

LUTHER KING CAPITAL MANAGEMENT

FOURTH QUARTER 2011 REVIEW

The Standard & Poor's 500 Index returned to its starting point following a tumultuous year, with the index closing up 2.1%, including dividends. Excluding income, the index itself ended the year at 1,257.6, the precise level at which it began the year. Volatility was central to the story line of 2011. The Japanese floods, Arab spring, Washington D.C. gridlock, U.S. debt downgrade, and European sovereign debt issues weighed on the U.S. equity market. The offset to these headwinds was strong U.S. corporate balance sheets, low equity valuations, higher corporate earnings, and improving economic data towards the end of the year.

The economy continues the expansion it began in the middle of 2009, and thus far economic growth has averaged 2.4% annually since the recovery began. In 2011, just as in 2010, markets experienced a scare over lack of growth prompting the Fed to take action. Economic output continues to move up, particularly due to the strength in capital spending. Investment in other areas of the economy, such as housing, remains well below a sustainable long-term rate. As the housing market continues to work through excess inventory and pricing seeks an appropriate level, construction related spending should increase later this year.

Europe continues to be a focal point for markets as leaders attempt to address both monetary and fiscal issues with an incomplete complement of solutions. We may not have seen the worst from Europe, as our view remains the European Central Bank (ECB) will be pressed to directly monetize sovereign debt, which it has thus far stridently resisted. While Europe will probably enter a recession in 2012, it represents only 14.0% of U.S. Gross Domestic Product (GDP). An economic contraction in Europe will weigh on global growth. However, our view is that the U.S. will not experience a recession in 2012, although our forecast calls for tepid domestic economic growth of 2.0% - 2.5%. As we highlighted in our third quarter review, tail risk remains high, broadening the range of potential outcomes.

A prominent event of 2012 will be the Presidential election. The bond rating agency, Standard & Poor's, downgraded the U.S. this past year from AAA in part due to the political impasse in Washington D.C. and poor outcome of the national debt-ceiling debate. Interestingly, 2012 marks an election year in countries representing almost half of global GDP including China, France, Russia, South Korea, Taiwan, Egypt, Greece, Slovakia, Finland, and Venezuela. This sets an interesting political backdrop for 2012.

ECONOMIC OVERVIEW

The discussion of economics has devolved into a discussion of politics. At this moment there seems to be a race between U.S. and European leaders as to who can behave most irresponsibly. In a revival of this summer's disastrous debt-ceiling debate in our nation's capital, Congress and the Administration were again recently embroiled, this time over how to address a Social Security tax break and unemployment benefits. Not to be outdone, European leaders continue to dash from one economic summit to another publishing communiqué after communiqué in a feverish attempt to placate markets and instill confidence.

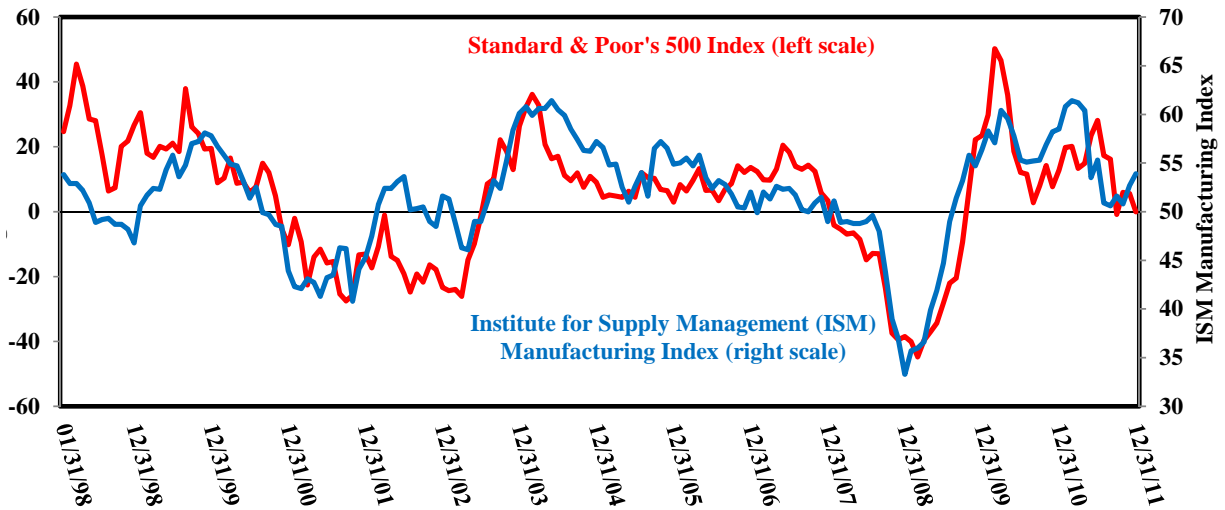
Below this din of noise lies a natural tension between the politicians' interest in self-preservation and the need to act in accordance for their constituents' long-term interest. When this tension goes awry capital markets and voters usually instigate change. By all accounts, the current actions of leaders on both sides of the Atlantic are subverting rationale behavior.

