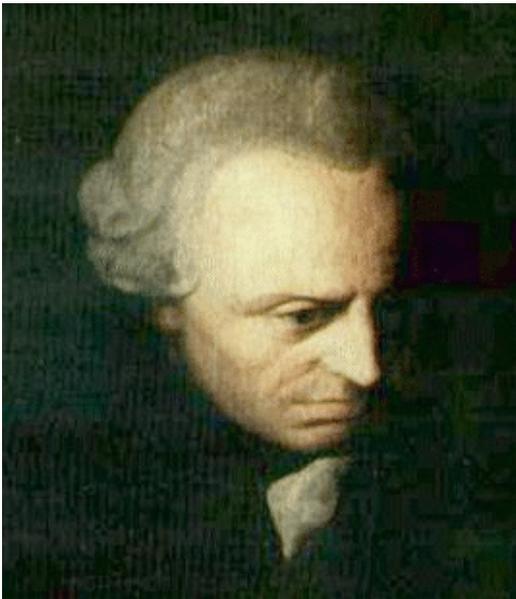


Knightsbridge Asset Management, LLC

November 1, 2007

Third Quarter Commentary



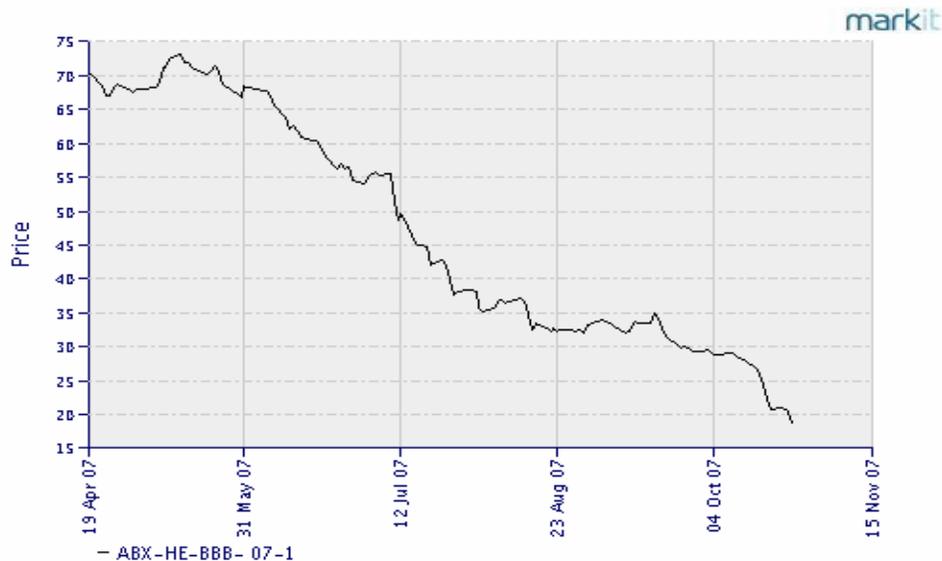
"Aus so krummern Holze, als woraus der Mensch gemacht ist, kann nichts ganz gerades gezimmert werden"

Translation:

"Out of the crooked timber of humanity no straight thing can ever be made"

- Immanuel Kant, 1724 - 1804
- German philosopher, essayist, anthropologist, astronomer
- Idea for a Universal History with a Cosmopolitan Purpose 1784
- Königsberg, East Prussia

Home to the Teutonic Knights of the Middle Ages, Königsberg, East Prussia (Germany) no longer exists as such. Could it be that BBB rated sub-prime mortgage paper and SIVs (Specialized Investment Vehicles) are destined for extinction as well? We observe that BBB rated sub-prime mortgage paper was accorded "crisis" status when it first traded off from par (100) to about the 70 level. It has since traded down to new lows just this past week at prices around 20. Clearly this crisis is not completely over, and it is becoming obvious that institutional holders of this paper will be taking writedowns (read losses) on almost all of the value of this paper. Bonds trading at 20 simply do not recover to par, ever.



