Knightsbridge Asset Management, LLC

July 13, 2017

Summer Quarterly Commentary

"Well, Apple invented the PC as we know it, and then it invented the graphical user interface as we know it eight years later (with the introduction of the Mac). But then, the company had a decade in which it took a nap."

Steve Jobs, 1955-2011
Co-founder of Apple Inc.
Former majority shareholder of Pixar

Economically and financially the second quarter unfolded much like the first quarter. While the "Trump Bump", i.e. the general upward movement of stocks, continued apace, the "Trump Trade", i.e. the movement of individual stocks according to anticipation of more robust economic growth, began to deflate. Actual economic conditions didn't lift off to match the lofty post-election expectations. Instead both economic and legislative expectations have begun drifting back to earth, as can be seen in the following chart showing "soft data" expectations drifting down towards "hard data" readings. In another reflection of the same trend, the U.S. Economic Surprise Index, which

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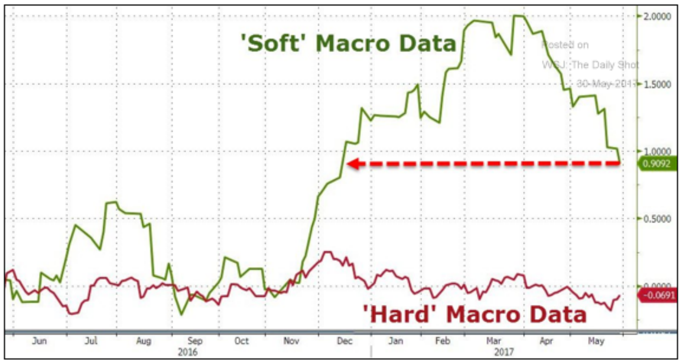
measures the gap between expectations and actual conditions, trailed off in recent months. Yes, the labor market has continued to heal and the economy has continued to expand, but progress has largely been steady at the pre-election pace.



Source: Zero Hedge; [Read full article]

Source: Danske Bank, @joshdigga

Many of our stocks responded to these conditions as we had expected, and in retrospect we were able to make a number of prescient moves. We did not expect the post-election expectations of increased economic growth to last, and so we sold or reduced some of our most economically sensitive positions. We correctly suspected that interest rates would not continue to rise unabated, so we trimmed our Bank of America common stock position[1] (which generally benefits from higher rates) and bought the Wells Fargo preferred stock position (which generally benefits from lower rates). We also took the opportunity to deploy capital in areas not caught up in the election euphoria. Health care had been a laggard in the year before our purchase of McKesson Corp., a cash generative drug distributor. Last quarter however, health care was one of the strongest sectors and the stock has performed nicely. We also did a good job of staying out of two areas that continued to be radioactive for investors: energy and retail[2].

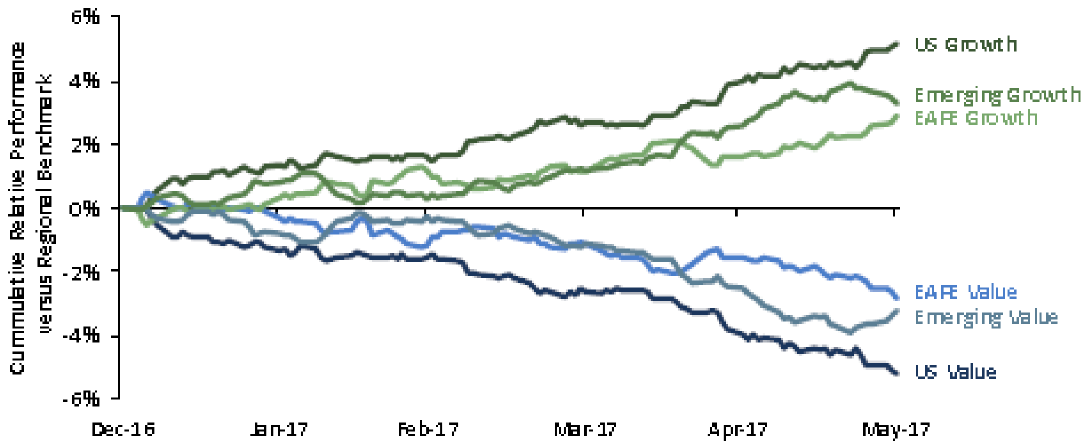
One thing that has definitely not benefitted us this year is the enormous headwind of being a value investor during a period when "growth" stocks trounced "value" stocks. At one point this year, the performance differential between growth and value stocks was just one percent behind the greatest differential ever – the dotcom bubble in

