Knightsbridge Asset Management, LLC

May 9, 2002

FIRST QUARTER COMMENTARY

"It is better by a noble boldness to run the risk of being subject to half of the evils we anticipate, than to remain in cowardly listlessness for fear of what may happen."

- Herodotus of Halicarnassus
485 to 425 B.C.
Greek Historian

Dubbed the "father of history" by Cicero, Herodotus' fifth century B.C. Histories hoped to preserve from decay the remembrance of what men had done. Prior to this, only epic poems such as *The Iliad* or *Gilgamesh* survived, more myth than fact. After Herodotus, Thucydides and others took up the cause of historical writing which centered mostly on the retelling of political succession, wars and evolution of conflict. Herodotus reminds us that staying the course is never easy, and so it is today.

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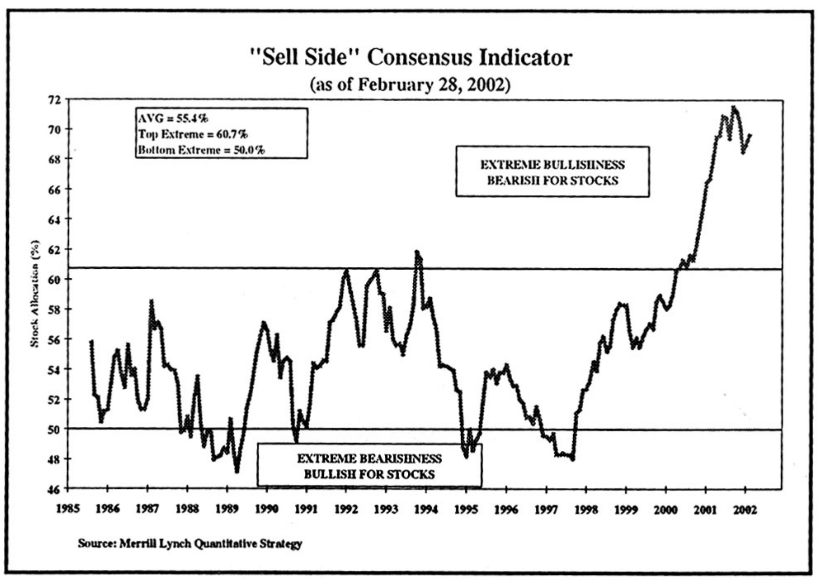
The operative assumption for most is that we've entered a new bull market following the post 9/11 bottom on September 21st. But to look at the likes of IBM, General Electric, JP Morgan, Bristol Myers, and Merrill Lynch, one wonders what exactly is going on here. Are not these companies supposed to be market leaders? Apparently not, as they have been eclipsed in performance by a host of smaller stocks of less familiar name. In recent years, institutional acceptance of indexation meant acceptance of the S&P 500 proxy, whose top quintile accounts for 71% of all value within this index. Although controversial, we held that this meant disproportionate capital flows accreting to a minority of names, driving their price/earnings ratios to questionable levels. Combined with the 70% hyper-optimistic average recommended allocation to equities for balanced accounts coming from Wall Street's portfolio strategists (see chart), the stage has been set for disappointment among holders of the mega-cap names.

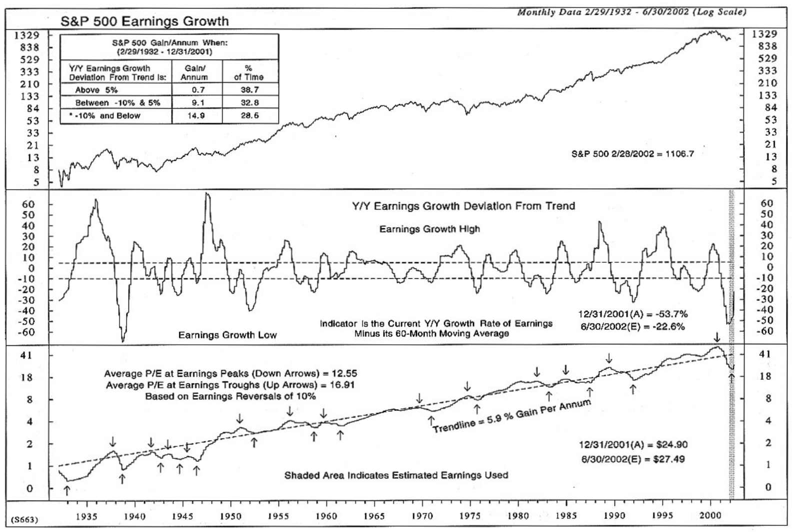
Capitalization Quintiles ($ Billions)			% of S&P500
Above		23.41	71.2
10.31	to	23.41	14.3
6.29	to	10.29	7.6
3.77	to	6.26	4.7
Below		3.71	2.2

