Knightsbridge Asset Management
division of Canterbury Capital Services, Inc.

April 17, 1995

FIRST QUARTER COMMENTARY

> "In the absence of objective truth, erroneous beliefs may have an astonishing power to survive in defiance of experience, and without the aid of conspiracy."
>
> Karl Raimund Popper, 1902-
> Austrian Philosopher, Professor
> London School of Economics, 1949-1969
> "Objective Knowledge" - 1972

In love with the prospect of the Fed having engineered a "soft landing", the market may be demonstrating the phenomenon so eloquently described by Dr. Popper. Experience offers us little hope that the Fed will have in fact delivered the "soft landing", once sufficient retrospective evidence can be observed. The Fed's last effort at a "soft landing" was from Q1-1989 thru Q2-1990 resulting in recession of 1991… in short, a failure. Fed chairmen dream of "soft landings". Greenspan predecessors Volker, Miller, and Burns all tried their best… to no avail. Therefore, one should view with skepticism *fait accompli*. Moreover, to the extent that the market accepts this as certainty, the higher the risks. The expected Fed response to the assumed slowing economic growth is that interest rate hikes are a relic of the past year. If, in fact, the lowering of long term interest rates over the past six (6) months, causes a reinvigorating of the economy, then the Fed may need to begin raising short term rates more vigorously, this time from a higher threshold.

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Certainly the dramatic slide of the dollar against the Yen…down 17% in three (3) months… may argue that the only tool left in the Fed toolbox… given that the U.S. Senate refused to pass the balanced budget amendment… is higher, not lower, interest rates. Recent intervention by the Bank of Japan, the Fed and the Bundesbank to shore up the dollar cannot hold sway over international opinion that the U.S. does not yet possess the political willpower to fiscally discipline itself.

Former Fed governor Wayne Angell writes:

> "The Fed will most likely want to see at least the key March economic data… before raising rates again… we continue to expect the Fed to hike funds rate by ½ percent at some point between mid-April and the May 23 FOMC (Federal Open Market Committee) meeting. By missing the opportunity to raise rates on March 28th, the Fed once again demonstrates its unwillingness to err on the side of restraint. We believe the Fed continues to err on the side of ease, as apparently do the foreign markets".

To repeat what we have said before, we expect 3 month T-bill rates to meet or exceed 30 year treasury bond rates… currently 5.6% and 7.4% respectively…before Fed tightening is complete (see chart #1).

One of the impacts of a falling dollar on the stock market is that it causes upward revisions of earnings' estimates for companies whose business has a significant export component. Since the vast majority of domestically domiciled exporting companies are large S&P 500 companies… exports are over 50% for Exxon, Mobil, Motorola, Gillette, Coca-Cola, DuPont, IBM, Boeing, Hewlett-Packard, Procter & Gamble, Phillip Morris, and Alcoa… these events have been stimulative to their dollar denominated earnings prospects. This may be why the S&P 500 (which is capitalization weighted, with the top 100 of the 500 accounting for 63% of the total) was up 9% in the first quarter versus only 4% for the broader based averages like the Russell 2000. In fact the disparity has become extreme (see chart #2). Since the momentum of dollar decline must abate… that is to say if it lost 17% in Q1, then with six (6) more quarters at this rate, it will be below zero!... so also must the earnings momentum of large multinationals abate. In short, we've probably about to see the best earnings momentum from

the large cap multinationals. At the same time, oil has broken $19.00 per barrel on the upside and gold poked its head briefly above $400 per ounce. And hardly anybody noticed! Many seem convinced inflation cannot be, and is not, a problem. In fact, inflation may be a bigger concern in the next year or two. The "Bank Credit Analyst" leading inflation index leads the consumer price index by about two (2) years. It is telling a less than optimistic story (see chart #3)… as also are industrial commodity prices and manufacturing capacity utilization. Yet inflation in the services sectors remain muted (see chart #4).

Clearly one of the major positive underpinnings for the stock market is lack of supply. As corporations repurchase shares, new issuances have failed to keep pace (see chart #5). This is a major plus. A net $600 billion has been repurchased since 1984. The value of the S&P 500 is $3600 billion. And the total inflow into international and global mutual funds in 1993 and 1994 was $80 billion (see chart #6), small in comparison. Much has been said about the decimation of capital that chased the emerging markets boom. Recently it has been suggested that a repatriation of this capital to the domestic stock market would provide significant stimulus. Although qualitatively a plus, it is not a large factor as can be seen from the numbers above.