Since our previous quarterly correspondence, the European Union, ECB and International Monetary Fund (IMF) have continued to offer incremental approaches in response to demands of sovereign debt investors for higher yields. It appears European stakeholders are attempting a supreme balancing act. They must provide that which the capital markets demand or face the inability to fund current spending. However, central European authorities must not alleviate the acute pressure being felt by member nations, lest their ability to extract concessions be compromised.

There lies ahead a great debate among all the European stakeholders. The question is whether or not austerity can unwind fiscal imbalances, or should leaders focus on pro-growth policies. The early indication is a heavy dose of austerity as the European nucleus of Germany and France appear to seek this course of action. However, austerity alone is incapable of returning the continental economy to health.

Domestically, economic data continue to remain favorable. The economy is currently expanding around 2% in real terms, which is neither strong enough to buffer a global economic shock or weak enough to grow overly concerned of recession. We now find ourselves more optimistic about certain areas of the economy since prior to the recession, including housing and autos. The data are finally beginning to suggest 2012 could see a meaningful upgrade in the outlook for both sectors. Manufacturing data, both domestically and abroad, signaled strength at the end of the year, and corporate earnings are closely aligned with manufacturing activity. The following chart illustrates the Institute for Supply Management (ISM) Manufacturing Index and the year-over-year change in the Standard & Poor's 500 Index, exhibiting this close relationship.