Even a modest reallocation to bonds or foreign securities from the index creates a wave of selling among all mega-cap names. It should be understood that this index selling is indiscriminate and seeks no relative merit among those mega-cap names, just as it was indiscriminate on the journey upward where indexed capital flowed in.



Occupying center stage at the moment is the controversy concerning corporations issuing 'qualified options' to employees in lieu of cash compensation. Since the value of these options is not considered compensation expense, there is no expense recognition on the income

statement in the same way there would be were it cash. Since there is now agreement between Alan Greenspan and Warren Buffett that such expense recognition should be made, contrary to the Bush and Clinton administrations' positions, one can assume that such a change will be forthcoming. On March 7th, Mr. Greenspan in testimony before the Senate Banking Committee stated that a best guess was that 2½% of (S&P 500) earnings growth rate came from not expensing stock option compensation costs. For comparison purposes, the very long-term earnings growth rate of the S&P 500 is reported at about 6% per year, as seen below.

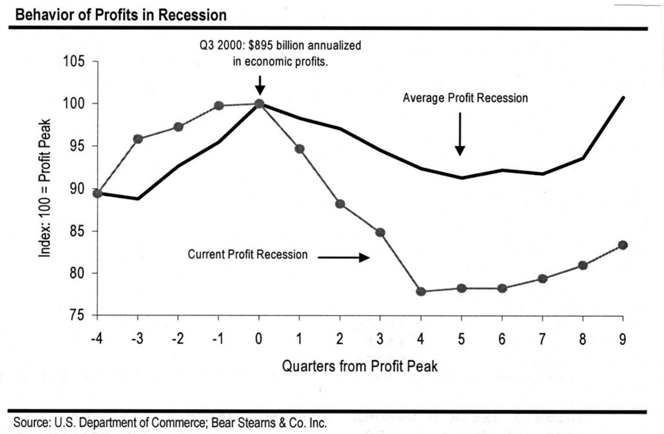


Not only does this unsettling statistic call into question the actual S&P 500 EPS growth rate, it also calls into question all the assumptions underlying the 'productivity miracle' of the late 1990's, used to justify lofty prices and P/E's in such misguided tomes as <u>Dow 36,000</u> by James K. Glassman and Kevin A. Hassett. In this book, it was argued that the equity risk premium should be *zero!* That means that stocks, (with higher volatility than bonds) should not be required to return more than bonds. Why? Because stocks, according to Glassman and Hassett, would always eventually produce higher returns which was sufficiently virtuous in and of itself to relieve stocks of the requirement of a higher return due to higher volatility (standard deviation of return). Historically, the equity risk premium has been 2% to 3%. So why zero? We'll use a 2½% number for the equity risk premium to walk through the math. The equity risk premium is expressed as return required above and beyond 10-year Treasuries. If 10-year Treasuries yield 5½ %, then stocks must be discounted in price to return, theoretically, 8% (5½ plus 2½). At S&P 500 levels of 1400, the index was discounting future returns of 5% to 6%, not 8%. We offer no proof of this, which is beyond the scope of this letter, but beg your indulgence while we attempt to develop this thought. Now if stocks are trading at a discount to provide a return of,

