Knightsbridge Asset Management, LLC

April 1, 2000

FIRST QUARTER COMMENTARY

"Everything in the world may be endured except continual prosperity"

Johann Wolfgang von Goethe
1749-1832
German writer, poet, dramatist,
and scientist

It would appear we are to test von Goethe's maxim with the current economic expansion the longest in 100 years. Continuing prosperity if not continual prosperity, has given rise to the now notorious "wealth effect". GDP (gross domestic product) growth rates are exceeding those deemed sustainable over the long term. Fourth quarter GDP rose at an astronomic 7.3% rate followed by 5.4% in the first quarter. The "wealth effect" combined with high GDP growth rates make for a potentially potent inflationary cocktail. Labor costs have charged ahead with first quarter's Employment Cost Index rising 1.4%, well above the expected 1.0% and the strongest advance in 11 years. In fact, William Poole, President of the St. Louis Fed cautioned last week "If inflation gets way from the Fed to any significant degree in the years ahead, then the dangers of recession will surely rise." We would change this statement in only one respect, replacing "years" with "months". In anticipation the Fed has raised rates five (5) times in succession producing an inverted yield curve, i.e. short-term interest rates higher than long term interest rates. In past years an inverted yield curve almost always produced… forgive us for dwelling on the "r" word… recession.

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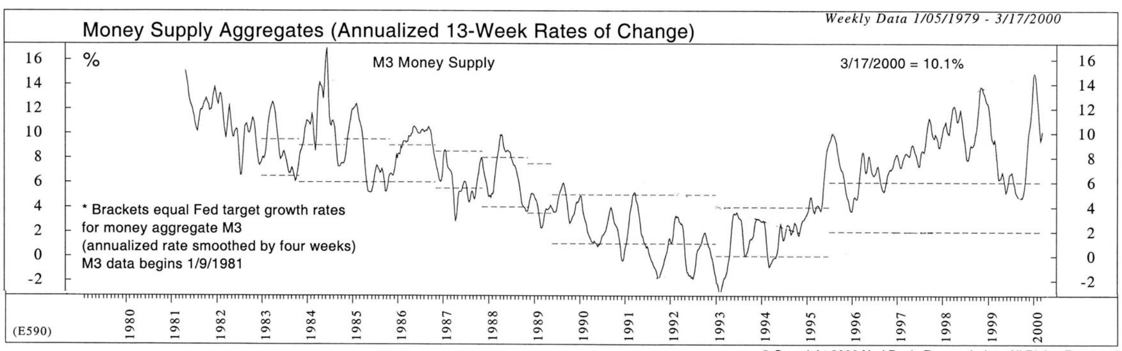
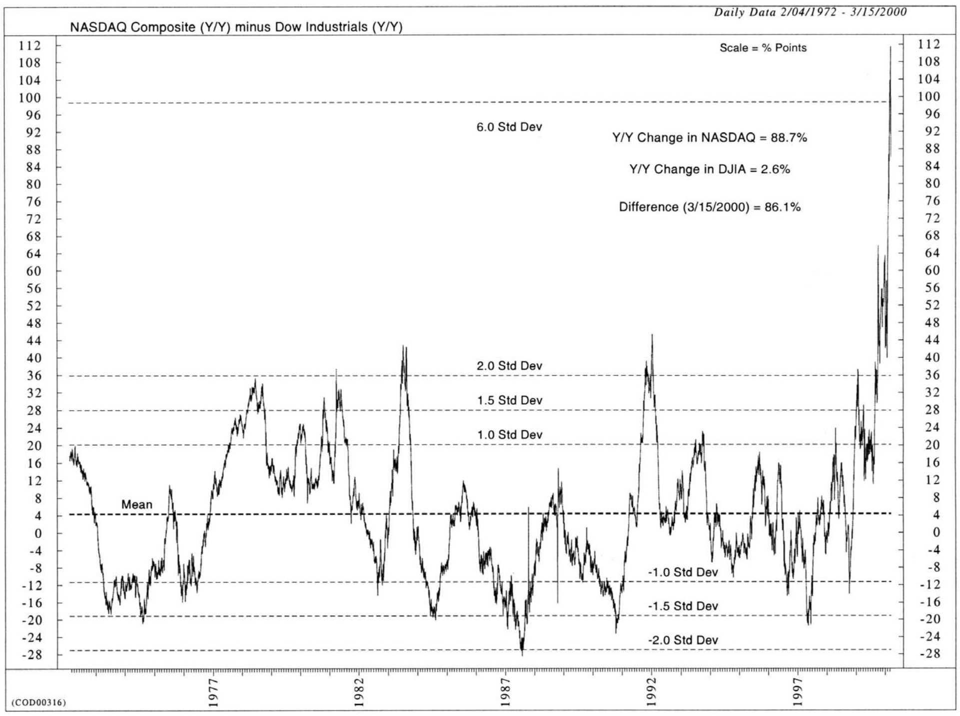
This time, however, Fed chairman Alan Greenspan has raised the price of money (interest rates) without restricting the supply of money. In the fall of 1998 money supply was aggressively expanded following the collapse of the Russian ruble and the over-leveraged Long Term Capital Management hedge fund. On the heels of this in the late summer and fall of 1999, Y2K fears caused the Fed to again expand money supply aggressively. Indeed, in Q3 1999, M3 money supply was expanded at a 15% annual rate.