**Standard & Poor's 500 Index
Institute for Supply Management (ISM) Manufacturing Index
(01/31/98 – 12/31/11)**

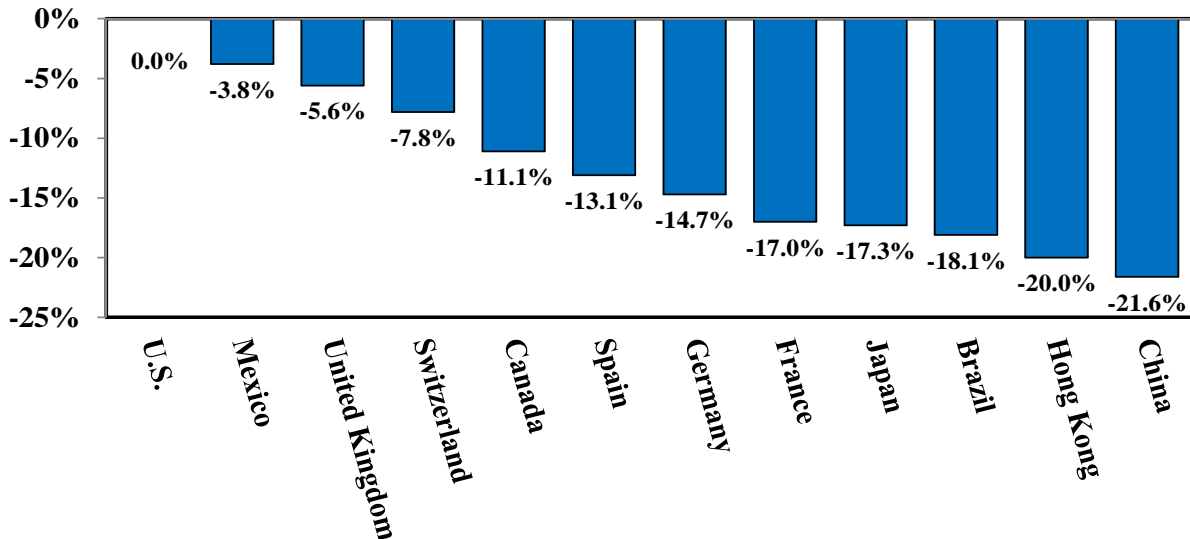


Source: Institute for Supply Management, Bloomberg

MARKET OVERVIEW

The U.S. equity market endured a barrage of global shocks and ended the year up slightly, including dividends. While emerging markets, particularly China, have received a great deal of attention recently, many of these markets declined significantly in 2011 as the chart below illustrates. The ability of the U.S. equity market to absorb extraneous shocks is a testament to the underlying strength of corporate profits, which we discuss further below.

**World Equity Markets
2011 Price Change**

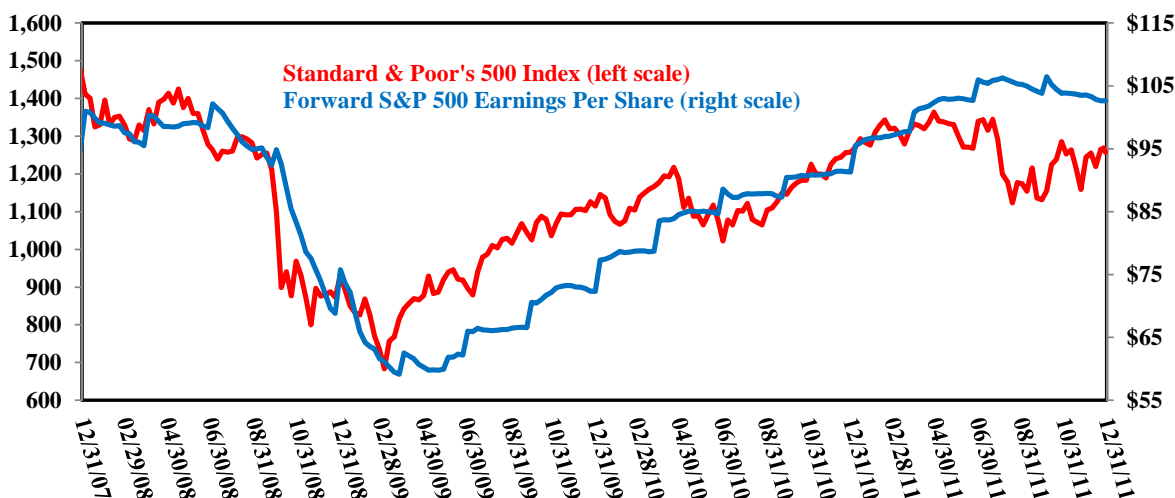


Source: Bloomberg

We remain positive in our outlook for the domestic equity market in 2012. Core inflation remains tame with little pressure from wages. Low inflation allows the Fed to retain an extremely easy monetary stance, which has primed the economy with credit and liquidity. Unfortunately, while the money supply has risen sharply, the velocity of money, or rate at which money trades hands, has yet to increase meaningfully. Favorable monetary policy will continue to lubricate the economy for some period and a pick-up in the velocity of money would be a welcome sign that the economy is responding.

