

# Knightsbridge Asset Management, LLC

April 30, 2004

## First Quarter Commentary

**"Nicht geschossen ist auch verfehlt"  
(tr: "Not shooting is also a miss")**

- Otto von Habsburg
- Austrian Archduke
- 1912-



With credit to our friend James Breiding, Geschäftsführer at Naissance Capital, Zürich, Switzerland, this old German hunting adage applies to all investors who unwisely thought they could circumvent the bear market's pain by retreating to cash...and subsequently failed to reinvest close to the bottom one year ago. From March 31, 2003 to March 31, 2004, the S&P 500 turned in an eye-bulging total return performance of +35%. Exactly one year ago, predictions that

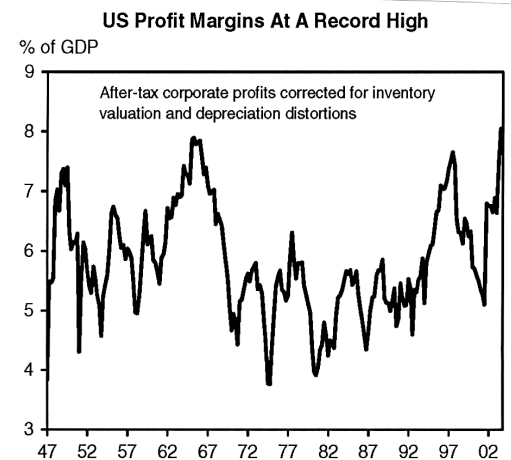
the U.S. stock market would never ever produce double digit returns again were common with many analyses exclaiming the mathematical certitude of low-single digit returns forever...(or even Dow 5000). So much for those brave prognosticators...the market Valkyries have spirited them away to ticker-tape Valhalla.



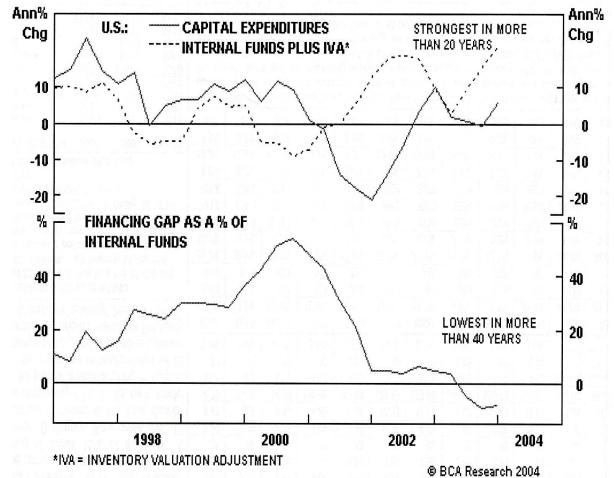
And short-selling hedge funds punch-drunk with easy profits in the cascading bear were shouting from the parapets a new way to make money in a declining market...only to be trumped by a reversal of fortune...worse than "The Donald" on a bad-hair day. And it is a difficult business. So to Herr Breiding und Herr von Habsburg, we say "Vielen Dank"!  
(thank you very much) and acknowledge that opportunities missed may be every bit as important as opportunities misjudged.

We think investors should be prepared for the current market to eventually go higher. Consider the following:

- 1) P/E ratios are at an 8-year low as of March 31<sup>st</sup>, 16.4 times trailing earnings adjusted for inventory valuation and capital consumption. The 45 year average is 15.0 times.
- 2) A correction to the market rise of the past twelve months is most likely partially completed in terms of historical probabilities. A decline of 11% on average within a 37 trading day period is the norm: so far the decline is 8.6% since the 1163 S & P 500 peak March 5<sup>th</sup>.
- 3) After-tax profit margins are at a post-WWII high of 8% as seen at right.
- 4) Market sentiment after correcting from extremely high readings in January is now neutral.
- 5) Concern over jobs growth in the economy has been ameliorated with the release of the March employment survey.
- 6) Free cash flow now exceeds dividends by 2 to 1, the first time in 10 years. Total cash flow exceeds dividends by a much higher 4.6 to 1.

