry shakeout.

As Roger mentioned, **Broadwing** was formerly called Cincinnati Bell; the company owned the local exchange assets in Cincinnati as well as the wireless and long distance services. The purchase of IXC’s assets gave **Broadwing** a great national broadband network.

We originally bought **Broadwing** thinking that it was going to be a potential takeover candidate, but during this past year, **Broadwing** has been one of the few telecommunications companies that has met its goals and delivered results on plan each quarter. This consistent execution is largely due to the leadership of Chairman Rick Ellenberger and his top-notch management team. Instead of being an acquiree, we believe at this point that **Broadwing** has the balance sheet and management skill to make smart, cheap acquisitions in a market fraught with bankruptcy. The current environment affords the opportunity to purchase attractive assets at pennies on the dollar.

Broadwing is doing very well on the fiber-optic side at a time when other companies are falling apart. They are adding a lot of customers, and there are two reasons why. Some of **Broadwing**’s competitors are offering cheaper services, but in an industry rife with players in financial difficulty, potential customers are willing to pay **Broadwing** more to get a financially stable partner. Sec-

only, given **Broadwing**’s solid financial position, the company has been able to attract some of the best employees, particularly marketing executives, who have been jumping ship from competing firms that are on the verge of going into bankruptcy.

Another element that differentiates **Broadwing** from the other industry players is its ability to offer a full suite of services to its clients. Under the recently announced Teleglobe transaction, Teleglobe (a subsidiary of **Bell Canada**) has agreed to purchase from **Broadwing** a minimum of \$180 million in transmission services, a deal that could signal a shift by the telecommunications carriers of moving away from purchasing dark fiber toward buying wavelength services from emerging carriers such as **Broadwing**. Under the agreement, **Broadwing** will also provide colocation, network consulting, engineering services, and local access services.

On the wireless side, as Roger mentioned, we own **Dobson** and **Leap Wireless**. We don’t own any of the big urban names

such as **AT&T** (T) or **Verizon** (VZ) because of the hyper-competitive nature of the urban markets.

Dobson just reported excellent numbers for the second quarter, and they have a relationship with **AT&T** such that **AT&T Wireless** (AWE) owns 43% of the stock. **Dobson** essentially goes into suburban and rural areas that **AT&T** does not yet want to enter, builds out those areas, and sees a very high cash flow growth rate given the fact that these areas are less competitive.

We own **Dobson** because they have a very good management team, they're good operators and, at some point within the next two or three years, **AT&T Wireless** will probably come in and purchase the company. If **AT&T** decides not to purchase **Dobson**, certainly **Cingular** and **Verizon** could be interested in the company.

Leap Wireless is a slightly different operation. They just started operating their business in 2000. What's interesting is that **Leap** is kind of the **Southwest Airlines** of the wireless industry. They're going into cities and offering basically a bare bones, no options cellular service at a very reasonable price, basically an unlimited number of minutes for approximately \$30 a month. They're going into mid-tier cities like Nashville, Phoenix, and Charlotte.

We think that **Leap** is very undervalued because it's not a national carrier and it's new. Also, just based on the value of the spectrum alone, we think it's probably a \$35 stock.

TWST: What is the timeframe that you anticipate for your investment?

Mr. King: When we decide to purchase a security for our respective portfolios, whether mid-, small-, or multi-cap, we establish a price target based on the various criteria on which we're focusing, and typically our time frame is one to two years. We would obviously hold a stock beyond that if the fundamentals changed such that the price target should be adjusted upward.

When we decide to buy a stock, we establish a quantifiable price target based on a number of various data points or objectives that we think will be achieved. Once a security reaches that price target, barring a dramatic change within the company itself, we probably would begin to use that stock as a source of funds.

As an example, in recent weeks we have largely liquidated our positions in a company called **St. Jude Medical** (STJ). We still own a very small portion of the stock in some accounts that have not yet owned the stock for 12 months. For individual taxable accounts, we are very tax sensitive and try to take long-term gains if possible. **St. Jude** is a stock that we began buying two or three years ago in the \$25 to \$30 range. The stock has done exceptionally well over the past 12 months. It met our price target when it reached the \$55-\$60 range, and we then began liquidating it.

Much to our chagrin, it's gone up somewhat, but on a valuation basis it has appreciated far beyond the parameters of where we think the valuation is inexpensive. In fact, today it's trading at 30 times earnings and there's little margin for error if something goes wrong.

TWST: What are your reasons for selling a stock?