Some have been hopeful that the current Congress might see its way clear to pass a cut in the capital gains tax rate. Although still a possibility, the 100 day "Contract with America" has yet to be modified by the more liberal Senate, who in their new-found religion, are mouthing concerns over the self created budget deficit and its conflict with tax reduction. If a cut is enacted, this would be a stimulative for smaller stocks (see chart #7). There is a clear correlation between performance in the non-institutionalized sector, (i.e., small stocks) and capital gain tax rates. Simply stated, lower tax rates make them more attractive to own since the institutionalized sector is managing mostly tax-exempt capital.

Our most recent portfolio addition is Times Mirror. The investment thesis is simple… although the details complex. We expect $4.40 in cash flow per share in 1995. At a price of 4.3x cash flow, this is truly cheap. This cheapness arises from the completed sale of cable operations to Cox Communications for $2.3 billion, some of which was used to reduce debt (to practically nothing) and some to a Cox equity carve-out which was completed just prior to our purchase. Concomitant twith this restructuring was a dividend reduction from $1.08 to $.24 annually. All other newspaper/media companies sell at 7.5x to 10.0x cash flow in the current market. Those multiples are depressed from the more normal 10.0x to 12.5x multiples normally seen for the likes of Tribune, Pulitzer, Gannett, New York Times, Washington Post, Lee, McClatchy, Scripps, etc. Although the negatives of major metropolitan newspaper companies are well publicized…..declining literacy, migration of ad revenues to other media, dramatically rising newsprint costs, etc.,the positives are ignored. Major metropolitan papers are close to a natural monopoly…..lack of competition never hurts profit margins. Moreover, in the case of Times Mirror ex-cable, 45% of cash flow comes from database, professional book, text-book, and magazine publishing. Furthermore, there is none of the financial leverage normally associated with low cash flow multiples…..only operating leverage…..and leverage to a potentially improving southern California economy to boot. To protect the total value of our investment here, we were behooved to tender our common stock for a PERC (preferred redemption equity class)…..think of it as convertible preferred stock with a conversion ceiling…..which we will sell at some point soon to repurchase more common stock. Times Mirror should eventually be a big winner.

A word also on RJR Nabisco. Kohlberg, Kravis, Roberts..who did the original 1989 leveraged buyout..are now completely out of the stock. A $1.50 dividend per share haas been declared simultaneous with a 5 for 1 reverse stock split. This should be positive for RJR Nabisco once the reverse split shuffle is out of the way. If you had 1000 shares now you will have 200 shares, but it will be $30 per share instead of $6 per share.

We underperformed the markets in the first quarter. Caution was not rewarded. But valuations remain generally stretched particularly among the big-cap stocks for reasons alluded to earlier. The S&P 500 dividend yield of 2.7% is

at an extreme low (see chart #8). How extreme? Only 3 calendar quarters out of the past 277 calendar quarters have had a yield this low. That's 70 years of history. Now is no time for bravery. The market seems to be discounting all of the positives with little attention paid to potential negatives. Difficulty is, these conditions can persist, absent catalysts to alter perceptions. Which brings us back to Professor Popper's observations regarding "objective truth".

We thank you for your patience and goodwill, and for the referrals many of you have sent our way. Rest assured will be trying our level best.

