Knightsbridge Asset Management

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FIRST QUARTER COMMENTARY

"Perplexity is the beginning of knowledge"
-Kahlil Gibran, 1883-1931
Lebanese poet and novelist
The Voice of the Master

February marked the beginning of the market decline that has perplexed many neophyte investors. At this writing the popular averages are off 10% from their peaks, the first such decline in six (6) years. Moreover, the NASDAQ Composite is off almost eighteen (18) percent, peak to trough, all in three (3) months time. Wasn't this supposed to be the Goldilocks; economy where everything was "just right, neither too9 hot nor too cold"? Turns out the economic porridge may have been a bit too hot with GDP growth pushing 3.8% the past two (2) quarters and just released "core rate" of inflation (excluding the mercurial food and energy components) for the March Producers Price Index at 0.4%! Neither bond not stock markets were prepared for this jolt as investors had become complacent and too wedded to the notion that the benign market conditions of the recent past would continue indefinitely. Such unbridled optimism has seldom been justified by any even-handed reading of economic history. It has been for this reason and others that we have been unwilling to be fully invested the past year. If nothing else, probabilities alone dictated that this market was due for correction. The recent one-quarter percent up-tick in the

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Federal Reserve Discount Rate ordered by Greenspan is likely to be soon followed by more of the same. Seldom in economic history has there been just a single such raise. In fact, in the past twenty-five (25) years, there have been eighteen (18) episodes where the Fed initiated tightening. Only four (4) cases where a single isolated tightening. Those cases were during periods of high inflation. Moreover, on average, the second tightening occurred only thirty nine (39) days later. Since March 25th was the FOMC's decision day, we might logically expect the next tightening around May 1st. However, this expectation is now well discounted by U.S. investment managers. Although a quarter percent was not much, it was boning about "irrational exuberance" was unfortunately incapable of achieving.

It is worth observing that the bidding-up of the large cap growth stocks… particularly the ones with international visibility… whose weighting in the S&P 500 to the NYSE Composite shows that the more representative NYSE Composite, has performed in a less spectacular manner. The ration of the S&P 500 to the NYSE Composite is at a twenty-five (25) year high… which those of you with long memories will remember as the days of the "Nifty 50". In 1972-1973 the extant group-think was growth stocks needed only be bought and never sold as superior earnings growth would bail one out of a badly timed purchase. The term "one decision stocks" crept into the market lexicon. Sadly, this then-new concept was laid to rest in the ensuing eighteen (18) months, as 1974 witnessed a chapter of market history that ended the worst bear market since the depression market of 1929-1932. So much for new concepts. Of course, the majority of today's market participants barely even remember 1987 much less 1974! It seems each age must witness its own set of perplexities before knowledge is attained. And after that knowledge is absorbed, one doesn't get to use it for another twenty-five years! Some system!

The facts seem to be that domestic economic strength is picking up steam. GDP growth, which ran 3.2% over four (4) quarters of 1996, ended 1996 at 3.8%. Although Q1 1997 has yet to be reported, it too is expected to be strong. Factory capacity utilization for March was just reported higher. And most surprising of all, this has been in the face of a relentlessly rising dollar which should be taking a toll on U.S. exports, weakening the domestic economy. Therefore, in addition to probabilistic reasons for further rate hikes we find fundamental reasons as well.

Since the consensus of bullish investment advisors has fallen from 83% to 27%, one must now expect the market to have temporarily bottomed. However, enough subsurface damage has been sustained to cause one to maintain caution. Fundamental valuations are still high. For example, the ration of stock price to sales revenue per share is at fifty (50) year high.

If we look at the ownership of stocks by individuals and include their retirement plan assets, we see the percentage of stocks in the net worth mix is up to 35.3%, challenging the 1968 high.

Clearly Wall Street has returned to Main Street with vengeance. Moreover, we must be prepared to live in this brave new world, however irrational it may appear. But risk assessment is one area where we separate ourselves from the crowd. We are indebted to Bob Farrell of Merrill Lynch Research for the following observations:

1. Not only has the public invested in equity mutual funds on a scale never seen before (90% of all money in equity mutual funds was invested in the last five years), last year the largest inflow (46%) was into the most speculative category of aggressive growth funds.

2. In 1996, equities in 401K plans rose to a new high of 62% (one-third in employer’s stock) versus 55% a year earlier. Conservative G.I.C. holdings dropped from 28.6% to 20.5%.

3. Assets in index funds, most of which offer no protection in a down market, reached $82 billion last year, up 58% from the previous year. Index fund purchases have accelerated further in 1997.

4. When asked in a recent survey what assets allocation change they would make if a bear market arrived, only 11% of institutional investors said they would reduce equity exposure.

5. The most popular bond funds in 1996 where the riskier high yield or junk bond funds even though the spread between "junk" yields and Treasuries reached a low for many years.

6. Leveraged purchases of securities were up $20 billion in 1996 to a record $97 billion (including a $6 billion rise in December alone).

7. Equity mutual funds hold the least cash (5.5%) in 20 years.

8. Corporations are buying back their shares at a record pace at constantly higher prices.

9. A recent survey of individual investors showed the majority expect rates of return in the next ten years to match the unusually high 14-15% of the last ten years.

We have an old axiom, i.e.., "Where the most money goes, the risks go up and the returns go down." Based on recent stock market performance and popularity of equities, it would appear this axiom is destined for the dust bin. What strikes us, however, is how risk is being disregarded. When markets go up long enough, investors tend to forget that Wall Street is one way only if you are driving a car.

The only people worried are those who have been worried too long. For example, James Grant has written an excellent but somewhat bearish book about cycles entitled, "The Trouble With Prosperity", that has not become a best seller. In fact, so far it has been limited to a printing of less then 15,000 copies. Contrast this with Paul Erdman's, "Crash of 1979", and Ravi Bart's, "The Great Depression of 1990", which were both best sellers when the public was concerned about risk.

We have made statements about strategy in the past year or more that have highlighted the importance of preservation of capital when rate of return are running far above normal and valuations are setting new benchmark historic highs. In a liquidity-driven bull market, any cautionary strategy, however, runs into a credibility problem with investors who view conservative policies as costly since rising prices convince them that "you cannot win if you are not in". The main risk that investors worry about today is not owning common stocks and missing out on the party.

We continue our caution and thank you for your understanding.

Very truly yours,

Alan T. Beimfohr