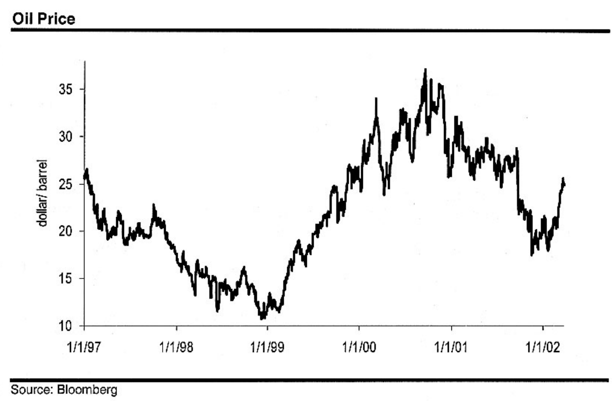
say 5% to 6%, then they are very richly priced indeed, and a mean reversion to an 8% number implies a significant reduction in price, like 30% to 40% even while earnings are going up! So if it takes two years for the fallacious thinking to be completely expunged (all while the earnings are growing 6% per year), then a 31.25% decline is required (1- 5.5/8.0), and all of it needs to be taken up by price drop. That's the good news. Now for the bad news.

To return to the 6% annual EPS growth rate of the S&P 500… some thought that the EPS growth rate had accelerated to 8% or so, but it is looking increasingly likely that accounting subterfuge… that is, generous use of qualified options that didn't have to be expensed… was responsible for the appearance of earnings growth rate increase. And now it is going to be taken away. A recent Merrill Lynch study of 32 technology companies issuing 10K's shows that in this sample, net income would have been reduced by a median 43% had these options been expensed. Salomon Smith Barney in a similar study confined to the U.S. pharmaceutical industry found a reduction in operating earnings of 8% (which translates to a higher number for reported earnings). If the 15% of the S&P 500 represented by technology stocks were the only guilty parties, then the 43% reduction implies a 6% (.43 X .15) earnings drop across the board. And now for some 'good' news.

Goodwill amortization… what's that? When a company acquires another company and pays a price in excess of book value (which is just about always), then the excess is referred to as 'goodwill'. This 'goodwill' heretofore needed to be amortized, or 'written off' over a period of time, generally 40 years. This fact reduced taxable earnings. Now FAS 142 will no longer require this gradual write-off, boosting reported earnings by, perhaps, 8% on the S&P 500. Therefore, FAS 142 may, in fact, be a complete offset to a new requirement to expense 'qualified options', in the aggregate. However, individual companies will be affected very differently. Take Cisco… whereas EPS might be increased by 20% due to FAS 142, they will be reduced by 40% if options are expensed. Caveat emptor, as usual.



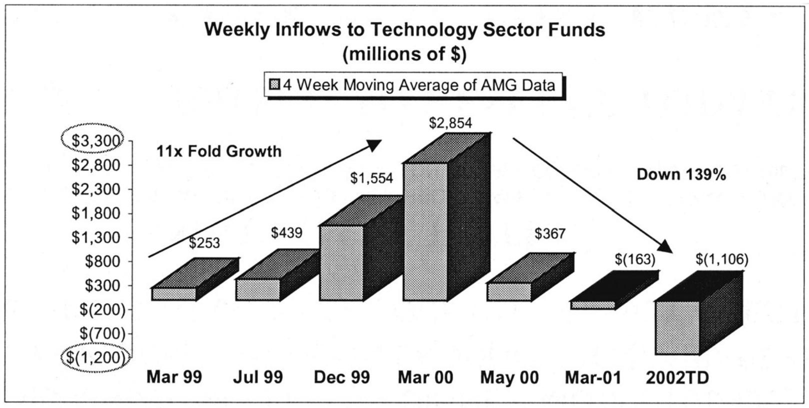
We believe the market is working through a series of problems, not the least of which is an overvaluation among the mega-cap issues. Other problems include the behavior of profits in this recession compared to past recessions.
As can be seen from the chart to the left, profits are recovering in sub-par fashion, and experienced a greater decline from the peak relative to past recessions. This is one reason for worry.