Subsumed into Stalin's Russia in 1945, Königsberg now exists as a stranded exclave, a discontinuous piece of Russia southwest of the Baltic nations of Estonia, Latvia and Lithuania, renamed Kaliningrad Oblast. The 300,000 Germans living there before WWII



were down to 50,000 at war's end. Historical accounts state that all German women were systematically raped by the Red Army starting in 1945, and any Germans left by 1949 were forcibly exiled. As to the fate of those exiled Germans, well, the gulags do not easily give up their secrets, but we can guess. Today the population is 78% Russian, with Russian the official language. In place of the war ravaged Königsberg Castle is a large glass office building deliberately erected by the Russians at this site to prevent the Castle's reconstruction. A

significant part of the Soviet fleet was moved from St. Petersburg to Kaliningrad, with this real estate declared off limits to foreign visitors.

In my distant memory I remember reading that all financial systems were unstable. Subsequent history has not disappointed. Examples of financial instability we all remember: President Nixon "closing the gold window", runaway inflation in the late 70's, savings & loan meltdowns of the early 80's, stock market crash of '87 and collapse of portfolio insurance, Mexican peso devaluation of '94, southeast Asian currency crises of '97, collapse of Long Term Capital Management in '98 along with the Russian ruble default to name but a few. Now we have the sub-prime mortgage crisis, yet to be resolved, followed by the SIV or asset-backed commercial paper crisis, these latter structured investment vehicles having been created by banks off-balance sheet.

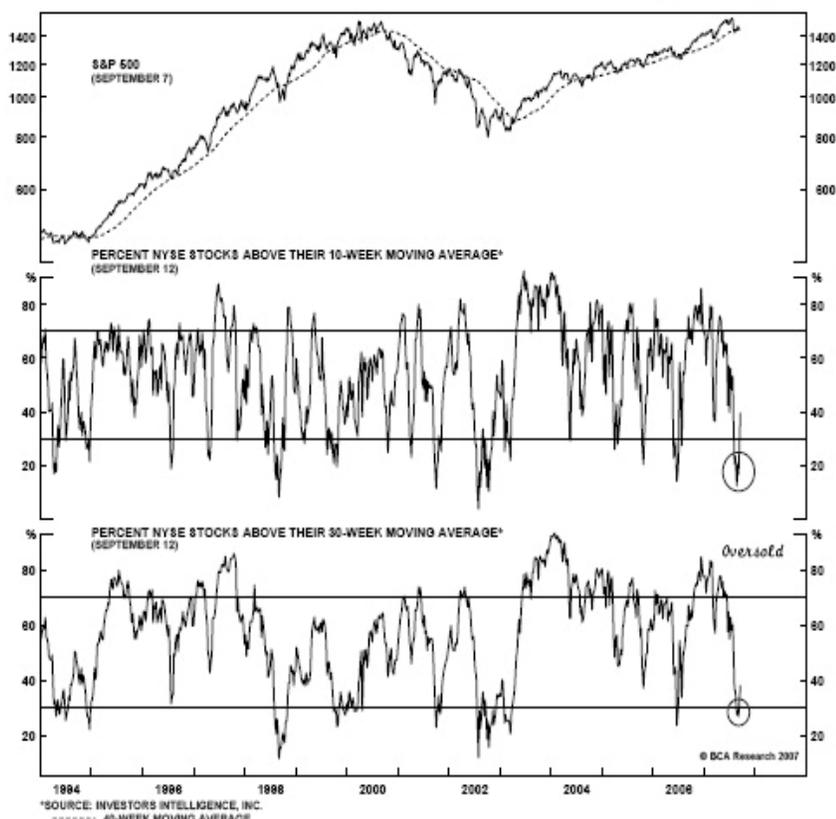
Just what is this all about? Well, among other things, this is about the quality of collateral and the fact that all collateral is not equal under differing conditions of stress. Collateral is only good so long as everybody is not trying to liquidate it at the same time, popularly known as a "fire sale". Therefore, since the banking system is run using primarily real estate as loan collateral, price declines can be tolerated to only a limited extent before serious damage is done to confidence in the entire banking system. The silver lining in this cloud is that the Federal Reserve will act predictably to restore the integrity of banking system collateral at all costs if need be. It is of little use to be able to declare victory over inflation, and Pyrrhic it would be, if the price be wholesale foreclosures and fire sale prices of housing collateral across the board. Since housing is relatively unaffordable at current prices and interest rates, rest assured the Fed will be trying to make the unaffordable affordable by lowering short term interest rates. If push comes to shove, this will be done without regard to the value of the dollar in world markets and/or inflationary considerations. Hence, the outsized 50 basis point (0.5%) cuts September 18th in both the Fed Funds Target Rate and the Federal Reserve Discount Rate to 4.75% and 5.25% respectively. We expect more.