[1] Except in taxable accounts which bought shares at the very low price of our initial purchase – in those accounts we felt tax concerns outweighed investment concerns.

[2] That is, until the recent purchases of DNOW, an oilfield services company, and SRG, a retail-focused real estate company with mixed-use development potential.

2000. While there are numerous definitions, value stocks are generally purchased because the price of the security is attractive relative to the earnings power of its operations, while growth stocks are purchased because of a perception that the underlying company can grow into and perhaps beyond its price tag. U.S. growth stocks have returned roughly 14% this year vs. 4% for value stocks. As value-oriented investors, in some years we benefit from our nature, (last year for example), and in other years, like the present, we face a persistent headwind.

Exhibit 2 – Styles Reversed Early in 2017 with Growth Outperforming Globally

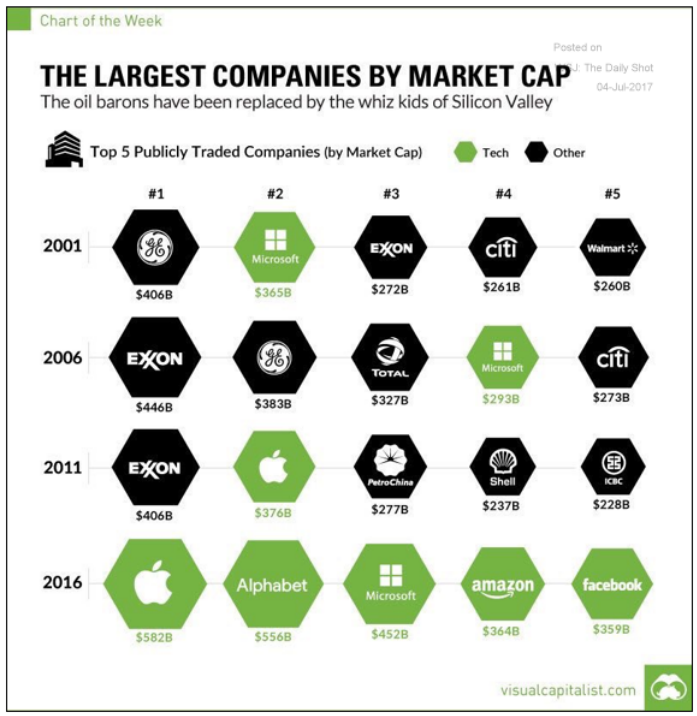


Source: GMO
Indexes include Russell 3000 Value, Russell 3000 Growth, MSCI EAFE Value, MSCI EAFE Growth, MSCI Emerging Value, and MSCI Emerging Growth.

This phenomenon is further illustrated by the extent to which technology shares have crushed the rest of the market. In fact as the chart at right illustrates, if you remove technology shares the broader market has hardly risen at all[3].

[3] Subsequent to the publication of this chart, technology shares gave back some ground but the general story remains intact.