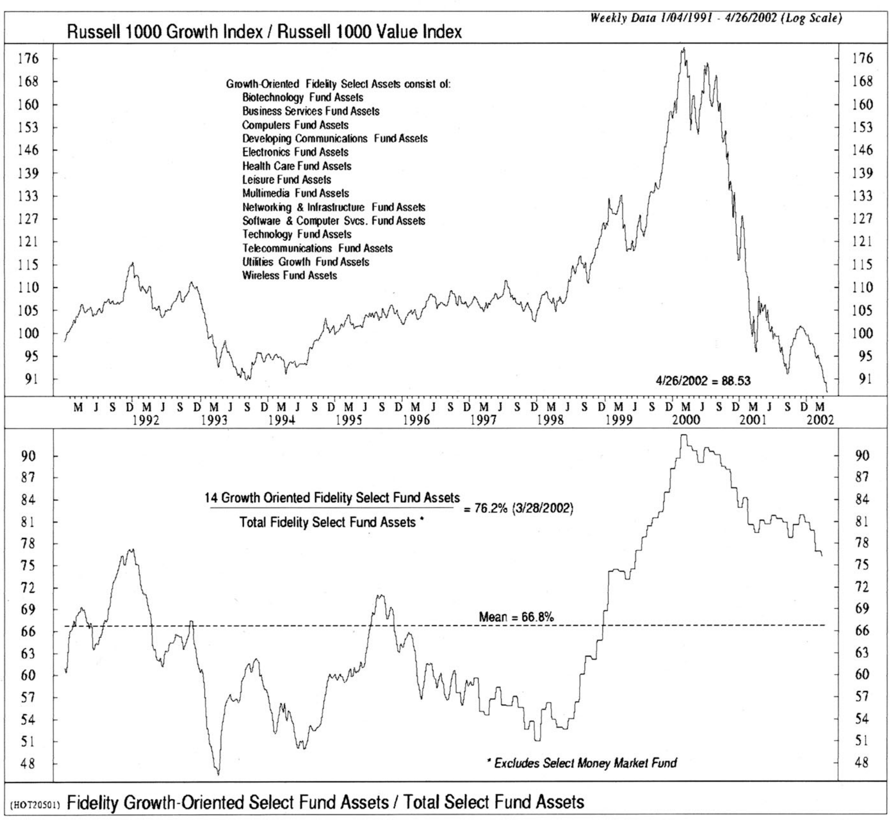
Another reason is oil. Looking backward at the winter of 2001-2002, we can see three (3) important events conspiring to send oil prices temporarily plummeting. One- all three of the world's largest economies, Japan, U.S. and Germany were in synchronized recession. Two- the U.S. had the warmest winter in 106 years. Three- events of September 11th caused demand for jet fuel to plunge as the airline industry experienced drops in bookings on the order of 25%. Curiously, oil at $18 per barrel was still 80% higher than the $10 per barrel seen during the Asian currency meltdown crisis of 1998. The recent rally to $28 per barrel has surprised most, but should be taken as a strong indication that oil prices will be settling in higher on this economic recovery, even assuming a premium for recent mid-east political risks. In fact, the strength of prices may be an indication international economies are recovering more rapidly than thought. Upward price movement has appropriately been attributed to a fear of disruption in Persian Gulf supply; perhaps as much as $2 to $4 per barrel. Some fear such high-energy prices could choke off recovery. However, energy consumption as a % of GDP is low by historical levels, and we are not of this mind. Furthermore, it is estimated that a $10/barrel increase from $22/barrel to $32/barrel would shave only 0.3% from

GDP growth in the first year, bolstering our conclusion that recovery will not be retarded much as a result. We observe that oil equities comprise only 7% of the S&P 500 versus a more normal 10%, and that expectations are low.

Another consideration is whether technology shares, currently 15% of the S&P 500 (down from 40%!) have gone as low as they can go. The technology stampede of 1999 and early 2000 does not appear to be fully worked off yet at first blush (see below).



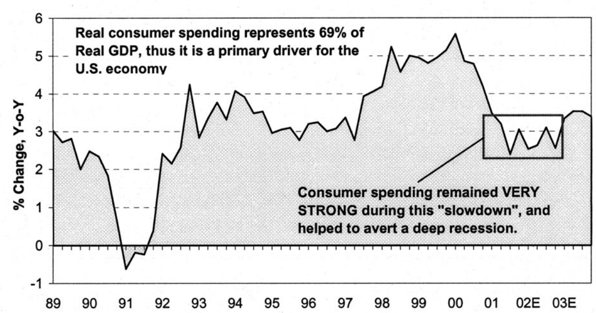
For example, looking at weekly inflows into technology sector funds since early 1999, as seen below, shows that of over $5 billion that went in only $1.3 billion has come out. Of course the residual $3.7 billion is shrunken mightily. And the $1.1 billion that came out so far in 2002 probably represented original purchases of two to



three times that amount. Although we do not know how many dollars must flow out to convince us a bottom is nigh for this group, it strikes us that the end of this sad tale may be near. Another view of the same subject shows Fidelity Select industry funds, which in early 2000 reached a point where 93% of all 'select' fund assets were in 'growth-oriented' funds (see bottom panel of above chart, page 6). We grant the fact that the 'growth-oriented' labels may be somewhat arbitrary, but to only have declined to where 76% of the total is 'growth oriented', well, that seems too high and headed lower.