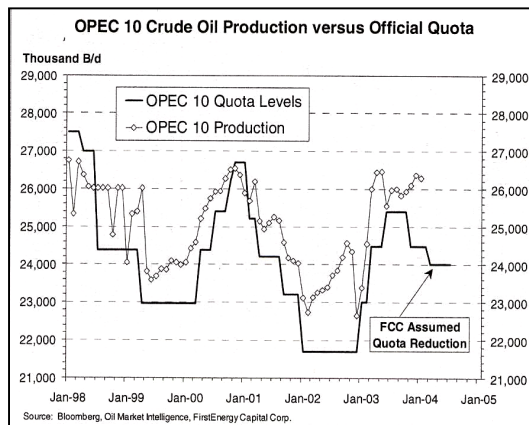


- 7) Corporations in the aggregate can now completely finance themselves internally.
- 8) First quarter earnings are being reported up 21% on average so far, versus first quarter last year.
- 9) Leading and lagging indicators both support a conclusion that equities are to be preferred over fixed income investments at this time.

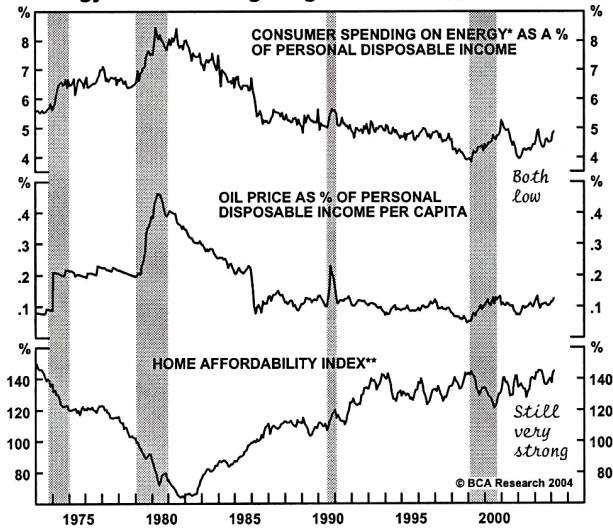


We are not unmindful that several serious uncertainties loom large on the horizon...namely, the presidential election (previously thought by many as recently as January to be "in the bag" for Bush in a Bush-Dean match-up), continuing angst over Iraq, worries about household debt and housing affordability particularly if interest rates should rise, among others such as jobs growth, energy prices, inflation, deflation, the dollar, trade deficits and budget deficits.

Energy concerns have been front-burnered of late. Because the dollar has declined, particularly against the Euro, OPEC and other non-OPEC producers demand a higher price to compensate. As can be seen in this chart, OPEC production is close to the maximum ever produced by them, and it may be an unrealistic expectation that Saudi (thought to have 16% spare production capacity) and Iraqi production will be the swing factors to keep prices from going higher long term. However, in the short term the recent allegation by Bob Woodward of the Washington Post that the House of Saud had promised the Bush



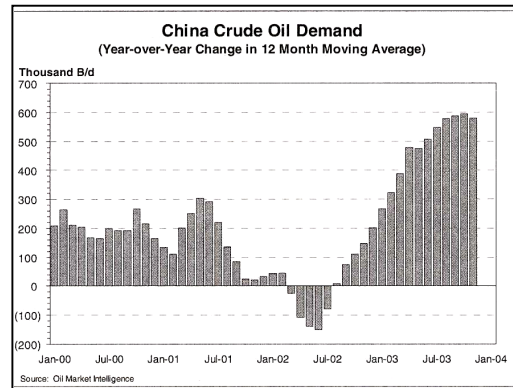
**Energy Not Such A Big Drag For Consumers**



\*INCLUDES GASOLINE, FUEL OIL, NATURAL GAS, AND ELECTRICITY  
 \*\*SOURCE: NATIONAL ASSOCIATION OF REALTORS  
 NOTE: SHADED AREAS REPRESENT PERIODS OF MAJOR OIL PRICE SHOCKS

