Knightsbridge Asset Management, LLC

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FIRST QUARTER COMMENTARY

"It is not danger, but rather the threat of danger, which most often primes the stress response. The central characteristic of the information that signals stress is uncertainty. Uncertainty calls forth an early warning, an alert to check for the possibility that a threat looms. A stirring in the bushes may or may not be a predator. But those small primates that startled into action at the first stir were the ones whose descendants have survived to write books."

-Daniel Goleman, Ph.D., Professor, Harvard University/Senior Editor, Psychology Today, author, Vital Lies, Simple Truths: The Psychology of Self-Deception

In a modern-day version of primates fleeing the scene of potential danger, CNBC carries an advertisement showing a middle-aged investor running and jumping hedges in his front lawn to avoid the mailman---who is about to deliver him his monthly brokerage statement. "Constructive denial" or, "selective inattention", is well documented, and, as Daniel Goleman states, "its ubiquity in everyday life qualifies it as a generic defense, perhaps the most common".

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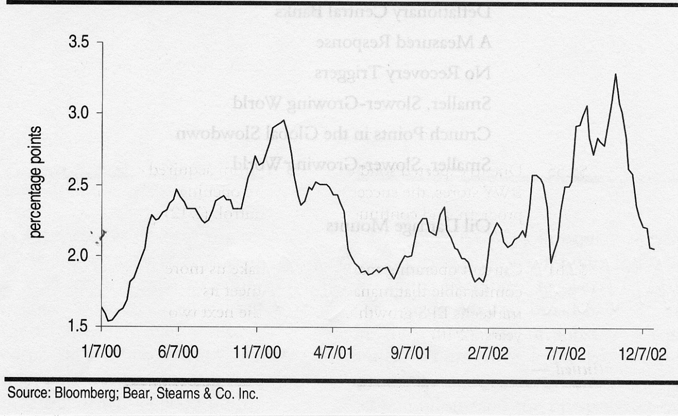
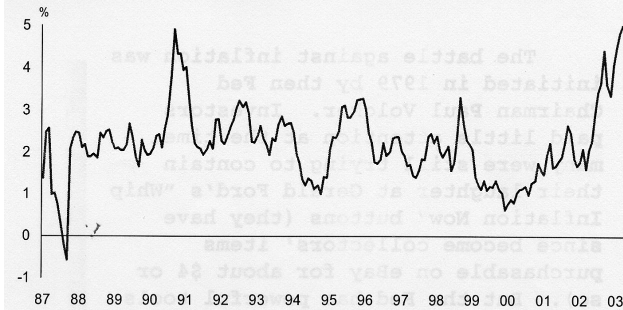
And so we identify two common reactions among investors to an environment that has made conventional economic analysis difficult---one reaction is to flee the equity markets for the safety of cash and the other is to stop thinking about it in the hope that "this too shall pass", a hope that in all objectivity must be said to run counter to the past three years' experience, the greatest bear market since the depression of the 1930's.

Conventional wisdom has it that the market is depressed due to earnings uncertainty and Iraq. We would postulate that the former conclusion is invalidated by contracting spreads between corporate and treasury bond yields (see chart below). If, in fact, the bond market believed that a recession was imminent, that we were, as they say, "double dipping", then these spreads would be widening, not contracting.



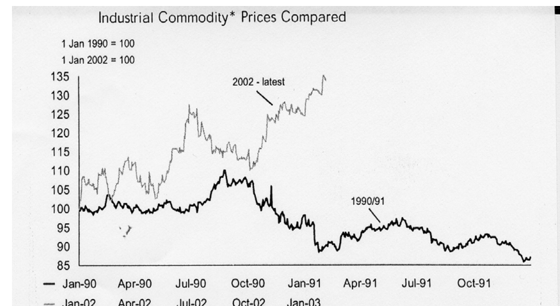
And so we take note of Iraq as a market factor. What, exactly, is operating on the equity market here? Given the rapidity with which the military confrontation has segued to other security and rebuilding concerns, we speculate there may be deeper and less visible factors that have troubled the market. Certainly the destruction of NATO, the diminishment of the U.N. and most importantly, the driving of the Franco-Prussian Euro-axis eastward into alliance with Russia and China, even if temporary, are disturbingly tectonic shifts.