Best regards,

Alan T. Beimfohr

Chart # 1

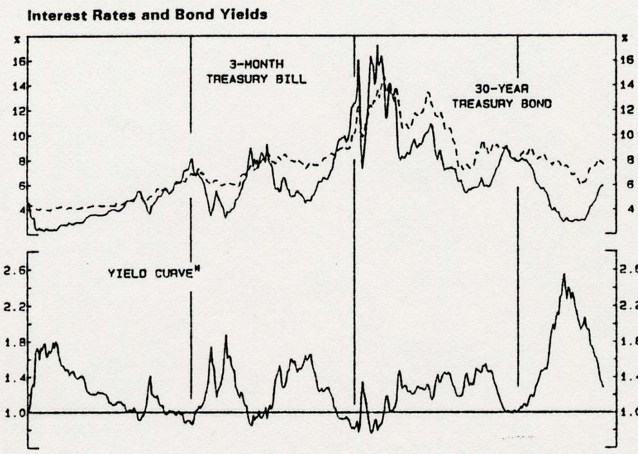


Chart #2

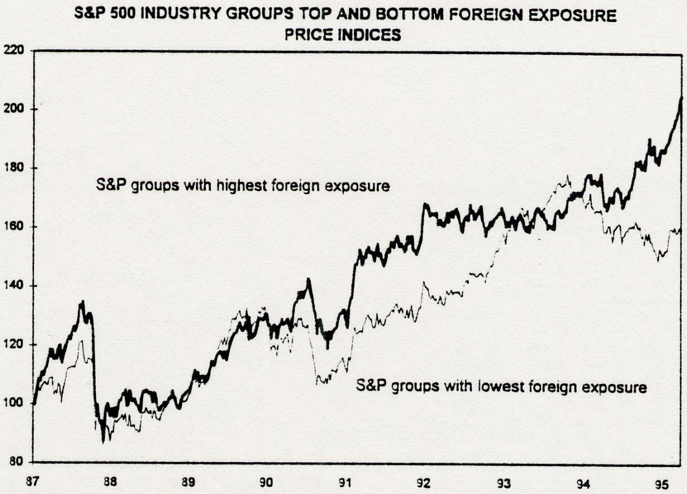