On the positive side of the ledger, the consumer and service economies are holding up well. The March 'consumer confidence' numbers rose from 95 to 110, the single largest monthly jump in consumer confidence since 1967.

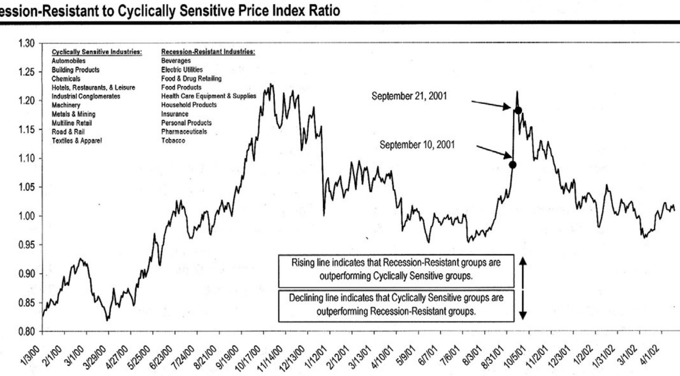
Real Consumer Spending



Source: U.S. Government statistics

Encouraging the consumer has been an accommodative Federal Reserve. Mr. Greenspan in recent comments has left the markets with the impression that inflation fighting is lower priority and ensuring the recovery is paramount. Although the extra dose of liquidity provided post 9/11 took rates lower than they might otherwise have gone, the current speculation is when and whether rates might be rising. Consensus speculation centers around August of this year for the first Fed Rate hike. With that in mind, we provide the following chart which interestingly shows the historical behavior of defensive stock groups (drugs, tobacco, utilities, etc.) versus cyclically sensitive groups. It is noteworthy that defensive stock group performance on a relative basis peaked out just after 9/11, once again proving the majority wrong and demonstrating the utility of 'contrary opinion'.

Recession-Resistant to Cyclically Sensitive Price Index Ratio



Note: Data plotted through April 16, 2002.

Source: Standard & Poor's; Bear, Stearns & Co. Inc.

Lastly, we wish to say a few words about gold and Japan. We believe it would be in error to attribute the recent price rise in gold, above $300 per ounce, to inflation expectations. The inflation thesis is lent some support from an increase in long-term bond yields, but gold price strength is probably more related to Japanese buying. Why? The Japanese government has tried just about every trick in the book to break the back of deflation in Japan. Recently, Japanese monetary authorities signaled that they would try to export their way to higher rates of GDP growth. The markets interpret this as being willing to depreciate the yen relative to dollars and euros, to whatever extent is necessary to get the job done. In short, risk some inflation in the domestic economy. Combined with the removal of deposit insurance, this sent Japanese yen-holders scurrying for cover in harder assets… like gold, real estate and stocks. Japanese commodity prices and real estate have ticked up for the first time in a very long time. Although the absolute level of Japanese government debt looms large, the good news is that it is relatively long term, insulated from short-term interest rate increases, and at very low rates of interest. Whether this debt can be paid off is a subject of great debate, but good news coming from the Japanese economy may not be far behind. Certainly the move in gold prices is also related to oil and Mid-East tensions. But other less well-known factors are also coming into play such as gold producers unwinding hedges that have been in place for years.

Although the markets have taken a corrective turn and continue to work off, mega-stock by mega-stock, the accumulated overvaluations of the late 1990's, another reality is that market breadth is pretty decent and the majority of names on the NYSE are turning in a better performance. And so, observing that the market is never a monolith, we appropriately reflect on the ancient advice of Herodotus and marvel at how little the reactions of humankind have changed. Our first quarter was strongly positive, but we have given much of it back as of this writing. Nevertheless, we forge ahead as always, and thank each of you for your interest and sponsorship.

Very truly yours,

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