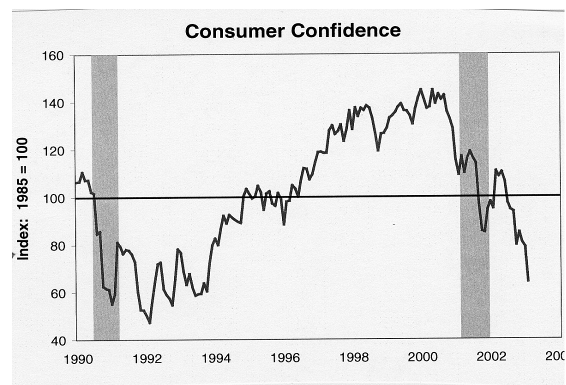
Economically, what does this portend for the U.S.? What does a permanent military presence in Saudi Arabia and Iraq mean besides a secure world oil supply for the #1 consumer from the #1 and #2 owners of oil reserves? These are difficult questions. Clearly, defense and nation-building spending is going up, particularly of the non-tech kind. We will have little help in rebuilding Iraq until or unless agreements are forthcoming to honor sovereign debt and prior contracts. We cannot expect much help from nations while we stiff them on monies owed.



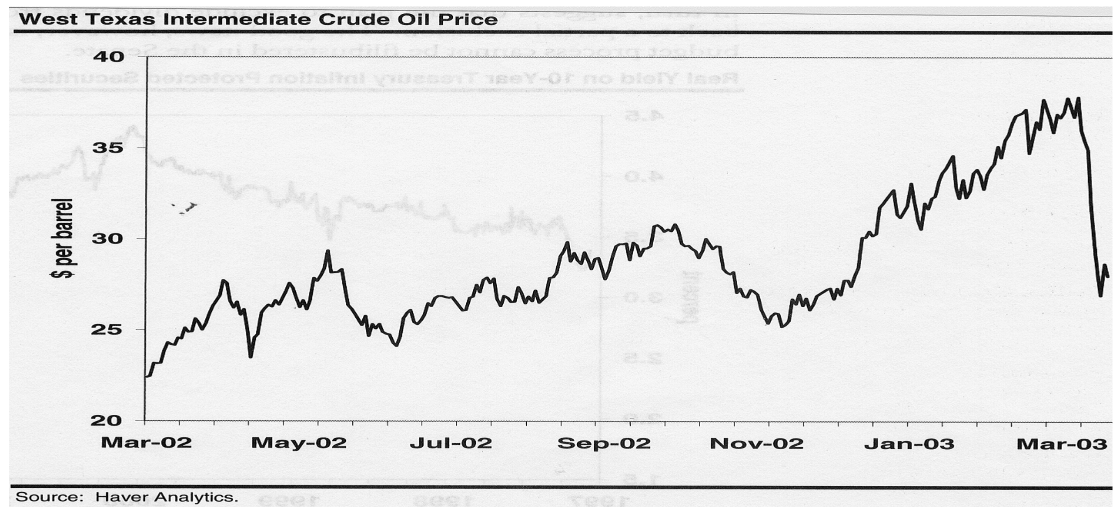
It is noteworthy that the equity risk premium has shot up to levels not seen in a long, long while. The rise of the equity risk premium at the same time that the bond market is saying there is lessening economic risk is troublesome. We would be inclined to assign partial attribution to unknowns created by implementation of the Bush Doctrine of pre-emptive strikes justified. Clearly the entire fabric of the post WW II security structure has been rent. Like it or not, we have become unilateralist; we are the new Rome. We are reminded that in 1943 Franklin D. Roosevelt was asked how long American troops would remain in Germany after the war, to which he replied "For at least one year…maybe two".

Nevertheless, we see light at the end of the proverbial tunnel. Lately we read some research that is brave enough to challenge some of the current economic and bearish market groupthink. For example, there is increasing evidence that the concept "American business has no pricing power" is flawed. It seems that industrial commodity prices, particularly since last October, have accelerated, aided by a falling dollar. Furthermore, the plunging of consumer confidence has been so dramatic as to almost guarantee that subsequent movement in the index will be to the upside. The frightening spectre of terrorism alert levels shifting among yellow, orange and red along with the "CNN effect" from Operation Iraqi Freedom practically guaranteed consumer confidence would take a severe beating, currently at a 12-year low. But it is likely to go up from here.