In stock market parlance, the domination of market gains by technology shares would be called "narrow leadership"... but some analysts take it narrower still by attributing much of the market's advance to an even smaller group of high-flying stocks known by the acronyms, FANG, FAANG, or FAAMG, which, depending on the grouping you prefer, consists of Facebook, Amazon, Apple, Netflix, Microsoft, and Google[4]. Various arrangements of these companies now represent a market value greater than the main stock indexes in France and Germany, and nearly as large as the main English index[5]. The FAAMG arrangement accounts for over 50% of the more than $1 trillion increase in the Nasdaq 100 this year, and makes up over 40% of the index's value. In truth, while some of the aforementioned numbers are impressive, the present situation (where only a few stocks make up much of the index value and are responsible for much of the market's advance) is not that unusual. If you look at any recent period and remove the top 1, 2, 3, 4, or 5 performing stocks from the index, you would find that the index's performance declines by an amount similar to what you'd get if you performed that exercise in any other period[6]. Thus leadership of the market by a few stocks is normal. What is not normal is that so many of these stocks are concentrated in one sector.



Going back to performance, the obvious question is, "If these tech companies are so great, then why don't we own them?" To this we have a few answers.

Answer #1: We do! Though it wasn't included in the original FANG acronym, Apple found a berth in the new-fangled FAANG after returning more than 25% year to date. We purchased Apple in October of 2015 when it seemed most analysts were convinced that iPhone sales were about to fall off a cliff. This quarter we also

[4] Google is now officially known as Alphabet, but is still represented in the acronyms by the letter G.
[5] These indices would be the CAC 40, the Dax, and the FTSE 100.
[6] A good analysis for can be found at https://www.aqr.com/cliffs-perspective/still-not-crazy-after-all-these-years

purchased an IT services firm, DXC Technology, which so far has been less successful (but still positive).

Answer #2: We might! We have actually looked somewhat closely at buying two of the aforementioned tech high-fliers in the past few years. We might conceivably own some of these companies in the future because, despite the soaring stock prices and national attention, we are not in the tech bubble 2.0, at least in terms of overall valuation. Looking at the below chart, one can see that current market valuation is far below the peak of the dotcom bubble, and tech sector valuation isn't even in the same solar system. Rather simplistically taking valuation to mean price divided by earnings or PE, it is worth noting the lower PEs of today have as much to do with large E's (earnings) as they do with reasonable P's (prices). Apple, Google, Facebook, and Microsoft make enormous profits (trailing 12 month GAAP net incomes of $46 billion, $21 billion, $12 billion, and $18 billion, respectively). However, such present-day windfalls are not universal. Relative to their size, Netflix and Amazon do not make large accounting profits (trailing 12 month GAAP net incomes of $340 million and $2.6 billion, respectively).

Chart 3: Price/12m Estimated Operating Earnings Ratios For S&P 500 & Information Technology Sector

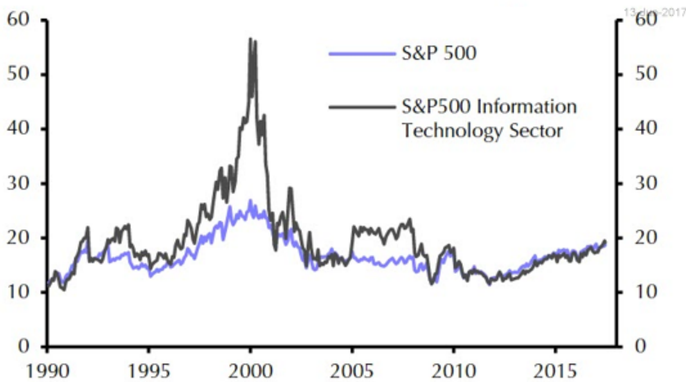
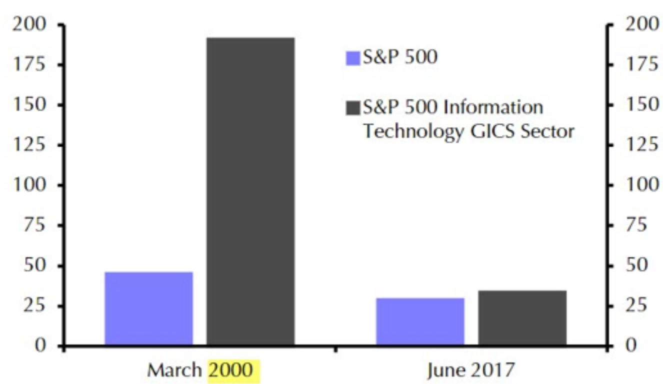


