

# Knightsbridge Asset Management, LLC

January 31, 2009

## Winter Quarterly Commentary

"Finally, and far more dangerously, our bond and currency markets could react with severe distress to fears about imbalances in the supply and demand for capital in the years ahead, or about the possibilities of inflation. Those effects have been diverted so far...but this cannot continue indefinitely, and change can occur with great force - and unpredictable timing."



Robert E. Rubin, 1938-  
Partner, Insight Venture Partners  
Co-Chairman, Goldman Sachs  
Office of the Chairman, Citigroup  
U. S. Secretary of the Treasury, 1995-1999  
Newsweek, December 29, 2009

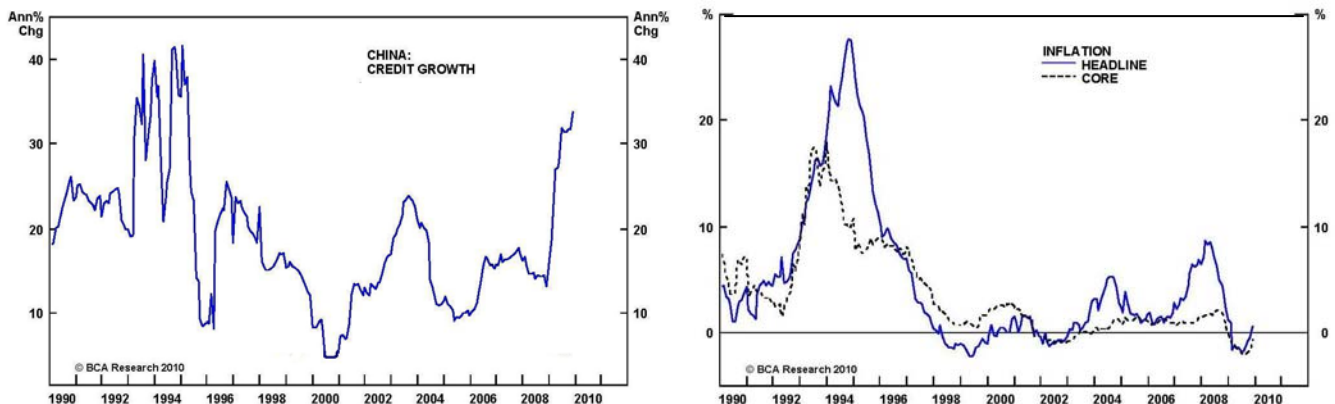
William Jefferson Clinton referred to Mr. Rubin as "the greatest Treasury Secretary since Alexander Hamilton". Others charge him with allowing the demise of the Glass-Steagall Act which had prevented commercial banks from entering the investment banking and brokerage business from 1933 to 1999. These detractors argue that had this Act still been in effect it would have helped prevent the banking crisis of 2007 - 2009.

We share Mr. Rubin's view that the economic backdrop is a precarious one, and that it remains to be seen if the U.S. balance sheet can or will be successfully shrunken: timing such will require the most deft handling so as to avoid a repeat downturn in the economy and simultaneously happen soon enough to prevent an accumulating inflation from becoming entrenched. Such execution precision is not a hallmark of governmental action.

Nor is the only issue one of whether or not the Fed is capable of successfully withdrawing monetary stimulus. Entwined in this issue is whether the Fed retains adequate political independence to execute this maneuver, assuming they can identify the perfect timing. The acrimonious reappointment of Chairman Bernanke portends a difficult-at-best proposition.

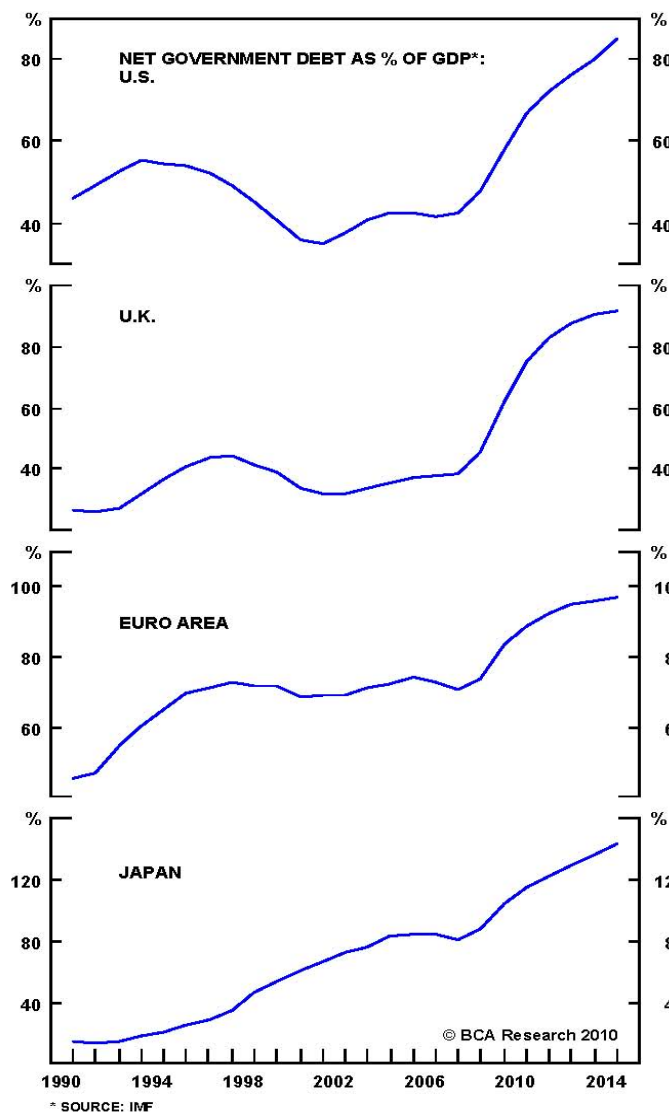
Pipeline inflation could presently suggest the need for a beginning uptick in shorter term interest rates towards the end of 2010, and we are left to speculate as to whether the persistent 10% unemployment can be reduced sufficiently before the need to raise interest rates becomes apparent.

