

SKBA CAPITAL MANAGEMENT

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JUNE MARKET JEOPARDY

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**Let's just take a random walk among nominally organized observations:
Beginning with the Answers & Working Back to the Questions!**

One way to think of financial markets is as a very sophisticated game of Jeopardy, and the host, Alex Trebek, in this sense becomes one incarnation of Mr. Market.

In the markets, prices are flashed at us daily, and each price is an answer – but we have to figure out what the question is.

Below are the answers, and you get to ask the right questions:

1. “The propensity for the markets to have problems will be minimal.”
2. Baa1
3. New Private Equity and Hedge Fund clients
4. China & China
5. An Arm & a Leg
6. \$2.02
7. Empty
8. “The cost of options.”
9. 2011
10. The Wall of Worry
11. Compounding

Just turn to the next page if you dare!

The Questions to the Answers

Answer: “The propensity for the markets to have problems will be minimal.”

Question: What was Ben Bernanke’s answer to the question regarding the impact on financial markets from the first boost in the Fed Funds rate after he became Fed Chairman?

Ok, it didn’t really happen exactly like this. The debate has already begun, however, about whether or not Chairman Bernanke will successfully navigate monetary policy through the rocky waters of financial markets he inherited in the middle of this decade or whether Greenspan’s policies were partly to blame for those problems (i.e., excesses in the housing market). Has he now tightened monetary policy too much? The corporate and investment world doesn’t think so. Credit is cheap and plentiful – no worries here. It’s a good time to issue debt to either buy your own shares or to buy other companies (as a private equity buyer or a public company).

Of course, if you allowed yourself to take on an option ARM at a low introductory teaser rate, you must be regretting your decision now. Bernanke appears to be more willing to err on the side of too much tightening to cement his credibility against inflation pressures. It is likely that just such uncertainty surrounding future policies could catch the market by surprise and increase the “propensity” for the market’s reaction to be far more than “minimal.” This is not an event to look forward to with optimism – particularly for highly-leveraged hedge funds and private equity firms.

Answer: Baa1

Question: What is the average debt rating of the largest 400 U.S. companies (by revenues) that issue debt?

The rating agency “reign of terror” over corporate America, in which chastened rating agencies “shot” company ratings first and then asked questions, lasted from 2000 through most of 2003. The average debt rating plunged in a fashion not seen since the Great Depression. 2004 marked the official end to this phenomenon, and from the fall of 2002 through 2006, credit quality spreads improved dramatically and have remained narrow. In fact, with junk bond spreads at a record low compared to Treasury bonds, no one appears to fear that anything could go wrong with the economy or corporate profits.

It is increasingly likely, however, that 2007 may represent the beginning of the next “reign of terror” as rating agencies feel

“forced” to downgrade to non-investment grade many subprime mortgage-backed issues and some domestic and foreign CDOs (collateralized debt obligations) that possess ratings triggers (meaning default may be triggered by a downgrade to junk status as investors are required to be paid back immediately). Everyone seems to think the subprime/default shoe has already been dropped with the short-lived crisis from the first quarter of 2007. No worry here. Just remember, however, the second shoe is men’s size 14! We prefer Treasuries.

Answer: New Private Equity and Hedge Fund Clients

Question: Who are at risk of becoming the “greater fools” in today’s market?

Looking around the markets, we are always trying to understand who is playing the “greater fool” game and who is truly trading based on an estimate of the present value of future cash flows from an asset. Right now, hedge funds account for a trillion dollars of assets and private equity is not far behind. It seems that with these massive amounts of money swirling around the equity market (particularly in private equity and hedge fund portfolios), that new clients of these asset classes are playing the greater fool game, with likely diminishing returns.

Stephen Nagel at Stanford documented that many Hedge Funds behave as sophisticated momentum investors. As value investors, we are pleased when the “hedgies” and now the private equity firms use excessive leverage to push up prices to irrationally exuberant ranges. Value investors are the natural sellers to such eager buyers.

Quantitatively, the success of hedge funds is changing fee levels in aggregate. When fees are 2% + 20% of profits above T-bills, you need a 10% pre-fee return just to hit an actuarial target of 7%. Now that, as a good consultant friend said to us, is the “high cost solution to the low return problem!”

Answer: China & China

Question: Who are the marginal producers and consumers globally?

The simplest way to put it is that for the past several years, companies have been pushing down costs by adding or shifting production capacity overseas, and the next step is for consumption in those countries to soak up some of the looming excess capacity.