Chart 4: "Shiller's" Cyclically-Adjusted Price/Reported Earnings Ratios For S&P 500 & Information Technology Sector



Sources – Bloomberg, Capital Economics

Another important difference between today and the dotcom era is the differing nature of the advantages of the leading companies. During the first episode, much of the excitement was around companies with "first mover advantage", which is the idea that the first company to do something will have a huge lead in ultimately dominating that space. This is a fallacy! GM ended up dominating Ford (which almost went bankrupt) despite Ford having a huge early lead. Per the quote at the beginning of this letter, Apple

had the first personal computers, yet this letter was composed on a Dell computer running Windows software. MySpace predated Facebook and Yahoo preceded Google. The examples are endless. Simply put, being first in no way ensures success.

However, many of today's tech giants have very different and more durable competitive advantages. The first is the advantage of scale, reflected in how Apple can spend more on phone R&D because they know they'll sell enough units to justify the investment, or how Amazon does enough business that they can afford to build their own custom sorting machines and build warehouses near every major metropolitan area to ensure speedy deliveries. A second and arguably stronger type of advantage is "network effects". This is when having more people use your product makes it more valuable. Think how Facebook is only useful because your friends are on it, or how Google can make its searches that much better because it can see what other people are searching for. Are there much-talked-of companies today that won't convert their first-mover-advantages to advantages of scale or network effects? Yes. But many of the tech giants appear to have already achieved these advantages and are here to stay.

Getting back to the final answer to "why don't we own more tech stocks" is Answer #3: we didn't think they were sufficiently good investments. While obvious, this might be surprising because we just wrote about what great companies most of these firms are. However, it's very important to realize that not all great companies are great stocks. Most often this occurs when the stock of a great company becomes too expensive[7]. Other times, a company with clearly great prospects in the long term doesn't stand to make any significant profits in the short term, which makes it all but impossible to establish an estimate of value for the company within a tight range. For value investors like us, if you can't establish a range of value for a company, then you can't buy the stock below that value, and if you're sticking to your process, you shouldn't.

Amazon is a company like that just described. It is undeniably a great company, whose dominance in multiple markets, high growth rate, and success in entering new businesses can't be denied. Amazon decimates entire industries by entering them. This was recently demonstrated when Amazon announced it was buying Whole Foods, and

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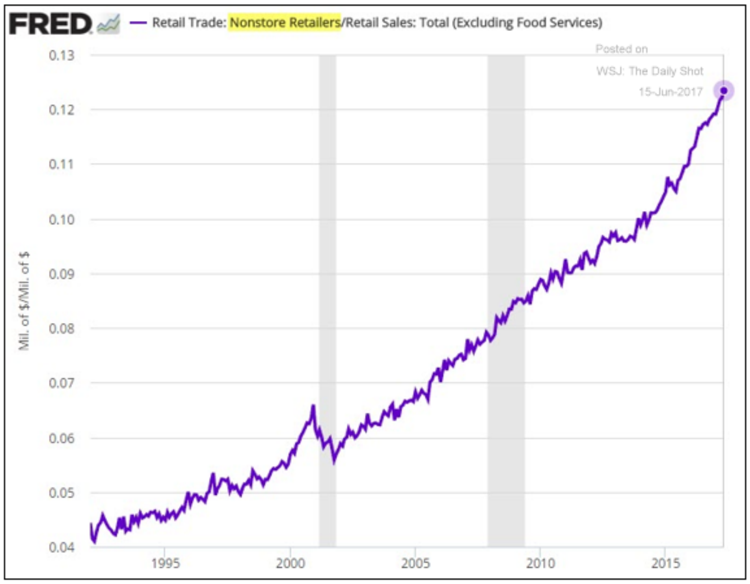
[7] The classic example of this is the "Nifty Fifty" stocks of the early 1970's when conventional wisdom held that these companies were so great the price paid for their stock didn't matter. Though many of these companies did go on to post many solid years of operating performance, the high prices paid did indeed ensure a disappointing experience for investors.

