

# Knightsbridge Asset Management, LLC

March 1st, 2005

## Fourth Quarter Commentary

*"Much of the real world is controlled as much by the "tails" of distributions as by means or averages: by the exceptional, not the mean; by the catastrophe, not the steady drip; by the very rich, not the middle class. We need to free ourselves from "average" thinking."*



Phillip W. Anderson, PhD 1923-  
Physicist and 1977 Nobel Laureate,  
"Some Thoughts About Distribution in  
Economics"

The Economy as an Evolving Complex  
System II, 1997

Professor Anderson, awarded the Nobel Prize in Physics for his work in superconductivity and disordered systems, is clearly a kindred spirit. After all, is not the stock market a "disordered system"? We grudgingly acknowledge that Phil could have a few IQ points on us, a deficit we hope to satisfy with cleverness. He outlines what most of us of long experience have observed; namely, that "average" stock market experiences have little to do with what we are about to experience next. We often read that the stock market is likely to produce 9% to 10% returns to the infinitely patient. Seldom are we reminded that an occasional 35% soon may be the hefty price exacted from us in this process.

Furthermore, since we are presumed to be infinitely patient, presumed to have infinite life spans in which to experience recovery, and presumed to lack all emotional attachment to the surplus created by decades of instant gratification denial, what can the problem possibly be?

Stock market risks and returns are always plucked from Ibbotson databases that go back to 1926. Eighty years of data. If we are to be believers in "mean reversion", then is it in fact safe to presume that the past eighty years is a valid approximation of all investment experiences that one could have? More to the point, have we seen all of the extreme "tails" of distributions, of both euphoria and ennui, of economic contraction and expansion, that we might experience? Or, should we concern ourselves with small probabilities of disruptive events? This reminds us of current theory that dinosaurs disappeared due to "punctuated equilibrium", perhaps a meteor striking earth and throwing up gazillions of tons of particulate matter into the atmosphere creating a nuclear winter? (In such case, what good is money anyway?) But does not the stock market live its own life of "punctuated equilibrium" wherein we call the punctuations "bear markets"?

As portfolio managers we wonder if the past eighty years of data are enough.....are the statistics influenced by the US dollar becoming the world's reserve currency in 1920 and could the Euro supplant the dollar in upcoming years. We wonder if there is an optimal population growth rate that maximizes GDP. What is the likelihood of winning two world wars? Do wars eventually stimulate economies? What if the Middle East becomes the next China? Lacking historical precedent to the contrary, should we assume nuclear weapons technology in the hands of all enemies. Portfolio management requires at least thinking about if not acting upon various ugly scenarios..... punctuated equilibrium..... and what particular confluence of events might enhance probabilities of occurrence. In other words, we are always looking over our shoulder, AND BEARING THE RISK THAT A DISASTER COULD OCCUR, irrespective of the small probability of occurrence at any given point in time! In 1987, the concept of portfolio insurance collapsed and the S&P 500 dropped 40% between August and October. At Knightsbridge, we would call this a "three standard deviation" event.....an infrequent occurrence. Opportunistically, if we had some cash we bought some stock. This was a rare event, but rare does not imply never. Much like the insurance company trying to hang a number on the probability of a giant tsunami occurring, most is

sophisticated guesswork. Clearly the mathematical mean frequency of occurrence is a different number one day before and one day after unless one is dealing with an infinite data set, which we never are. As Professor Anderson reminds, much of outcomes is determined by the rare, the infrequent, the exceptional.

This is also a bit like saying: "What would your portfolio performance have been without your worst performing stock?" We consider this a trivial question. There is always a worst performing stock and always a best performing stock. The statistician's quandary is how to treat "outliers". Outliers are very real, but by definition do not neatly fit into assumed "normal" distributions, the "bell" curve, which in reality may not be normal at all. This is also why predictions of the future are largely extrapolations of present circumstances, lacking a higher probability basis for something far from current experience.

We rarely have anything highly intelligent by way of prediction to say about "the coming year's market" which seems to be almost everyone's favorite question in January. Nevertheless, we are fairly good at assessing potentials for mean reversion. Presumptively, all portfolio managers want to buy "value", the problem being the eye of the beholder. To have a basis for assuming something is of "value", one must necessarily have some idea of others' expectations because this determines the outcome in essentially a "zero sum" (in the short term only) game. One must believe the outcome to be more positive than others currently believe. More to the point, one must judge the probability distribution of outcomes to either have a higher mean, a lower standard deviation, or both, relative to what others believe to be the case. So we are back to probabilities once again.