Some countries have already begun to take steps to reign in monetary and credit expansion, notably China and Australia. In the case of China, policy accommodation is being withdrawn. Just recently, Chinese authorities have mandated certain banks refrain from making any new loans at all. As can be seen below, even in the face of a worldwide recession slowing their export markets, things have been booming in China.



But back to the point of Mr. Rubin's commentary, some evidence would suggest the United States has yet to arrive at the breaking point in terms of the relationship of government debt to GDP (gross domestic product). The conclusion rests upon the Japanese

example where such a ratio is much more extreme, and also on a few European nations where the ratio is not far behind the U.S. example. The thinking here is that if Japan has yet to get into serious trouble with their outlandish ratio of government debt to GDP, then others must be safe on a relative basis, at least until such time as their ratios approach the Japanese ratio.



Harvard economist, Kenneth Rogoff, states it in more blunt terms as he observes that debt levels already being forecasted places the U.S. on an unsustainable trajectory wherein we are being pushed toward a tipping point where the dollar could plunge and interest rates skyrocket. Moreover, Rogoff says "We will hit a point where it comes on us very quickly, and you don't want to edge up to that point...going beyond 80%, you're taking a real chance." As seen in the chart on the left, the entire developed world is flirting with or exceeding those 80% thresholds.

We observe that these levels of indebtedness can only be serviced if interest rates stay very low. Unlike a mortgage that in most cases

would feature a self-liquidating dimension commonly referred to as 'principal amortization', generally, there is no such principal amortization (or sinking fund in bond market parlance) with government debt. This means the debt is never really paid off; it is only rolled-over. As for any hope one might have that politicians will correct their evil (mostly entitlement spending) ways, well, there is just no evidence to suggest this can happen in anything other than a total crisis environment, and we are not there yet apparently. Nevertheless, the American people are not

totally oblivious to what is going on. We were amused when we saw the following polls in the chart on the right by Strategas Research Partners.



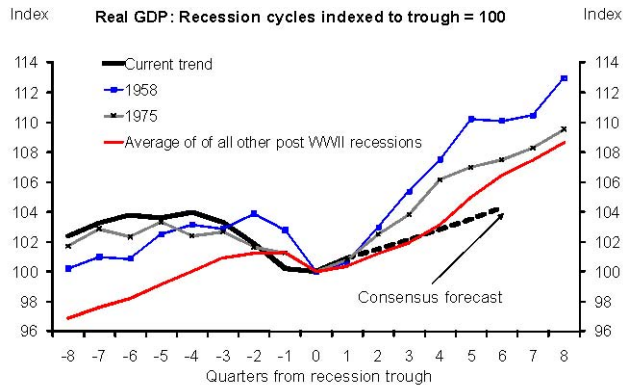
In view of the remarkable rebound from the March 2009 lows, a rise in the S&P 500 of some 66% plus (660 to 1100 at present) without so much as a single intervening pullback of 10%, it is surprising the investing public is so bearish. The most recent AAI (American Association of Independent Investors) poll reflects 35% bullish and 37% bearish. Since this is an honored contrary opinion sentiment reading that normally would reflect twice as many bulls as bears, such numbers are quite bearish and therefore generally predictive of higher markets ahead rather than a serious pullback. This bearishness is confirmed by the continuing net liquidations of equity mutual funds and the large purchases of bonds and historically low-yield fixed income products. We can only conclude that this is a reaction to two bear markets in the past decade that have taken the stock market down 50% each occurrence and left ten- and twenty-year equity returns below or close to bond market returns. We believe these investment actions once again will be proven suboptimal.

We view the dramatic recovery in the equity markets as a response to the "systemic collapse" outcome being taken from the front burner to the back burner. Equity values, whose prices in a good many cases reflected a large element of forced liquidation in the wake of Lehman's collapse, were not trading on accepted metrics of earnings or book values, and have returned to something close to normal.