seven food-peddling competitors lost $22 billion dollars in market value that same day[8]. The below, which shows the online percentage of retail sales is the scariest chart in American business[9]. The current reading is about 12.5%... where will it stop? Also note the trend is *accelerating*.



Source: St. Louis Fed

And yet, Amazon doesn't turn that much of a profit relative to its size, clout, market cap, or presence in the American psyche. In fact, one of the great advantages of Amazon is that it has cultivated a shareholder base that has basically allowed management to run the business at cost, which in turn has allowed the company to forgo meaningful profits and instead reinvest in lower prices and aggressive gambles into new markets. One of these gambles, started almost a decade ago, today is the dominant cloud computing platform Amazon Web Services which *does* generate substantial profits for the parent company. Even given these successes and recent increases in profitability, Amazon trades at a trailing multiple of earnings north of 180, and so for buyers of Amazon's stock today, long term success depends on the Seattle giant vastly increasing profitability... by about $17 billion dollars (~760%) if Amazon is ever to trade at the current market PE multiple of 24[10].

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8 Also on display way was how Amazon's CEO can seemingly do no wrong. The stock of an acquirer usually falls on the day of a deal announcement, but Amazon's went up.

9 And this isn't just because brick and mortar businesses are losing share to Amazon. Fun fact: online sales are often in general not as profitable for traditional retailers as their other sales, largely due to the cost of shipping, and especially returns. Another fun fact: many small items are actually cheaper in store vs online, again because of shipping costs.

10 This demonstration is overly simplistic in a number of ways, but nevertheless demonstrates the scale of the task for Amazon to grow into its valuation. Additionally there is a good argument to be made that Amazon ought to be valued based on its free cash flow, rather than GAAP earnings. But there are also valid criticisms of this argument (especially in the calculation of free cash flow) and such a detailed discussion is beyond the scope of this letter.

Will it? Will investors continue to allow Bezos to focus on new markets, low costs, and revenue growth rather than reported earnings growth? If not, and the stock falls, will Amazon's employees continue to agree to receive much of their compensation in company stock? Will Amazon ultimately be able to raise online prices to earn a better profit in their North American retail business without customers fleeing? Will a dangerous new online competitor emerge in the form of...Walmart?! Recently the behemoth retailer has gotten aggressive in the online space, buying rival Jet.com and just about any other online brand it can get its hands on. Could Walmart, an entity with disposable cash flow at least twice that of Amazon's, really take the gloves off and lower prices almost to the point of no profits in order to establish online market dominance... just like Amazon has? Could they credibly commit Jet.com to undercutting Amazon on price? It may sound far-fetched, but with the Walton family still controlling a sizable stake in the company, it's not impossible that the Bentonville giant could really start "playing for the long term".

Fortunately, we don't have to worry about these things. We can't reliably estimate Amazon's future earnings and therefore won't be purchasing it. We only need worry about Amazon destroying the businesses of the companies we own and seek to buy... and in that case we have been trying to stay as much out of its way as possible which, so far, has been a good strategy.

In the meantime, we endeavor to determine when we can and cannot reliably profit from technology's growing role in our lives, and when we can't, we seek not to be tempted into enviously chasing certain rising securities higher.

We thank you for your support.

Sincerely,

John G. Prichard | Miles E. Yourman

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