Mr. King: St. Jude illustrates an example of one of the three reasons we would sell a stock. It met our price target. A second reason we would sell a stock is if we find a more attractive alternative for investment. If we were fully invested and found a great investment opportunity with the potential of appreciating a considerable amount for our clients, we would accommodate this new opportunity by selling those holdings that were within 10% to 15% of their respective price targets. The third and most disappointing reason for any investor, particularly a fundamentally oriented firm, is that the fundamentals don't quite work out the way you would like them to, and you have to sit back and acknowledge that it's going to be a soured investment. You then exit the investment and redeploy the assets.

1-Year Daily Chart of Boston Scientific



Chart provided by www.BigCharts.com

TWST: What are some other recent purchases that you have made?

Mr. King: One is a company called **Alpharma** (ALO). **Alpharma** is a specialty pharmaceutical company that has global leadership in products for humans and animals. They are the largest manufacturer of generic liquid and topical pharmaceuticals in Europe, and they have a growing presence in Southeast Asia.

They are a leading producer of bulk antibiotics that are used for animals such as poultry, swine, and cattle; strangely enough, they also make vaccines for farmed fish. Their pharmaceutical products for human delivery are doing exceptionally well. The animal division, however, has been a drag on their operations over the last two or three quarters.

We've had too many chickens around the world and, as a result, some of the demand for these products has been deferred. **Alpharma** is a small-cap company that we believe is misunderstood by Wall Street. We believe that once the inventory balance in the animal drug area comes into better resolution around year-end, people are going to be focusing on this company a little more directly.

Another company that we have been acquiring a position in for a while is **VISX**; the symbol is **EYE**. **VISX** has developed a proprietary technology and system for laser vision correction. As most of your readers know, the LASIK surgery has been an area of very strong growth in recent years. We think that will continue despite the downturn of late. It is a discretionary procedure not covered by medical insurance, and the growth has slowed down some in recent quarters primarily due to the slowdown in the economy. We think that as the economy picks back up, **VISX**'s revenue growth will accelerate dramatically.

VISX was recently the subject of a takeover move by a well-known private investor, and the stock ran up to the mid-\$20s. At that point, we pruned our position and took some money off the table after having purchased it in the low to mid-teens. The stock is back down today around \$15-\$16, and we are acquiring more of the stock. We think, as a business, this company is distinctly undervalued, and they have some very good patent protection on their laser technology, a system that they have continued to improve. This technology would make a very nice plum for another diversified healthcare or medical device corporation. The fact that they were subject to a takeover earlier gives some credence to the fact that as a company it is very undervalued. Those are a couple of companies within the pharmaceutical and medical equipment area that we've been buying.

Another one that I'll just mention is **Boston Scientific** (**BSX**). **Boston Scientific** is a mid-cap company. They manufacture and market medical devices. Their devices, such as stents, are used in the areas of cardiology, electrophysiology, gastroenterology, and urology. We think **Boston Scientific** is mirroring **VISX** in some respects. It's a company that is involved in litigation with a company from which they buy some of their stents (**Medinol**) and, as a result, Wall Street is apprehensive about future developments at the company.

To their credit, **Boston Scientific** has continued to produce decent results despite the turbulence caused by their strained relationship with **Medinol**, the company's manufacturing partner. **Boston** has done this by making some very good tuck-in acquisitions, and they have continued their own internal product development such that their dependence on **Medinol** as a supplier diminishes each month. In our judgment, they've done an excellent job over the past year of executing their business plan and have improved their balance sheet dramatically by paying down a significant amount of long-term debt. In addition, they are working on a drug-coated stent, a product that, if approved by the FDA, could offer tremendous upside over the next two to three years. **Boston Scientific** has executed very well while operating in a highly competitive industry. In our judgment, it's selling at approximately 50%-60% of its value as a business concern.

We think that the steps they're making now to buttress their product offerings and enhance their sales force are going to pay some very handsome dividends down the road in terms of rev-

enue growth and obviously earnings. As Wall Street typically does, once the company's firing on all eight cylinders, they'll again embrace **Boston Scientific**, which used to be a growth stock darling.

We try to identify what we call wounded growth stocks — stocks which may have temporary problems that, on a long-term basis, are resolvable. This affords the opportunity to buy what we would characterize as growth at a reduced price.

TWST: What would you say are the competitive strengths of King Investment Advisors, Inc.?