Administration an open oil spigot prior to the election strikes us as completely plausible. Some believe that it may take prices at the pump of \$4 to \$5 per gallon to influence consumers to abandon gas-guzzling SUV's in favor of vehicles getting better mileage per gallon. This is because, as seen here at the left, the amount being spent as a percent of GDP on energy is at an historically very low level in spite of recent price increases, which gives energy

producers confidence that the price structure can go up without choking off worldwide economic recovery. China currently consumes 7% of the world's crude oil, (having surpassed Japan last year in crude imports) as well as consuming 31% of global coal production, making it a huge swing factor in the overall energy equation. This is particularly true in oil since Chinese auto sales are increasing 40% per year. In fact, an upward revaluation of the Chinese renminbi may occur sooner than previously thought to cool off the torrid 10% GDP growth and render their purchases of imported commodities cheaper. The most surprising statistic we've read lately comes from ISI Group research stating that China now runs a trade deficit with imports exceeding exports \$540 billion to \$521 billion. Shocking! Slowing growth in China is a stated policy goal of the current regime, and if accomplished should take pressure off the currently exploding commodity price structure.

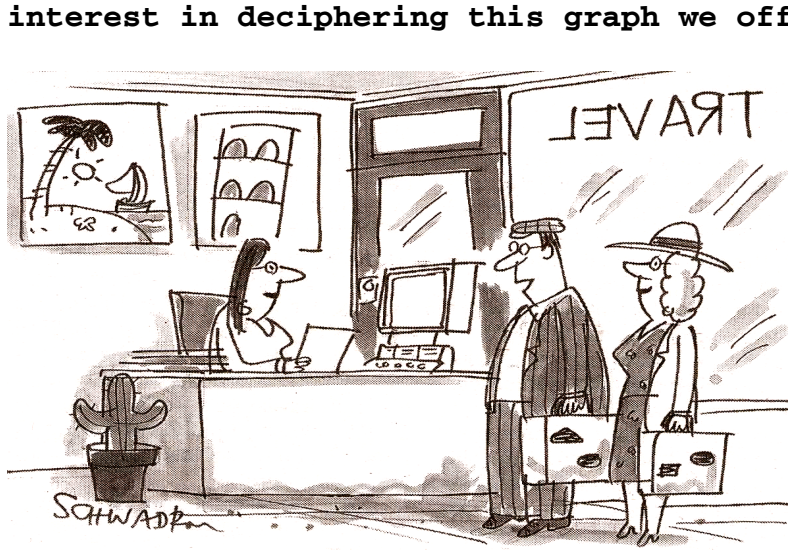
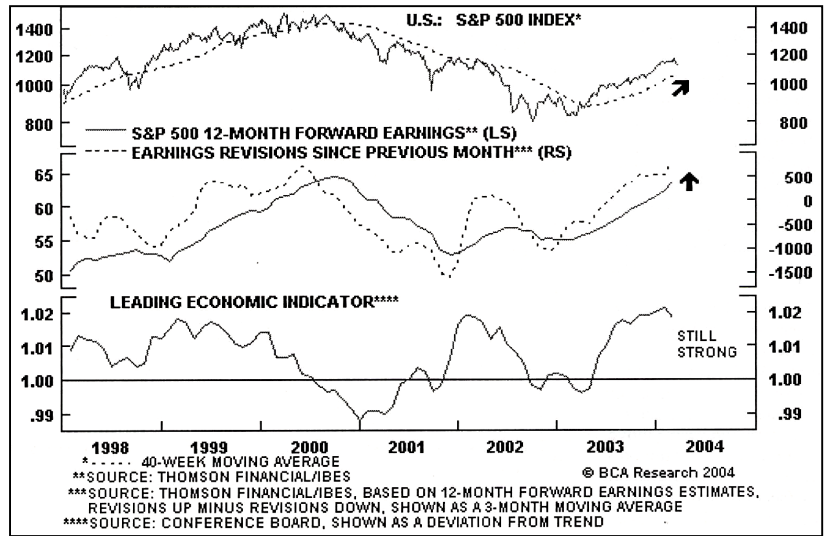


Meanwhile, fear of an inflationary resurgence is running strong in U.S. markets. But the reality is that the yield of 10 year treasuries, though rising from 3.7% to 4.4% recently, is still range bound within the 3.7% to 4.5% range of the past nine months. Moreover, we do not believe interest rates on ten year treasuries will be rising

anytime soon to the 6.5-7.0% rates that have historically signaled P/E ratio compression in the equity markets.

