King Investment Advisors, Inc.

## With Last Week Behind Us, Where Do We Go From Here?

For the week ended August 12, 2011, investors endured a stomach-churning 2500 point swing in the Dow Jones Industrial Average with the change for the week of only a -1.7% for the S&P 500 and -1.5% for the DJIA. However, the silver lining to this past week is the recognition that high volatility and high volume are usually synonymous with a bottoming process. Although a positive, investors are left with a disturbing feeling about the extreme volatility that we experienced within such a short period of time. Since the fall of 2007, we have witnessed 154 days where the Dow has fluctuated more than 2% in value. To put this into perspective, these total more days than were recorded in the 1950s, ‘60s, and ‘70s *combined*. Even in the 1990s, we had only 93 such trading days.

What is different today? A large part of the equation is the abundance of quantitative funds that participate in high frequency computerized trading. These funds manage money based on short-term stock price movements, not on fundamentals, and typically have a time frame of but a few hours. Furthermore, most of these traders prefer to “zero out” their holdings at the end of the day, going to cash overnight. That is not so troublesome when there is a ready group of buyers for their shares, but when there is not, prices can fall precipitously in a matter of minutes. These enormous price swings also trigger stock sales. As prices fall, large institutions that are highly leveraged are forced to liquidate their holdings to protect against further losses due to margin requirements, ultimately putting more pressure on prices. It is estimated that quant funds account for up to 70% of the daily average volume in the equity markets. Over the past week, reports are indicating that trades from quant and high-frequency trading firms tripled. Coupled with a 36% increase over the last eight months in margin debt—the biggest expansion since 2007—this combination made for a deadly mix for the equity markets as traditional buyers withdrew their bids. The volatility resulting from this type of trading creates fear and uneasiness in investors, but if rational heads prevail, it can become apparent that many strong companies with solid balance sheets are not worth 15% to 20% less than two weeks ago. It is still about company-specific fundamentals.

As we discussed in last week’s commentary, many headwinds abound. As one example, What are the global implications of a potential economic slowdown in Europe? There are, however, some positive signs emerging. U.S. payroll, unemployment, and retail sales have all been somewhat better than expected over the past two weeks. In addition, several indicators that are usually seen before the economy slips into a recession are not present. Usually, the 10-year versus 30-year U.S. Treasury curve will flatten or invert, whereas today it remains very steep. In fact, it is at the steepest level it has been in the last 35 years (and is in the 99$^{th}$ percentile in terms of steepness). This suggests that a double-dip recession over the near-term is less likely. Furthermore, corporate balance sheets are the strongest on record. Since 1950 there has not been a recession that started with corporate balance sheets being this healthy—excluding financials, cash as a percentage of assets is 11%, totaling $836 billion.

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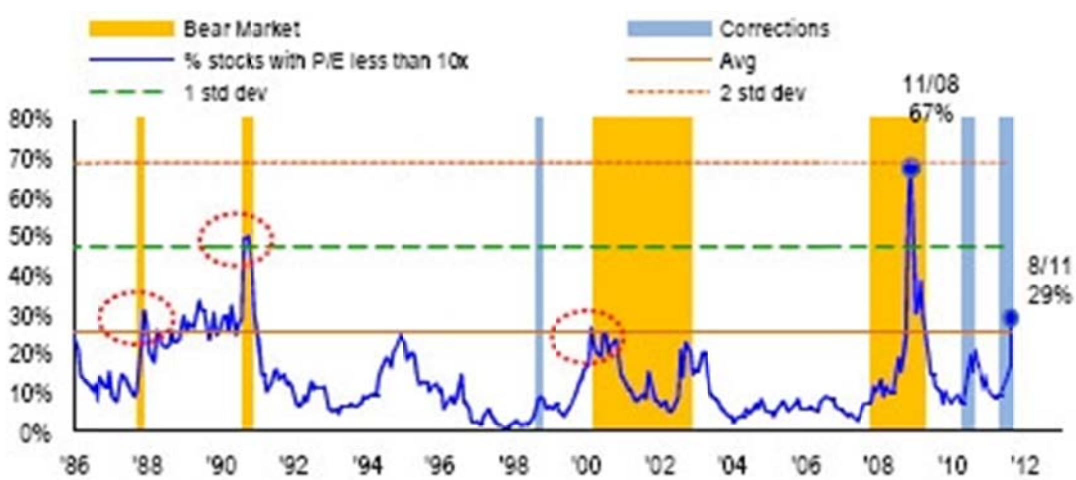
Source: J.P. Morgan, Bloomberg, and FactSet.

Contrary to the media hype, a sell-off of this magnitude is often not accompanied by a recession. In fact, a severe market downturn has only predicted a recession 30% of the time. Also, stock valuations indicate that the downside is limited. Nearly a third of stocks are trading at a P/E of less than 10x, a level associated with "end of recession" levels. In addition, the percentage of stocks trading above their 50-week moving average is zero, a level only seen in 2008 and not at any other time in the past 30 years. Also, despite the volatility and pessimism, insider buying skyrocketed last week and hit a level that is as high as it was in March 2009 when the market bottomed. In fact, between Friday the 5th of August and Tuesday the 9th, insider buyer was an all-time high, and existed across a wide variety of industries, including cyclical companies. Examples include Schlumberger Limited, Mylan Inc., STAAR Surgical Company, Boston Scientific Corp., and Callaway Golf Company.




Source: J.P. Morgan and Bloomberg.

Market volatility always creates opportunity. KING has identified many companies that have sold off to valuations that we believe are quite attractive. As a result, where appropriate, we have made some changes to client portfolios, which we believe will be rewarding over the next 12 to 18 months.

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Sources: *CBS MarketWatch*, J.P. Morgan *Equity Strategy*