Knightsbridge Asset Management

division of Canterbury Capital Services, Inc.

July 28, 1998

Second Quarter Commentary

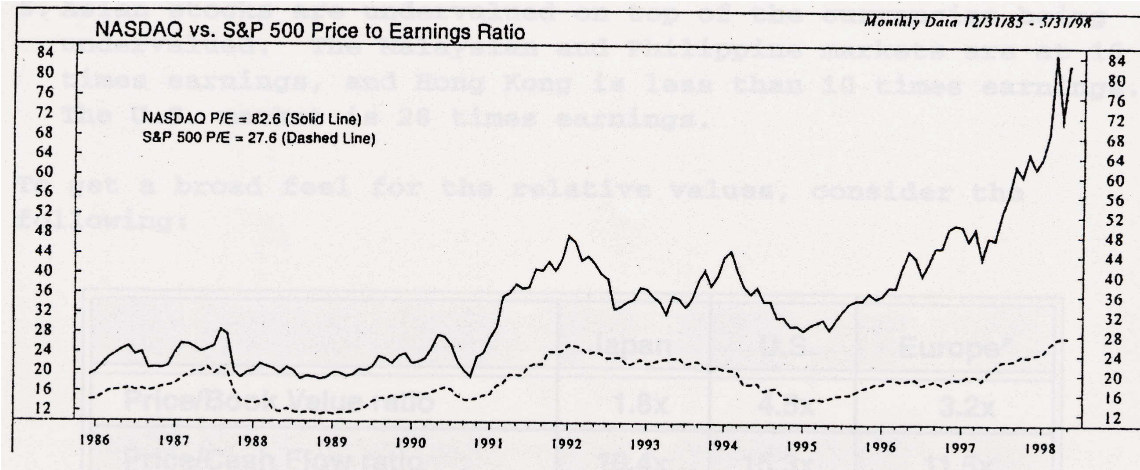
"The ruling passion, be it what it will,
the ruling passion conquers reason still."

Alexander Pope, 1688-1744
English Poet
Moral Essays
to Lord Bathurst, 1732

Reason is still being conquered by ruling passions for many participants in the U.S. market. One need only look at NASDAQ (the over-the-counter market) to see a whopping price to earnings ratio of 83! Yes, this is not a typo… that's eighty-three! This means it requires an $83 investment to generate $1 of earnings. Absent growth, that is an investment return of 1.2% per year.

Swept up in the new-age market euphoria, proponents claim a handful of high-tech issues bias this P/E statistic upwards since the NASDAQ average is a capitalization-weighted index. The four largest issues in the NASDAQ average are Microsoft, Intel, Cisco Systems, and Dell Computer. If they are removed, the P/E ratio for the rest of the list goes up to an even more astounding 93 times earnings. Only if one removes all issues reporting losses does the P/E ratio drop, and then only to 33!

660 Newport Center Drive • Suite 460 •Newport Beach • California 92660-6405
(949) 644-4444 • Fax (949) 717-5030 • www.knightsb.com



The flip side of this valuation coin is Asia. The Japanese over-the-counter market is trading between 8 and 9 times earnings.

Since their market tops several years ago, the Indonesian market is down 92%, Korea 79%, Malaysia 76%, Thailand 74%, Philippines 69%, Singapore 68% and Hong Kong 55%, all stated in US dollar terms. Even a McDonald's "Big Mac" is now 30% more expensive in New York City than in Tokyo. Yet in the midst of all this Asian gloom there are strong reasons for optimism:

1. **Asian currencies have overcorrected and are currently about 30% undervalued, in the aggregate.**

2. **Confirming this undervaluaton is a resurgence in export competitiveness. Korean *imports* in US dollar terms have fallen 37% versus *exports*, which have only fallen 3%, year-to-date through May 1998. The Korean won is estimated to be 34% undervalued on a price parity basis.**

3. **Asian savings rates are typically double to triple those in the U.S.**

4. **Although there is currently an excess of infrastructure in place, the power plants, expressways, airports and buildings built in the last few years will stand them in good stead in the years to come. One only needs to think of how depressed Orange County real estate was in 1993 versus today, to get the idea.**