The current bearish case vocalized by advocates of this persuasion runs something like this: P/E's are high by historical standards, the market is already up by a large amount, interest rates are probably set to rise, earnings momentum may have peaked, and therefore the stock market is probably headed south. Our answers are: not really, yes, yes, yes and not yet.

Let's look at leading indicators. Both leading and lagging economic indicators indicate the preference for stocks over bonds. And leading indicators, though peaking, are still strong. As can be seen in this chart, as long as leading indicators persist above 1.00, the S&P 500 has tended to keep advancing. For those of you with neither the patience nor the interest in deciphering this graph we offer up for your



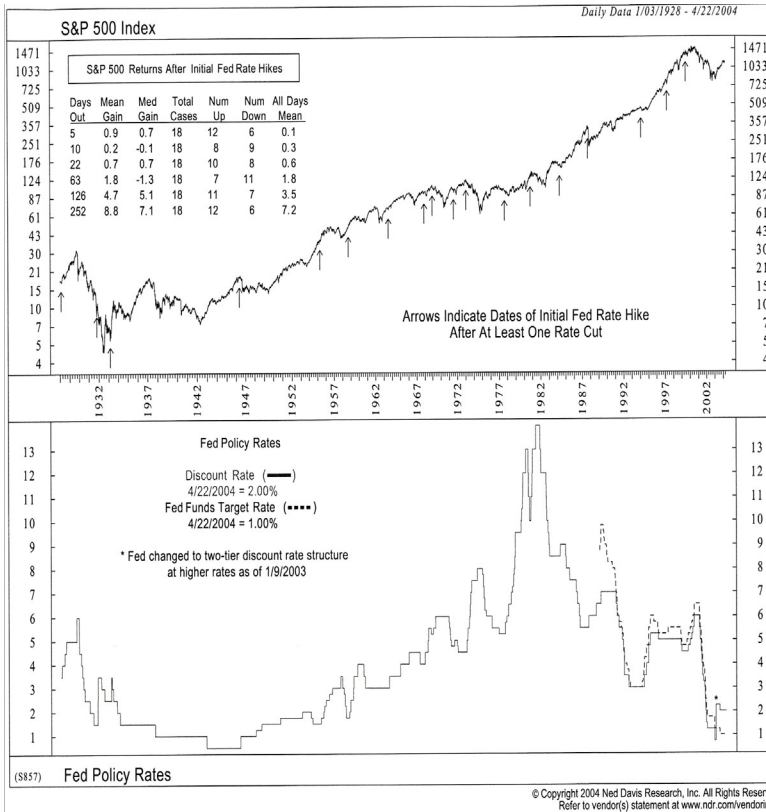
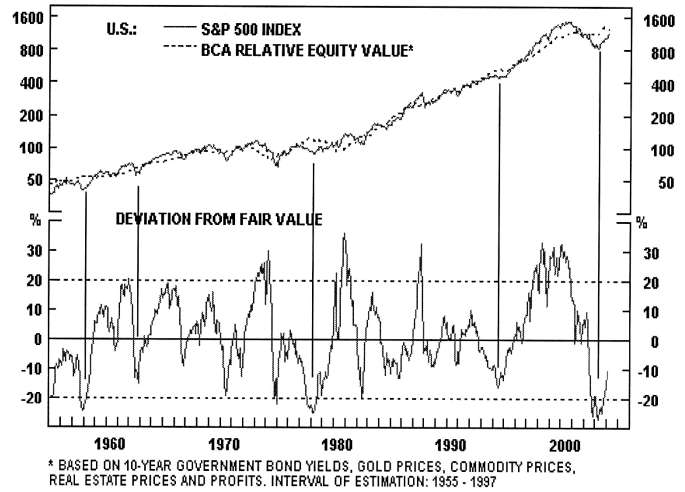
mild amusement the cartoon at left.

Another way of looking at relative expensiveness or cheapness is to look at the S&P 500 (80% of the value of all publicly traded stocks) relative to real estate prices, commodities,

"We'd just like to get away from all leading economic indicators for a while."