Partly for these reasons the raising of interest rates has yet to cause any slowing of the economy. Moreover, it is argued by some that the highest growth sectors of the economy, predominantly "technology" companies, are largely impervious to interest rate increases as their predominant source of funding comes from the venture capital markets rather than the credit markets. Therefore, as this line of reasoning goes, any Fed induced credit contraction and/or raising of the cost of money will affect only the "old economy" and not the technology driven "new economy". We do not believe this. Simply stated, the "old economy" is the buyer of the "new economy's" products, and a slowing of the former will slow the latter.

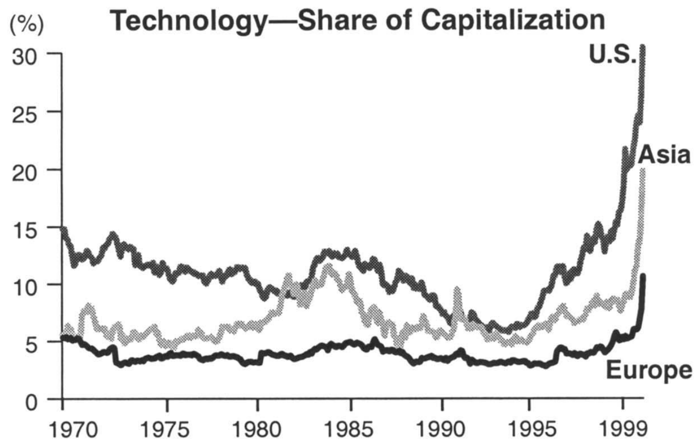
We all have a penchant for wanting to simplify the complex. Binary descriptors such as black/white, on/off are particularly useful for a televised sound bite. Certainly the rise in popularity of the expressions "old economy"/"new economy" and "technology"/"non-technology" fall in this category.

Unfortunately, these descriptors do little to shed light, and are of dubious value in analysis. However, because the "old economy" stocks are dominant in the Dow Jones Industrial Average (DJIA), and "new economy" stocks dominant in the NASDAQ, comparisons are inevitably drawn. Some of these comparisons are astounding. Take for example, the performance dichotomy between the DJIA and NASDAQ. The chart below depicts this in statistical terms that may only be fully appreciated by those with a true mathematical bent.



If we may digress a bit into the dry world of probability and statistics: for events that are normally distributed, we speak of the mean (mathematical average) and standard deviations from that mean. One standard deviation from the mean encompasses 68.3% of all observable events. Three standard deviations encompasses 99.7% of all observable events. Six standard deviations encompasses 99.9999999% of all observable events. The out-performance of NASDAQ over the DJIA had become a six sigma (standard deviation) event which carries a probability of one in 1,000,000,000. Wow! A continuation of this trend is not impossible; it just carries with it an extraordinarily low probability of occurrence. Therefore, a reasoned analysis would carry the expectation of "mean reversion", i.e., relative underperformance of NASDAQ and technology stocks, the latter recently 34% of the S&P 500 by market capitalization.