5. **Asian stocks are undervalued on top of the currencies being undervalued. The Malaysian and Philippine markets are at 10 times earnings, and Hong Kong is less than 10 times earnings. The U.S. market is 28 times earnings.**

To get a broad feel for the relative values, consider the following:

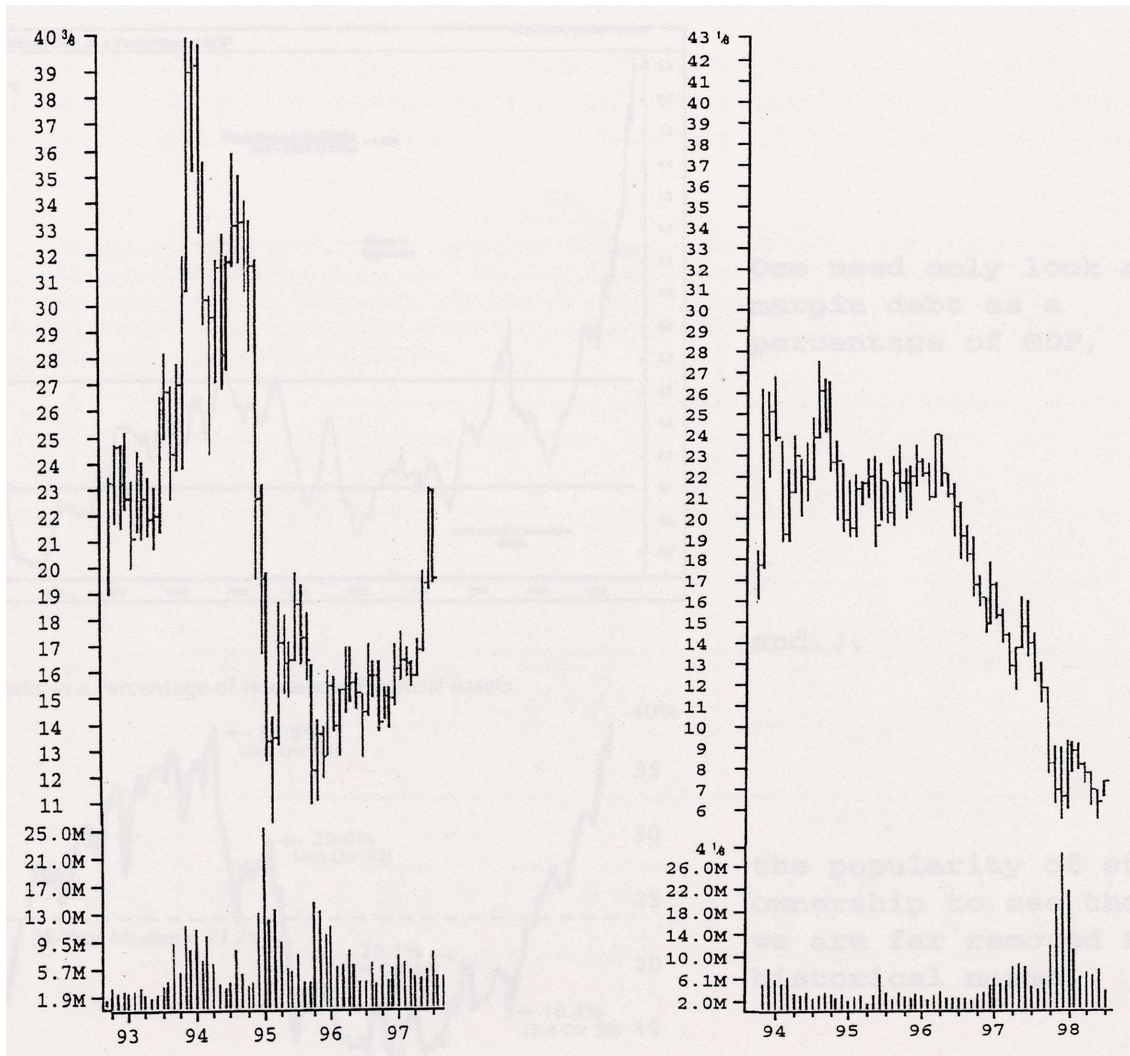
	Japan	U.S.	Europe*
Price/Book Value ratio	1.8x	4.5x	3.2x
Price/Cash Flow ratio	10.4x	15.3x	11.5x

average of Germany, France and U.K.