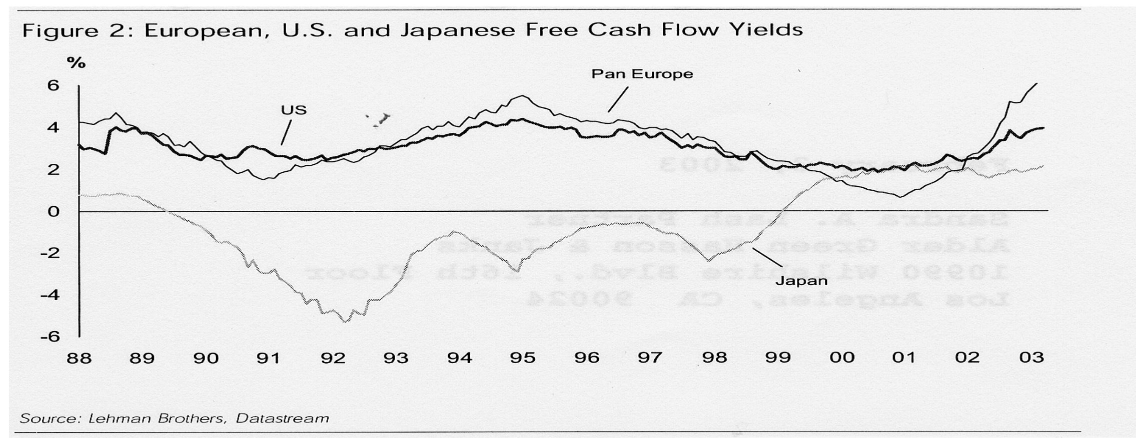




Also helpful to the markets is the recent drop in crude oil prices, which in and of itself may contribute an additional 0.5% in GDP growth.



Moreover, we note once again that free cash flow (cash flow minus capital expenditures) has risen across the globe to levels not seen in 15 years.



And lastly, P/E ratios are reasonable; 14.0x for the world P/E versus 19.4x over the last decade, 14.8x for the U.S. versus 18.0x over the last decade, and 15x over the past century. In fact, our judgment is that the U.S. market P/E should probably be somewhere in the 17x to 19x range given current interest rates.

Global Valuation

10 Year Averages

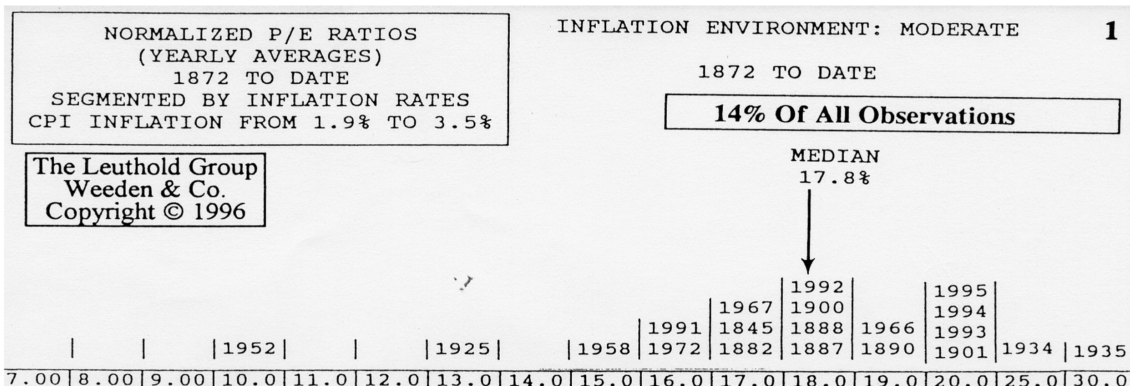
	12 month Forward PE					
	US	Eur ex UK	UK	Japan	Asia ex Jap	World
BASIC INDUSTRIES	16.5	14.1	13.7	49.7	14.5	17.7
CAPITAL GOODS	18.0	16.4	13.8	37.8	13.4	19.9
CONSUMER CYCLICALS	16.8	17.6	15.0	36.3	16.0	19.9
CONSUMER STABLES	20.1	19.3	14.3	38.5	15.5	19.4
ENERGY	18.6	16.5	17.5	37.6	11.5	18.0
FINANCIALS & INSURANCE	13.1	15.8	13.1	52.9	12.3	16.0
HEALTH CARE	21.5	21.5	21.4	28.9	19.1	22.3
TECHNOLOGY	24.7	26.4	20.7	59.1	18.8	28.2
UTILITIES	14.6	15.9	13.8	34.9	13.3	15.1
TELECOMS	20.3	25.9	25.2	93.5	18.9	22.8
MARKET	18.0	17.6	15.9	41.3	13.7	19.4