The equity market is closely correlated with corporate earnings and while economic activity is not robust, GDP recorded a new high in the fourth quarter of 2011. We estimate the earnings per share of the Standard & Poor's 500 Index companies will be \$95 - \$97 for 2011, a new high. Corporate earnings growth in 2012 will likely be in the range of 5% - 8%. The chart below highlights the strong relationship between the level of the equity market and corporate earnings. We characterized the market decline in the summer of 2010 as a growth scare, but corporate earnings continued to grow, eventually leading the market higher. The summer of 2011 witnessed a similar growth scare, from which the market began recovering prior to the U.S. debt downgrade and concerns over European sovereign debt intensified. Although we expect corporate earnings growth to be tepid in the coming year, the market Price/Earnings multiple of just over 12X suggests there is little in the way of multiple compression likely and, in fact, we anticipate multiple expansion once the growth outlook is more favorable.

**Standard & Poor's 500 Index
Price/Year-Forward Earnings Expectations
(12/31/07 – 12/31/11)**

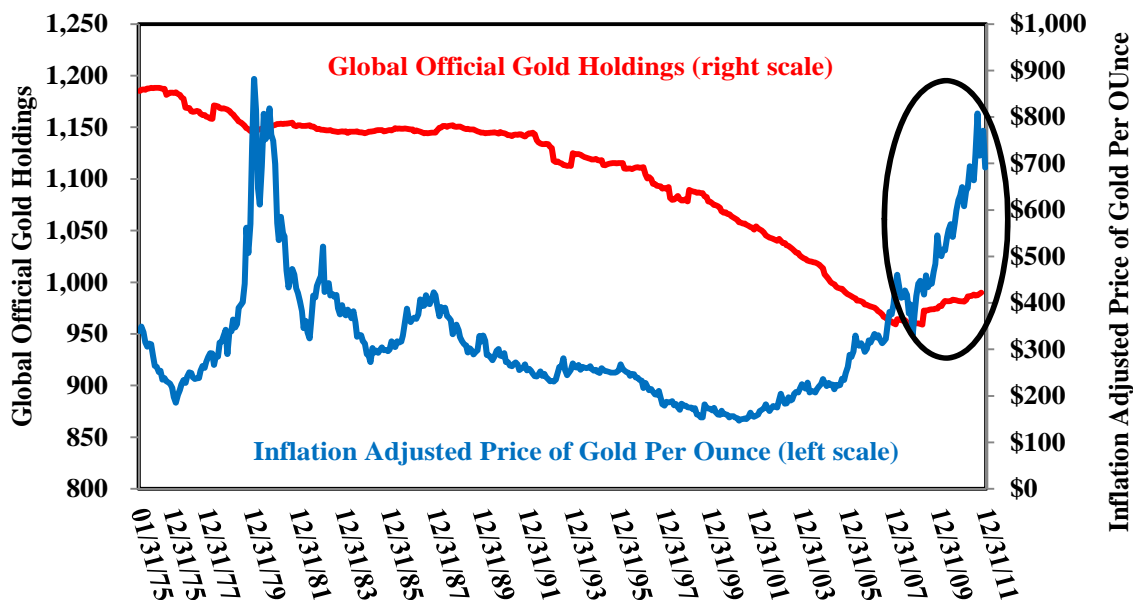


Source: Bloomberg

We are beginning to see the stabilization of housing on the horizon. Several recent data points support our view that 2012 could bring a material upgrade in the prospect for housing. Building permits reached a three-year high of 653,000 in October. The National Association of Home Builders published Homebuilder Sentiment Index reached a four-year high in November. The vacancy rate of homes recently fell to 2.4%, the lowest level since mid-2006. We may initially see a bifurcated housing market with some markets, such as Nevada and California continuing to struggle, while other areas such as Washington D.C./Virginia and Boston experience home price appreciation. One of the items we highlighted last quarter that would provide a boost to the overall economy is if the Administration introduced an agenda to aggressively address housing. There are initial signs that we may indeed see the Administration introduce further action related to housing in the run-up to the election.