Japan's position in the Asian equation cannot be overestimated. The fact is that Japan has a slow growing and aging population that is not as consumer oriented as the U.S. It is not a realistic expectation that Japan will pull the rest of Asia out of recession. Rather, it is far more likely that the U.S. and Europe will pull Korea, Malaysia, Thailand, etc. out of recession first, through consuming their cheap exports, which in turn will stimulate the Japanese economy.

The currency devaluations of the Southeast Asian countries have brought about high interest rates which, when combined with recession, provide a powerful combination to bring their respective stock markets to their knees. We want to be bargain hunting in this environment. One should recall the Mexican peso devaluation of early 1995 and the subsequent recovery in the Bolsa de Valores. This is a good comparison to the Korean won devaluation of late 1997.

We might use the Mexico Fund (MXF) and the Korea Fund (KF) as proxies for their respective markets. We can see the affect of the Mexican peso devaluation on Mexico Fund (1995) and compare it to the Korean won devaluation on Korea Fund (1997-8).

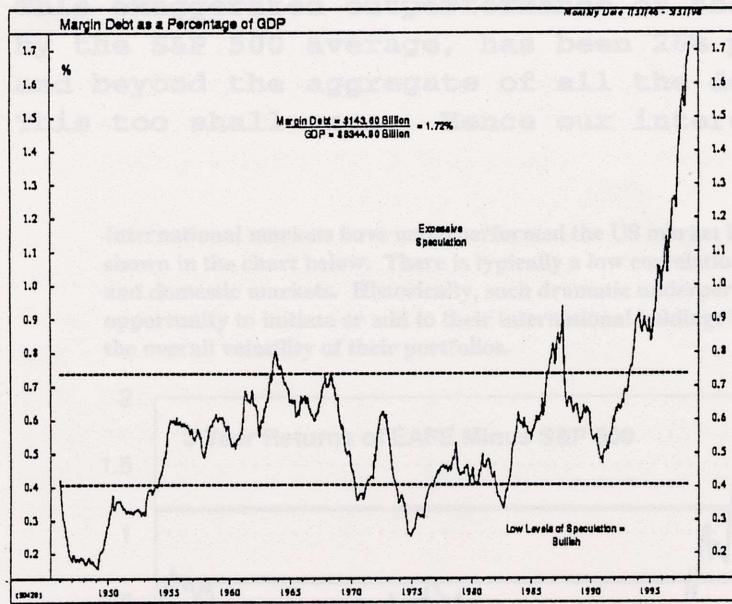


Mexico Fund before, during, and after devaluation of the peso in 1995.

Korea Fund before, and during devaluation of won in 1997-8.

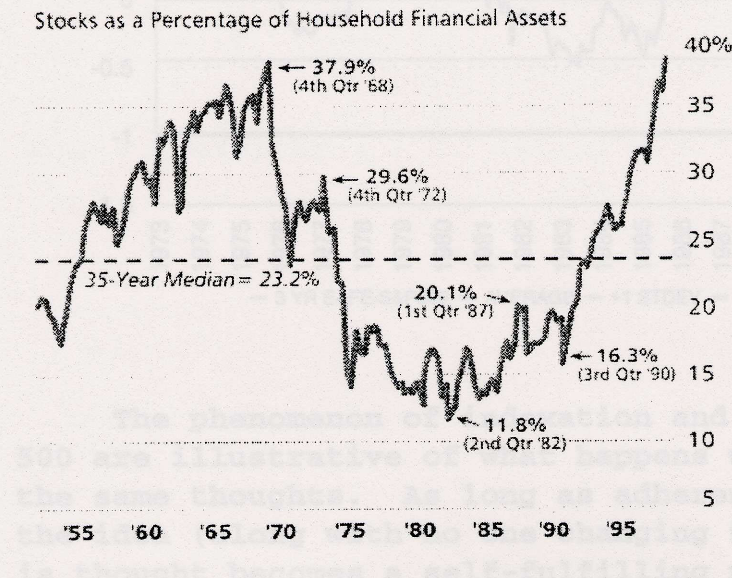
Although simplified for presentation purposes here, the conclusion is that recovery is expected, and one must be prepared to withstand the onslaught of the business press as it reports the doom and gloom of the day. It is this very gloom that provides the opportunity to buy cheaply.