Global Valuation

Current Values

	12 month Forward PE					
	US	Eur ex UK	UK	Japan	Asia exJap	World
BASIC INDUSTRIES	16.4	9.8	10.9	19.2	11.2	12.7
CAPITAL GOODS	14.2	11.8	12.2	20.0	9.0	13.7
CONSUMER CYCLICALS	14.6	8.8	11.8	14.0	9.6	12.8
CONSUMER STABLES	14.2	13.4	12.1	21.0	13.9	13.9
ENERGY	15.0	11.1	15.1	20.6	9.0	13.5
FINANCIALS[1]	10.8	9.1	10.2	18.4	10.4	10.4
HEALTH CARE	17.5	15.0	14.4	16.8	19.3	16.7
TECHNOLOGY	23.1	24.8	17.4	24.4	14.2	22.7
UTILITIES	10.3	10.6	11.5	15.4	9.7	11.1
TELECOMS	13.9	25.7	NM	18.5	9.3	28.3
MARKET	14.8	11.7	15.9	17.4	10.7	14.0

Lest we be accused by our readership of being delirious optimists, we offer evidence that 17x to 19x is an appropriate P/E expectation. The following chart shows that for all years from 1872 to 1995 wherein CPI (Consumer Price Index)inflation has ranged between 1.9% and 3.5%, arguably the current levels, that the median (half higher, half lower) P/E was 17.8x, as shown in the histogram below. Therefore, if the U.S. market moves from 14.8x to 17.8x (*without any earnings increases at all*) this would by itself generate a 20% gain from current levels.



The past twelve months delivered an extremely difficult environment in which it seemed there was nowhere to hide. Cumulative declines produced conditions not seen in the U.S. stock market since 1973-1974 and in many cases 1929-1932. Every economic sector, equity style and range of market capitalization produced negative returns and bonds outperformed stocks over the last three years by a record margin.

We attempted to navigate through the last few years with a defensive posture (including exposure to gold, oil, defense and utility stocks and investment in Asia). This helped us outperform the S&P 500 Index by over ten percent per year on average over the last three years. However, you can't spend relative out-performance and we are not pleased to report two years of losses followed by an additional quarter of loss (largely recovered as of this writing) in equity portfolios. We do see improving market conditions and strong prospects of positive returns going forward following the recent carnage.

Knightsbridge portfolio holdings are trading at single digit price to earnings (P/E) ratios on 2003 earnings estimates and the majority of our holdings included in the S&P 500 Index rank among the lowest twenty percent of 2003 P/E ratios.

We well understand that investors have been forced to weather the tumult and angst of recent times, the likes of which occur perhaps once in a generation. We are empathetic to those who responded to "a stirring in the bushes" and were "startled into action". Nevertheless, we believe that like the investor running from the mailman, "constructive denial" or "benign neglect" may in fact be an acceptable defense for investors fearful of shooting-themselves-in-the-foot, and that enduring the pain of decline is a necessary concomitant to successful long-term investing, simply because markets do not always go up.

The fact that the market has successfully tested the October lows under conditions of extreme duress and extraordinarily negative sentiment reaffirms our positive outlook.

We are grateful for your continued support and forbearance. We look ahead to better times.

Very truly yours,

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