Chart # 3

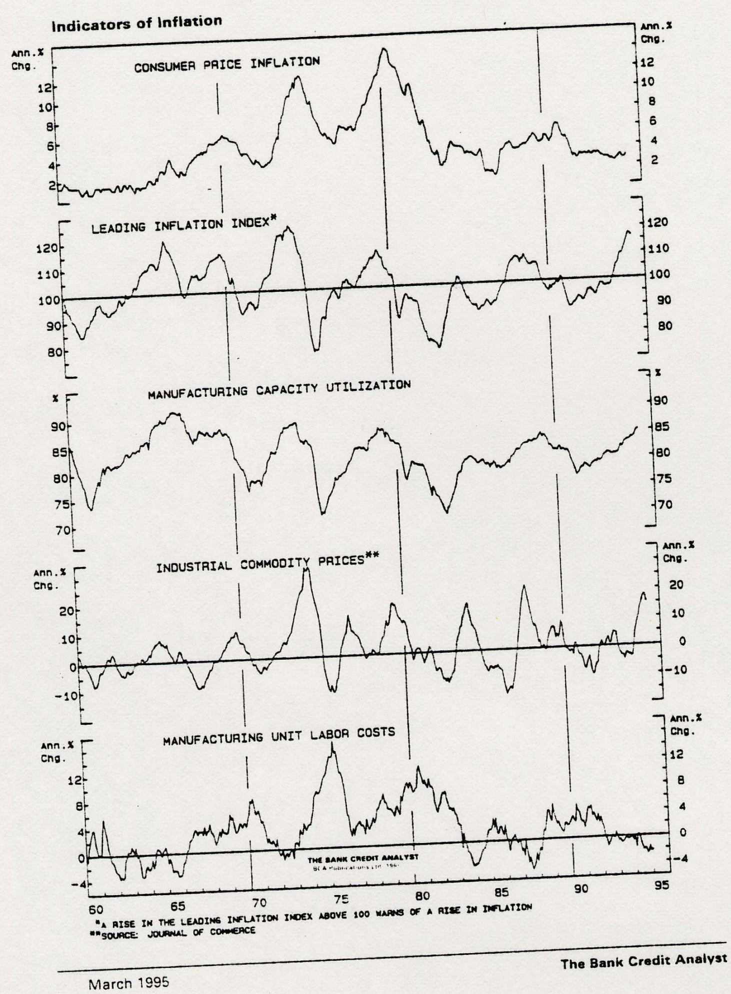


Chart # 4

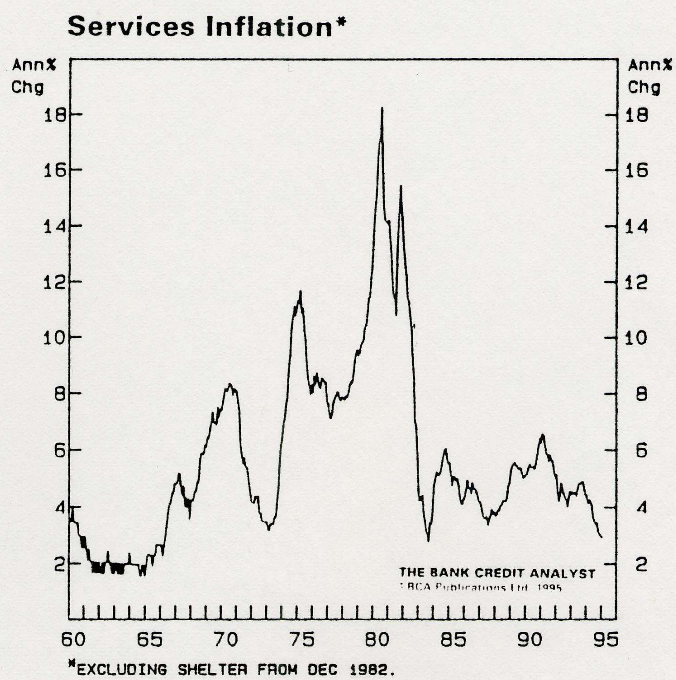
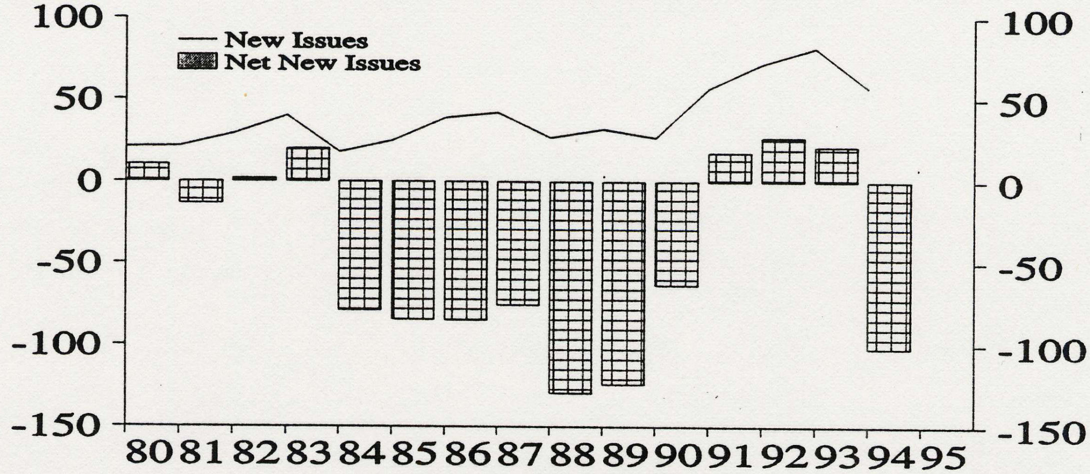