Our investment goal is really pretty simple.....we want to accrete capital at a rate that is faster than others accrete capital taking similar amounts of risk over time. Part of this entails spending some time trying to figure out what everyone else is doing to make sure we are doing as little of that as possible. We will have our big winners and big losers. We hope more of the former than the latter. When we see a stock where some anomalistic condition has made it cheap or identifies it as being cheap, we may develop an opinion that is wide of current aggregate opinion, but we will spend considerable time making sure we understand the

negative story. Only when our opinion is widely divergent do we have potential for great gain...or loss. This is where our judgment of probability of outcomes comes into play. We ask ourselves the question "What if things revert to normalcy in a few years?", "What would have to occur for that to happen?", "What is the probability of that happening?", and, "What is the resultant return to shareholders under such a scenario?" Short of buying index funds as a passive investor, active management is a process of arbitraging one's opinions against the market's opinion, pure and simple.....or perhaps pure and not so simple.

We write these quarterly letters, fourteen years now, to attempt to highlight what we think are the more extreme aspects of the market environment so that our readership, not all of whom are clients, may ask themselves whether or not they are in any way contributors to these extremes thereby endangering their financial state. Being believers in behavioral finance, we feel that by thinking about extremes.....not the steady drip.....that the appropriate investment tilts will be realized.

So just where are we now? As we enter 2005, we ask what the current extremes are. Let's look at forward P/E's. For starters, the world stock market forward P/E at 15.1 times earnings is the lowest in



fourteen years. The world stock market forward P/E is 16% below its fifteen-year mean of 18.0 times forward earnings. The US stock market is at a P/E of 16.2 on forward earnings versus a fifteen year average of 17.2. Moreover, the Japanese market at 15.9 times forward earnings is the lowest forward P/E ever recorded. These are low multiples, particularly in the context of current interest rates. However, futures market pricing is telling us that short-term interest rates are destined to rise further, and both the low P/E story along side the rates on longer-term treasuries tell us that earnings expectations going forward may not adequately reflect an economic slowdown in 2005. Furthermore, recent oil prices, again above \$50 per barrel, combined with

recessions looming in Japan, Germany and Italy must accentuate this prospect.

**A 17.7x Multiple Seems Reasonable for a 4-5% Interest Rate Environment — Data through 1997**

10-Yr. Yield	LTM P/E				% of Observations
	Average	Median	Percentiles 10th	90th	
<3%	11.9	12.3	9.8	13.3	7%
3-4%	16.3	16.8	12.5	21.3	11%
4-5%	17.8	17.8	16.0	18.9	12%
5-6%	17.6	17.7	16.2	19.1	8%
6-7%	17.7	17.8	15.5	20.8	16%
7-8%	13.5	14.1	8.9	19.2	17%
8-9%	13.1	13.2	8.1	18.1	11%
9-10%	10.7	11.6	7.4	13.0	4%
10-11%	10.2	11.0	7.2	12.8	4%
>11%	9.3	9.1	7.7	11.5	9%

April 1953—December 1997 (monthly data). Source: Standard & Poor's, Federal Reserve, Thomson Financial, Morgan Stanley Research.

It is interesting to observe that when ten-year treasuries yielded between 4% and 5% in the 1953-1997 timeframe, the 10<sup>th</sup> percentile to 90<sup>th</sup> percentile of trailing P/E ratios was 16.0X to 18.9X earnings respectively in the US, currently 17.7x. Therefore, one might calculate that a P/E

expansion is possible from current levels, and, combined with, say, 6% to 7% earnings growth could result in the market going up double digits in 2005. A more pessimistic interpretation still leaves ample room for increases in ten-year treasury yields from the current 4.3% all the way to 5% without damage to P/E's.

The overall judgment that P/E's are low might not be valid if earnings growth of 6% to 7% were not possible. Such was the expectation in the late 1940's. Earnings growth was assumed to be non-existent, and investors felt stocks needed to compete with bonds solely on the basis of yield alone. In fact, the thinking was that a dividend paying stock needed to yield more than, say, the bonds of the same company because the dividend was junior to a bond coupon. Lending some

Global ex Japan Free Cash Flow/Dividend Cover Ratio (Non-Financials) and Forward Dividend Growth