While we don’t place a high probability on China’s economy “imploding,” we do believe that China’s controls on capital flows combined with easy money and exploding credit have contributed to the growing trade and capital imbalances and

fueled a dangerous upward spiral in Chinese stock valuations. No worry, this is probably just fine if you enjoy rollercoaster rides.

Answer: An Arm & a Leg

Question: What do most consumers say when asked what it costs to fill up their gas tanks?

Joking aside, it used to be that the official measurement of the CPI overstated the real rate of inflation. With changes in the construction of the index a few years ago, we're not so sure anymore. It is true that energy is not as large a part of consumption as it was 25 years ago. Yet industrial and consumer prices (and corporate cost structures) have yet to feel the full burden of higher and rising energy, materials, rents (including the "owner-occupied rent equivalent"), imports and labor costs. Most forecasters view the "core" inflation rate as tame. No worries here. Who eats the core anyway? In our view, nearly all the risks to the urban CPI and the core CPI are to the upside, eventually putting pressure on real incomes and on corporate profits.

Answer: \$2.02

Question: What was the last EPS forecast by a tech company CEO just prior to announcing a 2 cent per share earnings shortfall compared to Wall Street's consensus estimates that caused a 40% decline in his stock's price?

The era of management's giving precise earnings estimate "guidance" and Wall Street analysts routinely accepting and incorporating this "guidance" into their earnings estimates should (or perhaps has) officially come to an end. This model of communication has failed and actually increased stock price volatility as the narrow range of earnings estimates around consensus (and the propensity of investors to attempt to act simultaneously on disappointing news) has dramatically increased the odds that a shortfall from expectations will generate dire consequences for a stock's price. If the goal is to build sustained wealth, who benefits from this model? No one. CEOs and CFOs are slowly getting the message, however, and reducing the guidance they offer, widening the range of possible outcomes, and/or offering more sensitivity analysis tied to internal or external events. Naturally, there will be at least one CEO who didn't get the message. The result will be ugly for investors.

Answer: Empty

Question: What will be the status of the Social Security Trust Fund in 2040?

The unfunded liabilities of our Social Security system are enormous, and the problems begin far sooner than 2040. Few under 50-year olds really expect to receive the benefits promised from Social Security when they retire – that's much of the Baby Boom generation and all of those that follow. Pushing out the retirement age and reducing the CPI boost to benefits would be good partial solutions, but they don't seem to be politically palatable right now. Shifting from today's pay-as-you-go system to a truly funded one would solve the problem - eventually. The solution that would hurt financial markets and the economy the most, however, would be a decision to raise payroll taxes to fund the same level of projected benefits. Not to worry, the real debate on these issues won't really begin until 2008 or 2009 anyway.

Answer: "The cost of options."

Question: What excuse did that tech company CEO give for the shortfall in earnings versus expectations?

Almost everyone started expensing some level of options costs in 2006. Of course, managements have figured out how to minimize the effect for now by lowering volatility assumptions or by having accelerated vesting in 2005 (before the costs had to be recognized in anything but a footnote). No one wants to count them as an expense as part of "operating earnings." No worries here, they're just a non-cash charge.

The right methodology is still widely debated, but we have long recognized that the true cost of options has reduced the cash flow that is truly available to be distributed to shareholders (in the form of dividends or NET stock buybacks) or reinvested in business growth. Determining such costs are important when estimating what a company's normalized distributable earning power really is. It isn't as high as Wall Street analysts think.

Answer: 2011

Question: When will all of the cuts in tax rates enacted in the last few years end and revert back to their former (significantly higher) levels?

It concerns us that the importance of "making the tax cuts permanent" dropped out of the headlines and is now not even a remote legislative priority. The rate cuts that were due to be phased out early were thankfully extended, but this just means that by the end of 2010, all of the tax cuts that have been such an important underpinning to the economic recovery since 2002 and to the stock market's advance will expire at the same time. Without certainty about these tax rates, how can taxpayers and corporations appropriately plan for the future? Oddly, concern about higher tax rates in the future may boost economic activity

today at the expense of future activity. So not to worry now, right? Let's make hay while the sun shines.

Answer: The Wall of Worry

Question: What is the market supposedly climbing over? What, me worry?

Answer: Compounding

Question: Why is capital allocation so important to returns?

The most important decisions in the investment business are:

1. *How we allocate our intellectual capital internally as a firm,*
2. *How we allocate our client's capital in the portfolio, and*
3. *How the companies in our portfolios allocate the capital their businesses generate.*

The allocation of capital at each of these levels is key to sustainable returns for companies, portfolios and our firm. Over time, even modestly better upside returns or downside protection compounds into improved risk-adjusted returns. So we're paid to worry at the right time.

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