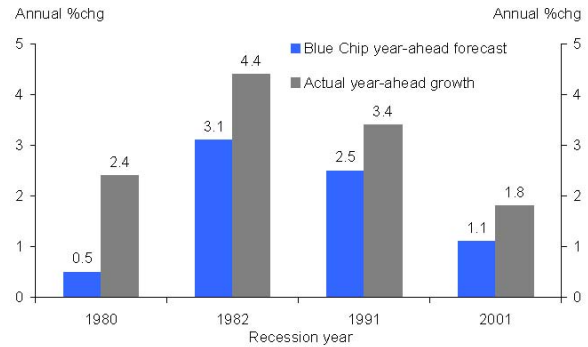
With the return of credit spreads to familiar deltas from the blown-out post-Lehman extremes, equities have responded as theory would suggest...they went up. Deflating credit spreads, a good thing, have a high historical correlation to powerfully rising equity markets. With this factor now largely behind us, the continuing bull market baton must be passed to other factors such

as earnings growth, and to some extent, P/E expansion, for the market to continue to rise.

There is a strong tendency for professional economists to underestimate the power of an economy that is turning the corner to better times, as can be seen here:



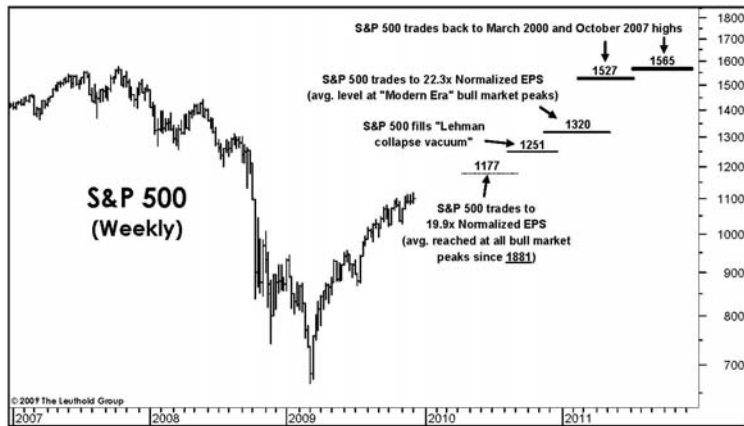
Note: Assumes current U.S. recession trough in 2009Q2  
 Source: BEA, Blue Chip Consensus, DB Global Markets Research



Note: GNP forecast for the 1980, 1982 and 1991 recession, GDP forecast for the 2001 recession.  
 Source: BEA, Blue Chip Consensus, DB Global Markets Research

The 5.7% GDP gain recently reported for Q4, a large number, is dismissed by some as a temporary aberration, particularly in light of the fact that 2.7% of the 5.7% came from inventory rebuilding. However, this is a normal contribution from inventory rebuilds at this point in the economic cycle. We believe the consensus 3.2% GDP gain for 2010 will be proven in retrospect to have been too low. We observe that the powerfully influencing housing and auto industries should be stimulated by these two facts: auto sales rates are below scrap rates, and homebuilding is below the rate of household formations.

We expect the equity market to continue upward but at a more subdued pace than 2009. Since the market appears to be trading at 14.2 times 2010 earnings of \$75 to \$80, there is not much room for P/E expansion between the present and historical P/E's of 15 to 16 times earnings...about 9%. The heavy lifting will have to be done by earnings growth and not P/E growth. Nevertheless, a move toward the \$95 to \$100 earnings level, keeping in mind that in 2007 we attained peak earnings on trailing four quarters of \$92, would add another 25% to valuations. Combined with a 9% contribution from P/E expansion, that would give the market room to advance an additional 34%, say over the next two years, or to 1474 on the S&P 500.



This chart on the left by The Leuthold Group lays it out well (the reference to "normalized" earnings here is taken to mean the average of the past five years of reported earnings).

We also note that historically the equity market trades at 1.5 times sales revenue and is currently trading at 1.2 times sales revenue, suggesting room for upside appreciation of 25% from this factor, absent any inflation in sales revenue in 2010 and 2011. We would judge that some inflation and some population growth would probably add 6% and 4% in 2010 and 2011 respectively to sales revenue, so an additional 10% could be added to the 25% to get to 35%, not dissimilar to the 34% arrived at in the above P/E ratio analysis.

Although there are scary and not-so-predictable macro-economic forces lurking in the wings, we recall what one 80 year-old chief investment officer of a major institution told us in New York recently..."one can purchase a high quality portfolio of mega-cap names yielding 3% and trading at 13 times earnings...I have to think that on a risk adjusted basis that this will be superior in outcome to almost any other investment one can make." We shall see, but we are inclined to agree.

We thank our constituents for their loyalty and tenacity through historic times.

Very truly yours,

Alan T. Beimfohr

John G. Prichard, CFA

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