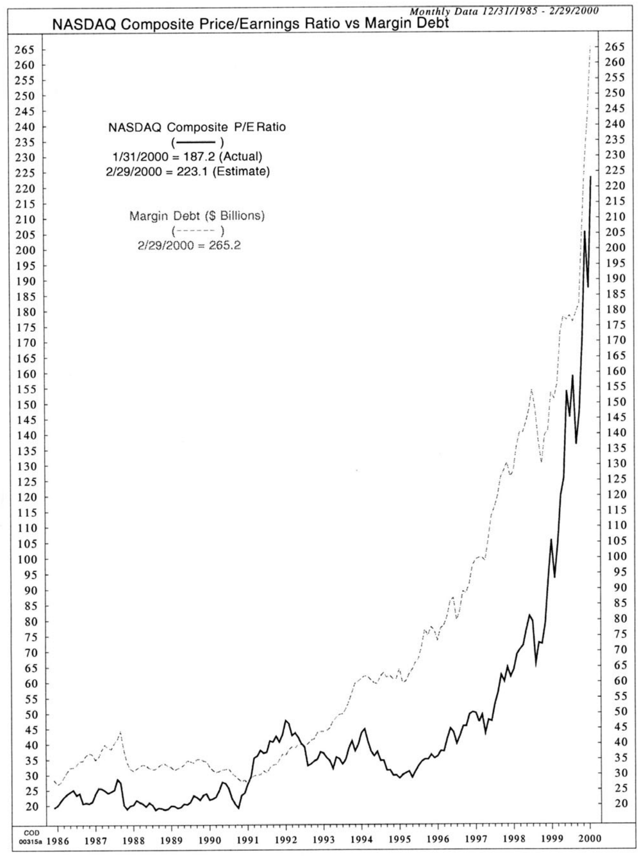
In the 1920's technology stocks were electric utilities and radio broadcasting stocks. Those are now stodgy low earnings growth rate companies. Today, we consider anything related to the Internet and biotechnology to be "technology". However, we would submit that there are many ".coms" that are not technology companies but rather marketing companies. Likewise, there are many companies artificially segregated into industry groupings by Standard & Poors whose business is truly technological but not falling in the technology group… defense stocks such as Raytheon, Lockheed Martin, Litton, TRW, Rockwell, General Dynamics, and Loral come immediately to mind. Nor do these artificial groupings necessarily define and segregate earnings growth rates. Certainly Home Depot is not a technology stock but is a high earnings growth rate company. Therefore, the usefulness of the binary descriptor "technology"/"non-technology" is limited. Nevertheless, it has become the dominant theme for the market in the new year/new millennium. We recall the following recent comment by Intel Chairman Andrew Grove, "In five years there will be no internet companies because every company will be an Internet company." We take note.



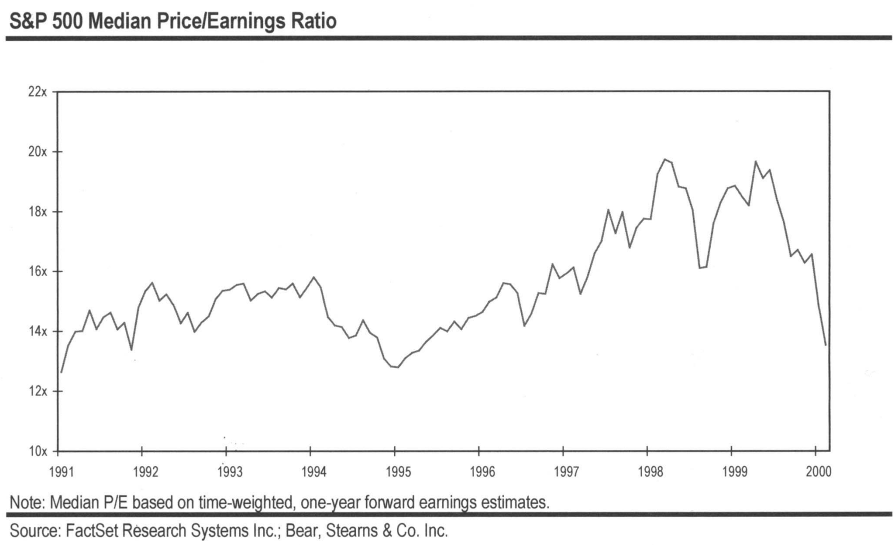
Source: MSCI, Standard & Poor's and Bernstein

Battle hardened veterans that we are, the level of speculation we see still astounds us. Our quarterly letter of exactly one year ago pointed out that the price/earnings ratio of NASDAQ had exceeded 100 for the first time ever. Tame stuff it seems because it has now reached an eye-popping and pupil-dilating 200!

Moreover, margin debt has likewise been climbing at a meteoric rate, rising $100 billion in 1999 alone, and rising 45% in the October to February timeframe, or $83 billion in four months. This occurred all while the market value of the NYSE was *falling* some $400 billion (from $11.8 trillion to $11.4 trillion) in the same timeframe. Current margin rules allow for a 50% down payment on stock purchases. The Fed has been criticized in some quarters for failing to raise the percentage requirement. It is rumored Mr. Greenspan sports a populist philosophy that espouses equality for small-time speculators since the big institutional players have other options such as futures and offshore borrowing capabilities where Fed rules don't apply. We applaud his egalitarian belief system but are left wondering if this is really practical under current circumstances.