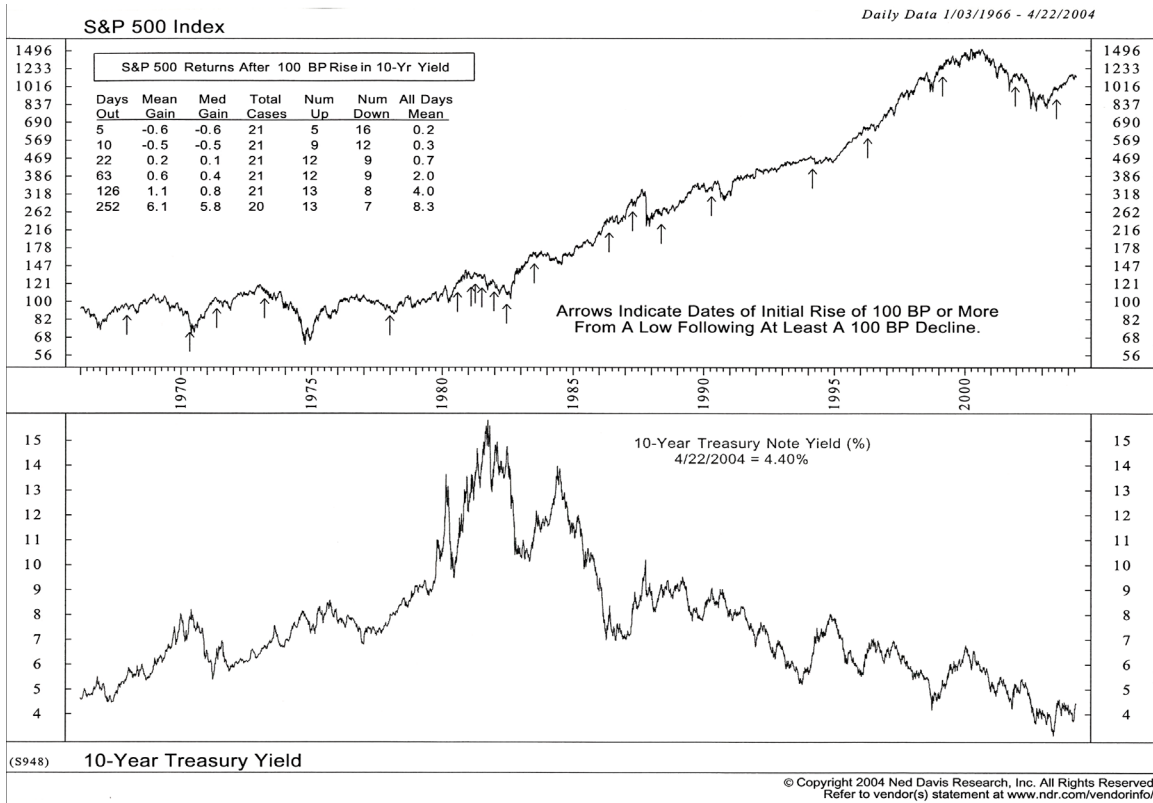
gold, treasury yields and corporate profits. This comparison as seen below, shows stocks to still be cheap coming off lows not seen for 50 plus years.

The prospect of interest rates creeping higher has some investors concerned that the competition from higher rates will cause the stock market to begin declining. Although this line of thinking carries some superficial logic, the conclusion is not validated by history. In fact, as this chart shows, one year (252 trading days) after the first Fed discount rate hike, the stock market as measured by the S&P 500 has historically advanced an additional 8.8% (total return). Other evidence



shows that the one year total returns do not turn negative until the fourth hike has taken place. Moreover, a 100 basis point (1%) rise in the ten year Treasury bond yield is likewise followed by positive stock market returns, though slightly less at 6.1% (total return) on average. Therefore, we conclude there are yet positive days ahead for this market and that

investors would be well advised to curb their bearishness at this juncture, and save it for a later date.



Otto von Habsburg was slated to become the inheritor of the the reins of power of the Austro-Hungarian empire. But such was not to be the case as WWI intervened, forcing him into exile in its aftermath. Nevertheless, he lived on to fight another day and become a leading proponent of the European Union. His life's example places extra weight behind the old German hunting adage "Not shooting is also a miss". So we reload in anticipation of the next opportunity.

Very truly yours,

Alan T. Beimfohr

John G. Prichard, CFA