Mr. King: I think Eric Miller, of what used to be known as **DLJ**, said it takes about 12 years to become a good portfolio manager. I'm sure there are a lot of younger managers at some of the big name mutual funds who might disagree with that. I think that we have a number of strengths. Certainly our experience is one.

The four portfolio managers of the firm have been in the investment business an average of 20 years. We also have a staff that is well seasoned. On top of the experience of this firm, I think there is a willingness to push the envelope in a sense, in terms of moving outside of the conventional thought process of Wall Street.

You rarely make good returns over a long period of time by doing that with which you're comfortable, or that which makes everyone else comfortable. Opportunity usually arises in those situations where you're able to buy a company that's distinctly undervalued, and that's usually because you have a large number of sellers who have been more than willing to get away from the stock.

We like to focus on stocks and take positions in them when they are at levels where there is some element of discomfort among the broader investment community; many of the examples I mentioned earlier reflect this point. I think our Business Valuation Approach is one that enables us to work in all market capitalizations, and to avail ourselves of opportunities in different types of markets.

As your readers well know, sometimes growth stocks are in vogue, sometimes value stocks are in vogue, sometimes something in between, and you have to find opportunity where the market will provide it to you. We have obviously seen a tremendous investment mania over the last couple of years. I've often described what happened in 1998, 1999, and the first part of 2000 as a bubble blown up by all the participants in the electronic casino we call the stock market. Much of what was going on really was gambling, and I think the discipline to which we adhere keeps one's feet on the ground.

Adhering to this discipline will, in most cases, help us avoid stepping on landmines and steer us away from stocks where, on an intrinsic value basis, there's no logical reason for the securities to be trading at some stratospheric multiple of earnings or revenues. I think a consistent application of our discipline has enabled us to benefit and participate in the markets no matter which style, growth or value, is currently in vogue; this process has worked well for us over long periods of time.

Another advantage is the size of this firm. Since we manage \$1 billion in assets, a much smaller amount than many of our competitors, we are able to participate in securities that, quite frankly, other firms, unless they have some very specialized sector funds, really cannot avail themselves of in any significant way. We can take a meaningful position in a \$500 million, \$1 billion, or \$2-\$3 billion market capitalization company where we see tremendous upside. If we're successful with our stock selection, it will impact the portfolio, as opposed to larger managers who may only be able to buy less than a 1% position without significantly impacting the stock's price. If you own 100 or 150 stocks, even if one of them doubles, the odds are it's not going to impact the portfolio in a meaningful way.

So we typically own 25-35 securities, and possibly 40 in an extremely large portfolio. As a result, due to our focus on finding undervalued securities, you see a real impact on the portfolio when value is realized. That's obviously a key reason our performance has been so good over a long period of time.

TWST: What advice would you give to investors who are coming into the market at this time?

Mr. King: One of the lessons many have learned over the past year and a half is to be realistic in your expectations. Successful investing is a long-term process. It requires patience, and you really should not expect to make money over a sustained period of time by buying companies that are overvalued. Returns tend to deviate back to the mean, and I think we're in the process of seeing that.

Investors with realistic expectations should be focused on value, but they should also recognize that if you limit yourself to a very strict definition of value without taking into account potential growth, you will shortchange yourself. I think the greatest advice you can give to anyone in the investment business is have patience and know the reasons why you own a stock; have a very solid conviction and a realistic view of where you think the price of that stock can go over a business cycle or a market cycle. Quantify that, and have a time frame in mind. That, to me, is the best thing to keep in mind when you're investing.

It is important to also have some sense of the value of the underlying business. If the value of the underlying business of a stock is worth \$30, and it's trading at \$40-\$45, you had better recognize that there is some tremendous downside potential. By the same token, if your work says that a company's worth \$30, and it's trading at \$20, or \$15, be patient; that value will usually come out.

Mr. Swanson: On a more current note, going along with what Roger said, we would really advise people entering the market right now to not get trapped into buying some of these technology stocks thinking they look cheap. Even though many have fallen a long way, if you look at the underlying value of these companies, particularly some of those that used to be considered large-cap favorites (**Lucent, Amazon, and Cisco**), they're still overvalued compared to their intrinsic value. One of our big concerns for new investors now is that they are buying these stocks thinking they are at a bottom, and we still think they have a way to fall.

Within the technology sector, there are some stocks you can cherry pick that are undervalued, but you really need to do some research in order to find those; don't just go out and buy the big names that have fallen 50%-60%.

TWST: Thank you (PS).

Note: Opinions and recommendations are as of 8/13/01.

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