During 2011 the price of gold climbed to almost \$1,900/oz. before ending the year at \$1,575/oz. The IMF reports the amount of gold held by governments around the world, known as the Global Official Gold Holdings. It is interesting to note that coincident with the Fed's first announcement of \$1.15 billion of debt monetization in March 2009, the sum holdings of gold by central banks around the world began to climb. As with equities, the price of gold is set at the margin, meaning the price last paid usually sets the price for all buyers. If central banks remain net purchasers of gold, it will likely continue to support historically high prices for gold.

**Inflation Adjusted Price of Gold Per Ounce
Global Official Gold Holdings
(01/31/75 – 12/31/11)**



Source: International Monetary Fund, Bloomberg

We remain positive on the domestic economic outlook. Employment is showing early signs of improvement, with the unemployment rate dropping to 8.5% at the most recent reading. Consumers continue to reduce their debt loads, while also continuing to increase spending year-over-year. Corporate profit margins remain extremely high, providing traction for incremental capital spending. The wide output gap between what the economy is currently producing and its capacity to produce suggests that broad-based inflation will continue to be held at bay.

CONCLUSION

A litany of events in Europe has roiled world markets: policymakers are slow to form substantive solutions, the ECB continues to behave in a myopic fashion and core EU countries remain unwilling to socialize debt. European banks hold sovereign debt, which carries a zero risk weighting for capital purposes, and desperately need to shrink their balance sheets to bolster capital ratios to the detriment of credit formation. Ultimately, the ECB is the only institution in Europe that can brandish a printing press and unequivocally reverse the negative feedback loop in which the continent currently finds itself. Bureaucrats and the ECB are united in resistance to this idea. If policymakers squander the temporary calm produced by several liquidity programs, when the severity of sovereign funding again arises, a much stronger response from the ECB will be required. Unfortunately, we have unlikely met the threshold of pain required to arrive at a sustainable solution.

We remain positive with regard to corporate profit growth and expect the equity market to continue to follow the trend of corporate profits. Given the historically high levels of cash on corporate balance sheets and fewer reinvestment opportunities, we expect many companies to remain focused on returning cash to shareholders through both dividends and share repurchases. We also would not be surprised to see an increase in merger activity. The rate of corporate profit growth will be hampered by sluggish global demand and the potential reversal of domestic tailwinds which have included accelerated capital spending incentives and incremental fiscal stimulus. Politicians in Washington D.C. must act rationally or bear the responsibility for further downgrades of U.S. sovereign debt.

The market volatility we experienced in 2011 will remain a part of the environment in 2012. As investors this can be extremely frustrating in the short-run, particularly when it is accompanied by high correlation among stocks. However, experience has taught us that patience can be a significant advantage when investing in such an environment. We continue to identify companies which we believe have the ability to reinvest internally generated cash flow back into the business at increasing rates of return. We believe the current environment is allowing us to build positions in high quality companies at attractive valuations.

FINANCIAL MARKET TOTAL RETURN*

	Fourth Quarter 2011	Six Months Ending 12/31/11	One Year Ending 12/31/11	Annualized Return Two Years Ending 12/31/11	Annualized Return Three Years Ending 12/31/11	Annualized Return Five Years Ending 12/31/11
Standard & Poor's 500 Index	11.82%	(3.69%)	2.11%	8.39%	14.11%	(0.25%)
Russell 2000 Index	15.47%	(9.77%)	(4.18%)	10.25%	15.63%	0.15%
Value Line Composite Index	11.36%	(13.15%)	(9.58%)	5.40%	15.71%	(4.44%)
Dow Jones Industrial Average	12.45%	(0.69%)	7.41%	10.29%	13.98%	1.56%
NASDAQ (OTC) Composite	8.21%	(5.53%)	(1.17%)	8.28%	19.46%	2.51%
Barclays Capital Gov't/Credit Intermediate Bond Index	0.84%	3.25%	5.80%	5.85%	5.65%	5.88%

** Total Return Includes Income*

Michael C. Yeager, CFA, CPA
January 4, 2012

IMPORTANT INFORMATION

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