There is no shortage of evidence that the casino mentality dominates U.S. markets. This warrants a cautious approach in our opinion. The insanity of the current environment is exemplified by the IPO market and the initial public offering / carve-out of Palm Inc. from 3Com (Palm, Inc. makes the ubiquitous Palm Pilot). After the offering, 3Com continued to own 95% of Palm Inc. Yet on the first day of the Palm Inc. IPO, Palm traded up to $165 per share (it's now $40) at which point it was worth $51 billion, almost double the $28 billion of 3Com. In other words, the non-Palm Inc. business of 3Com had a negative value of some $ 23 billion! Say what? Although this defies all rationality, it is a sign of the times, particularly for the tech sector. We note that $38 billion went into tech funds in 1999, more than went in cumulatively during the past half century prior to 1999. Other stalwarts go languishing on the NYSE, or worse, get pounded down like Procter & Gamble after a "disappointing quarter". Some of these drubbings are so abrupt and severe one would think they were about to entertain a chapter eleven filing. With momentum money chasing any and all northward leaning stocks, God help those that are heading south. Amid this confusion we see developing opportunities. We are beginning to see these valuation dichotomies work to our favor as the median price/earnings ratio for the S&P 500 has been dropping of late to a level 13 times forward earnings. We emphasize that this is a ***median*** number and not a ***cap-weighted*** number which is still 29 times forward earnings for the S&P 500.



What this says is that the entire market is not overvalued, rather that the overvaluation is among a minority of the very largest capitalization companies, some of which trade on NASDAQ and some the NYSE. When it comes to "market capitalization" (number of shares multiplied by price per share), it is hard to believe that last month JDS Uniphase had a larger market cap than Procter & Gamble, Ariba a greater market cap than Alcoa, Sycamore Networks a greater market cap than Boeing, and Akamai Technologies a market cap equal to Caterpillar, Eastman Kodak and United Airlines combined.

A recent study looked at the subsequent investment return from stocks that had reached a P/E ratio of 100 times earnings in the period from 1972 to 1995. The conclusion was a return of 2% per annum. If one were to adopt the dangerous assumption that 100 X EPS stocks did as well as NASDAQ since 1995, the return would rise to 7% per annum. These returns would have been achieved at a risk level of 19 times the S&P 500 and 100 times T-bills.

Indeed, it may be that these valuation extremes are beginning to be corrected. March 10th was a particularly noteworthy day. NASDAQ peaked on March 10th and is off 27% as of April 27th. Yet the DJIA bottomed on the *same* day and in the same time frame is up 17%! This short-term performance variance of 44% in 33 trading days is exceedingly extreme for two major averages. Perhaps we run the risk of becoming numbed by such statistics, having lived through this era of repeated extremes, but so far, it appears we are seeing a classic reversal of fortunes.

The fixed income markets also have been on a roller coaster so far in 2000. After reaching yields of 6.75% on thirty-year treasuries in January a buy program initiated by PIMCO caused a stampede, pushing yields down to 5.85% in two months. Such a move is the equivalent of a 12% gain in bond price. Although corporates have not moved as much as treasuries, they too have rallied. For accounts with a fixed income component, we have purchased long-term investment grade, mostly non-callable corporate bonds.

Our primary concern remains that the Fed has yet to accomplish its goal after five successive tightenings. Mr. Greenspan was quoted during a mid-January speech to the Economic Club of New York as follows:

> **"Feverish economic growth and a persistent run-up in stock prices have created imbalances that could eventually bring the economy to a debilitating halt."**

So far, the only "debilitating halt" we see has been to the rise in NASDAQ technology stocks over the past seven weeks.

We recently attended the third annual Milken Institute symposium sponsored by controversial junk-bond-impresario-ex-convict-turned-philanthropist Michael Milken. No less than nine (9) Nobel Prize winners in economics were present to offer us their views.* Of particular interest was a comment that versus twenty years ago, we use almost half as much energy per unit of

GDP output. This undoubtedly is a major contributing reason to why $30.00 per barrel oil, up from $10.00 exactly one year ago, has not impacted overall inflation to a greater extent.

In conclusion, we believe the recent downward "adjustment" for NASDAQ and Internet focused stocks has further to run as the reality sets in that the protective barriers to competitive entry are non-existent. Such a fundamental backdrop combined with unprecedented recent euphoria suggests that discretion is the better part of investment valor.

We thank you for your support and confidence.

Very truly yours,

Alan T. Beimfohr **John G. Prichard, CFA**

*****_Kenneth Arrow, Stanford University, 1972 Nobel Prize_
Gary S. Becker, University of Chicago, 1992 Nobel Prize
James M. Buchanan, George Mason University, 1986 Nobel Prize
Laurence R. Klein, W.P. Carey & Co., 1980 Nobel Prize
Franco Modigliani, Massachusetts Institute of Technology, 1985 Nobel Prize
John F. Nash, Princeton University, 1994 Nobel Prize
Douglas C. North, Washington University, 1993 Nobel Prize
Myron Scholes, Stanford University, 1997 Nobel Prize
Reinhard Selten, University of Bonn (Germany), 1994 Nobel Prize