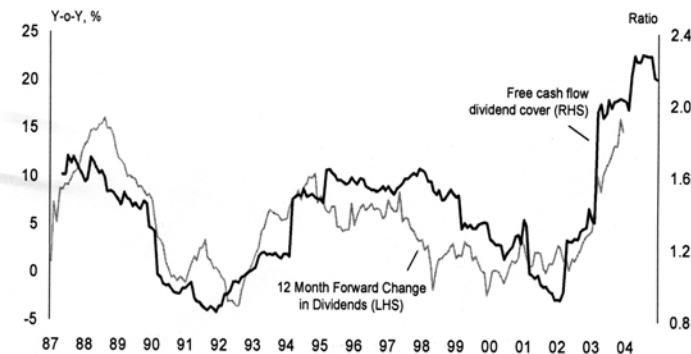


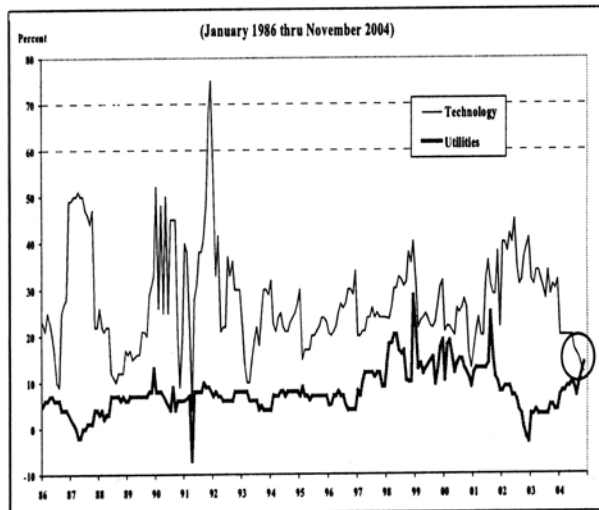
Chart shows the level of free cash flow dividend cover (using last available accounts at each point in time) and the 12 month forward growth rate in dividends. Free cash flow is defined as cash flow from operations less capex. Universe is the FTSE World index  
Source: Lehman Brothers Equity Strategy, WorldScope, Datastream, FTSE

credence to this line of thinking is the high level of cash on balance sheets, high free cash flows, and the high rate at which dividends are being increased as seen here.

This phenomenon gets generally positive treatment in the business press, with such activity currently stimulated by low tax rates of

15% on dividend income. However, there is a darker side to this which is that higher dividend payout rates may be signaling that 1) inadequate corporate reinvestment opportunities are available, and 2) reduced balance sheet leverage resulting from high free cash flows will mean lower earnings growth rates going forward, other factors equal. This is precisely the worry for Microsoft shareholders, despite or possibly because of, paying the largest dividend of any company in modern history. In fact, we ask the question: just as there has been a shortage of yield available at acceptable risk, could there now be a shortage of earnings growth available? Supportive of this notion is the observation that earnings growth for technology stocks has fallen to a level equal to that of utility stocks!

### S&P 500 Technology vs Utilities: Forecasted Next Year EPS Growth



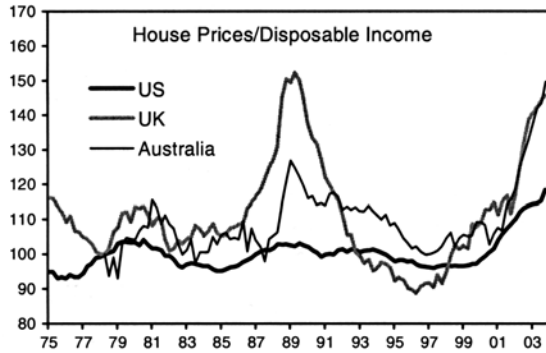
Source: Merrill Lynch Quantitative Strategy, Merrill Lynch Fundamental Equity Research, Thomson Financial

These twin realities along with higher inflation numbers flowing through the economic pipeline may be painting the new economic picture.....they used to call it "stagflation".

The evidence that higher rates of inflation are upon us is abundant. To make a very long story short, evidence suggests that the dollar denominated price of gold is a very strong predictor of increases in inflation with very high positive correlation. This

would suggest that we would start to feel the affects of the increase in the price of gold over the past two years both last year in the CPI and this year as well. That seems to be playing out exactly as theory predicts, and as we have said before, we expect to see 3% inflation in the near future. Although a case cannot be made for stocks being hugely cheap, the fact remains that financial assets, relative to real estate assets, are less popular as seen in the following charts:

**Housing Looks Expensive in Major Economies**

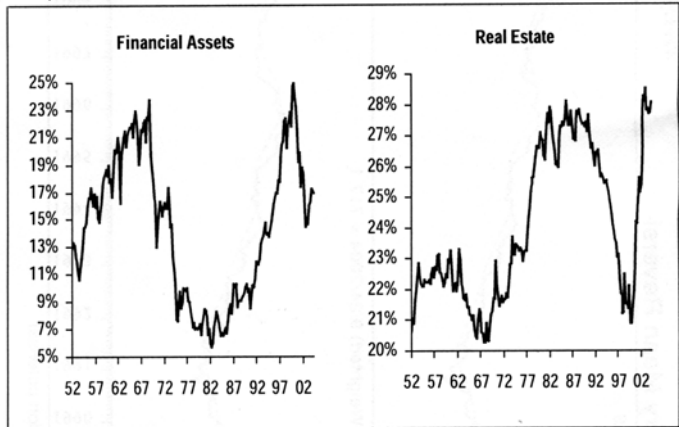


Goldman Sachs Investment Research

Since we believe that investment success stems from avoidance of the most popular, these charts speak for themselves. In conclusion, we believe the equity market is positioned to deliver "average" results, which incorporates a slowing of the world economy, somewhat higher inflation and rising short-term interest rates.

Nevertheless, like Phillip Anderson, we suspect that the 2005 experience, could surprise, as it did in 2004, by delivering something other than the "steady drip".

**Household Financial and Real Estate Assets Soar**  
(as a percent of Total Household Assets)



Source: Federal Reserve Board, Merrill Lynch

Very truly yours,

Alan T. Beimfohr

John G. Prichard, CFA