Chart # 5

Estimates of Net Equity Issues of Nonfinancial Corporations

Billions of Dollars - Annual Rates



Source: Federal Reserve

Chart # 6

INTERNATIONAL FUNDS

1985 - PRESENT

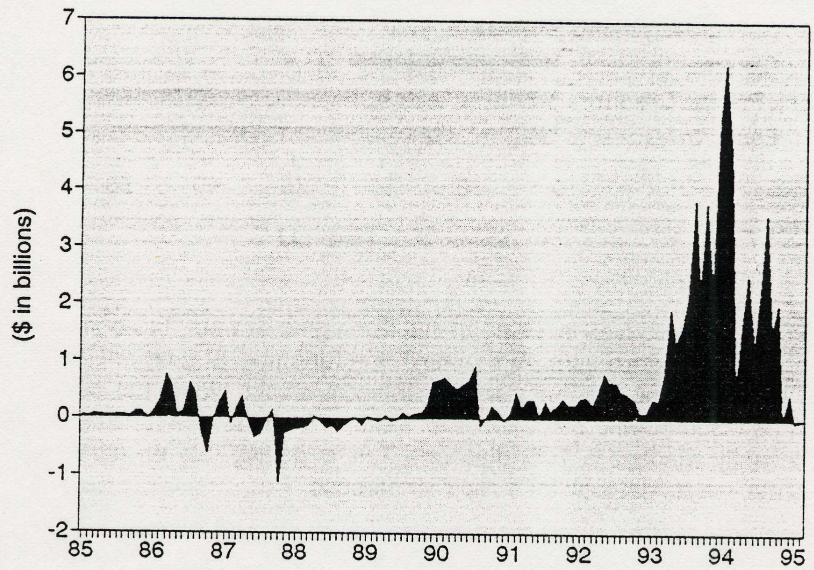
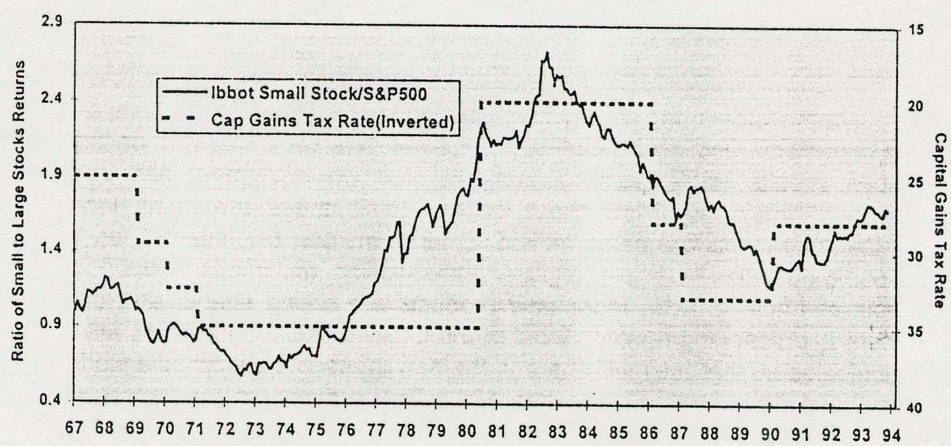