Financial systems are part of the "crooked timber of humanity from which no straight thing can ever be made". Crises in general and financial crises in particular provide the necessary political context for important change. Few have any vested interest in systemic collapse, so that whatever band-aids, fixes or solutions might be implemented are often only able to be implemented in a crisis environment. Only in the crisis environment can the competing factions be compelled to relinquish some degree of self interest for the common good. Such pulling together is now being attempted in the creation of a \$100 billion facility to bail out the SIV (structured investment vehicle) problem, proposed by former Goldman Sachs CEO and now Treasury Secretary Henry "Hank" Paulson. With a mixed reception so far, we will see if other fixes are proposed to prevent the wholesale liquidation of collateral at fire sale prices.

Following liquidity injections designed to prevent the sub-prime mortgage crisis from spreading, the stock market made important lows August 16th as seen in the following chart. The percentage of NYSE stocks above their 30-week moving average fell to below 30%, a condition seen only once since March 2003: the end of the last bear market.

Moreover, on that same day, over 1000 U.S. stocks recorded 52-week lows while only ten stocks hit new highs. From these lows a swift rally ensued taking some market averages to new all-time highs. As it became clear last week the credit crunch was alive and well, the Dow Jones Industrial Average dropped 370 points on October 19th amid multi-billion dollar bank earnings write-offs, and a perverse celebration of the 20th anniversary of the October 1987 crash.

NYSE Stocks Above Their 10- & 30-Week Moving Averages



This latest downward swoon is associated with:

- 1) lower than expected third quarter earnings,
- 2) spreading of the sub-prime crunch to SIVs,
- 3) talk of increased probabilities of recession,
- 4) need for further bank write-offs,
- 5) a worrisome decline in the dollar, now \$1.43 per euro, and
- 6) \$90 oil.



Amid this significant list of negatives we observe that the stock market has managed to hold positive ground year-to-date. Therefore, we think the most probable course for the equity markets is a successful test of the August lows followed by a challenge of the market highs. We believe market highs will be fueled by excess liquidity and money growth.



Although investors have been rattled by the increase in volatility and headlines in the popular business press, as seen here, we note such headlines do not generally occur at market tops or even close to market tops.



We note that all important market bottoms have been characterized this way, and take this as a contrarian and bullish sign as the market appears to be prepared to climb the proverbial "wall of worry". We must say we are impressed with the performance of equities in the face of the recent negative headlines. That the stock market was able to digest this first bout of negativity and move generally higher is an important clue that should not be ignored. Although we all would prefer stability and predictability, we acknowledge our reality that "from the crooked timber of humanity no straight thing can ever be made".

Among other things, Immanuel Kant argued that reasoning is too limited to know anything beyond human experience. It would then follow that "human reasoning" cannot conceive of any "straight thing". In short, Kant would postulate that the stock market, a creation of human reasoning, must therefore only reflect human experience. Since that experience operates on "fear and greed", we deduce that success must hinge in some meaningful way upon "buying fear" and "selling greed" in one form or another, and therefore investors are well advised to try to keep the emotional content of decision making at a minimum, difficult in the current environment.

We thank our investors for maintaining an even keel during the recent turmoil.

Very truly yours,

Alan T. Beimfohr

John G. Prichard, CFA

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