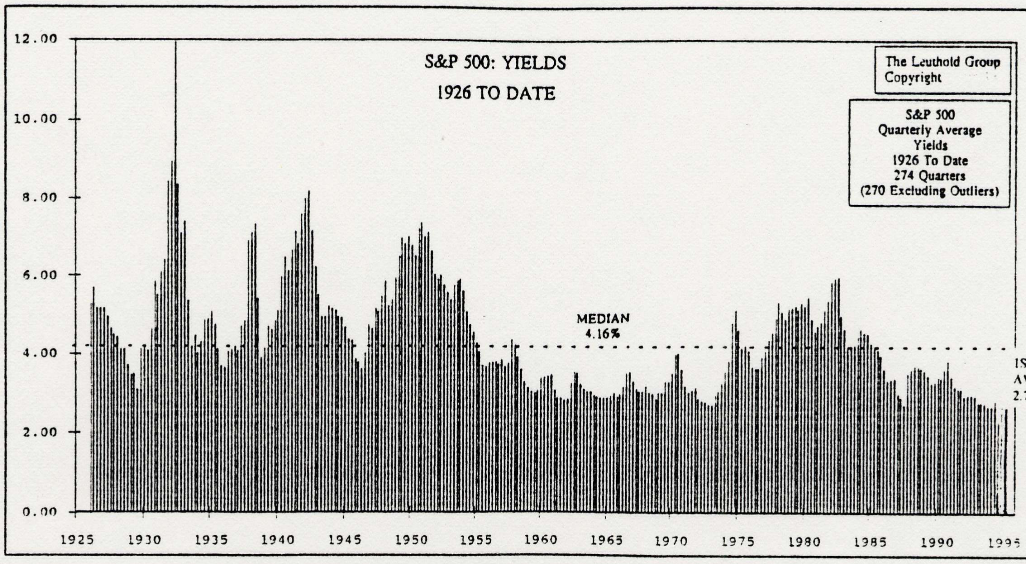
Chart # 7

Capital Gains & Small Stocks

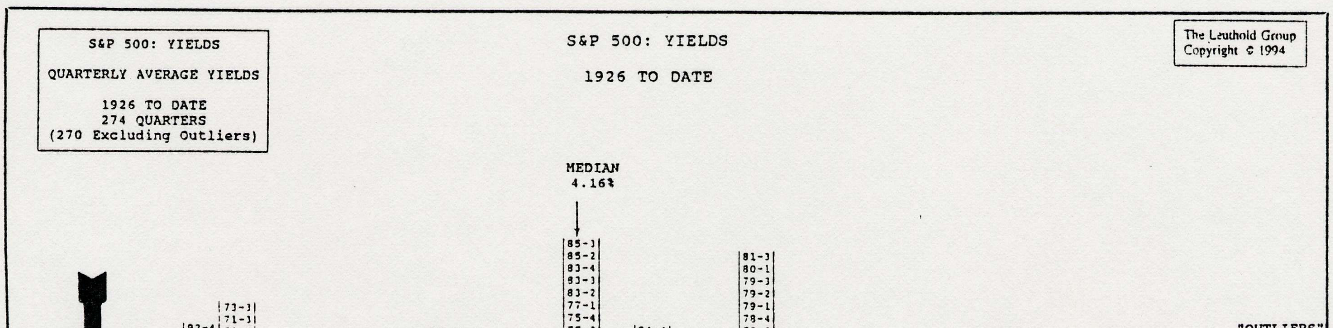


Source: ML Quantitative Analysis, ML Economics, Amer. Council for Capital Formation

Chart # 8



- While the histograms are quite good for comparing today's levels with historical readings, a chronological chart makes it easier to see the various trends which have developed over time. Thus, they become a very useful supplement to the histograms.
- The median S&P 500 yield, 1926 to date, has been 4.16%. As is clearly depicted on this chart, the current quarterly average of 2.87% is one of the lowest average yield over the entire history presented above. Using the yield as a valuation tool, it is clear that the market has not been "cheap" since 1985.
- This chronological chart of the S&P 500 yield is relatively new. We think it portrays a good long term picture of stock market valuation. In the near future we hope to provide more of these chronological charts within our Benchmarks publication. Until then if clients would like a chronological chart of a particular series please feel free to call us.



- Today's 2.84% indicated yield currently ranks in the 97th percentile of this 68 year study which tracks the S&P 500 yields. We therefore conclude that stocks are now radically overvalued based on this past history.
- The current 2.84% yield, calculated for the S&P 500, is based on the current indicated next 12 month dividend rate of $12.90 as published in Barron's.
- The high yields in the early 1930s noted on the histogram are misleading and prevailed only momentarily, as dividends were cut sharply during the Depression. These outliers have been excluded from the decile distribution and the calculations of the median and average. At the other end, the extreme low yields of 1972 were the product of nifty fifty frenzy. Yields fell below even that extreme in 1987, but the fourth quarter of 1993 and the first quarter of 1994 have recorded new record low yields.
- Historically, stock yield comparisons with short term fixed income yields (treasury bills and commercial paper) have not been a particularly good valuation benchmark. While this comparison did prove to be helpful in the 1967-1982 period, the longer term record is poor.
- Today's low stock yields are of greater concern when compared with today's high bond yields. Quality corporate bonds now yield 2.9 times the S&P 500, with T-bonds yielding 2.7 times as much.
- Note that on the decile distributions, we consider stocks to be overvalued in only the ninth and tenth deciles. Stocks are viewed as cheap in the first three deciles.

Decile Distribution
(excludes outliers)

	First Decile	6.10 and above	Stocks Cheap
	Second Decile	5.37% to 6.10%	
	Third Decile	4.99% to 5.37%	
	Fourth Decile	4.60% to 4.99%	
	Fifth Decile	4.16% to 4.60%	
	Sixth Decile	3.77% to 4.16%	
	Seventh Decile	3.54% to 3.77%	
	Eighth Decile	3.19% to 3.54%	
	Ninth Decile	3.00% to 3.19%	Stocks Expensive
NOW →	Tenth Decile	Below 3.00%	

Median: 4.16%
Average: 4.41%

High Quartile: 5.19% and above
Low Quartile: 3.35% and below

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