We are still very much concerned by the speculative froth in the U.S. markets and observe daily, anecdotal evidence showing valuation extremes and a gunslinging attitude toward the U.S. market. One need only look at margin debt as a percentage of GDP and the popularity of stock ownership to see that we are far removed from historical norms.



One need only look at margin debt as a percentage of GDP,

and…

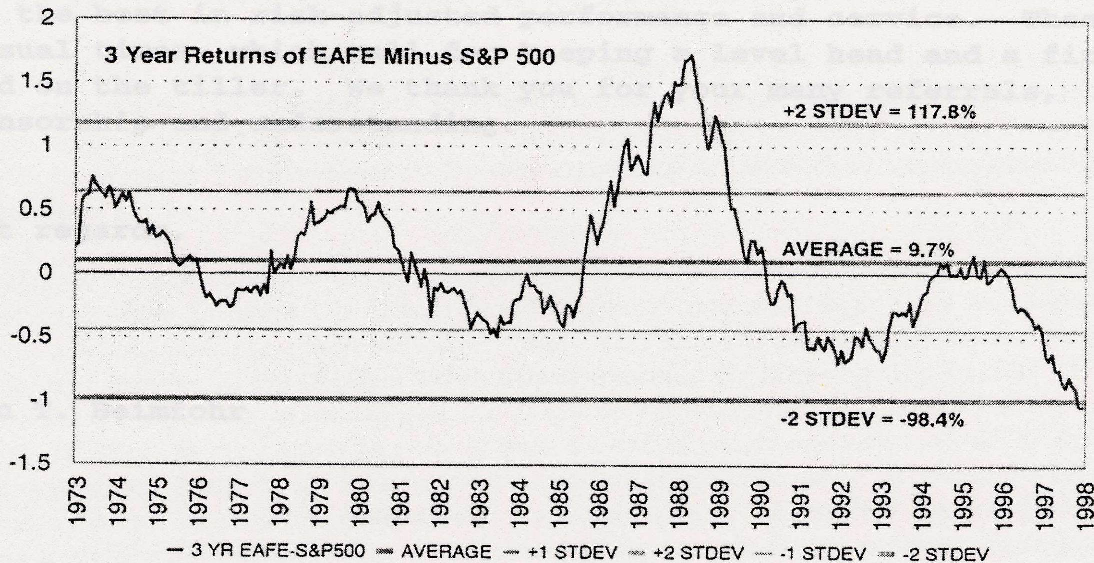


the popularity of stock ownership to see that we are far removed from historical norms.

As contrary opinion indicators, both of these charts are spelling "caution", loud and clear!

Now is certainly the time to beef up the foreign market exposure in one's portfolio. The chart below is a bit complex, but is worthwhile studying. It shows the 3 year returns of the Europe and Far East (EAFE) markets relative to the S&P 500 average. The peak of foreign stock performance relative to the U.S. market was in the 3 year period ending 1988. What we see now, in 1998, is that the U.S. market has outperformed the foreign markets by almost 100% (actually 98.4%) over the past 3 years.

This exaggerated outperformance of the U.S. markets represented by the S&P 500 average, has been 26% per year for 3 years above and beyond the aggregate of all the developed world's markets. This too shall pass. Hence our interest in the Asian markets.



The phenomenon of indexation and the performance of the S&P 500 are illustrative of what happens when enough people all think the same thoughts. As long as adherents are being converted to the idea (along with no one changing their mind), then that which is thought becomes a self-fulfilling prophecy. But should that mindset lose proponents, "Katy bar the door!" It is likely that the market in the U.S. is undergoing a broad topping process. Breadth and momentum are fading, and the average stock is having a very difficult time. Any company missing it's quarterly earnings expectation will have its stock summarily executed, many falling 30 or 40% in the process. This is not the behavior of a nascent bull market, but rather one very long in the tooth.

The Asian markets have been rocked by unexpected GDP growth declines, currency turmoil, and political resignations, of which Hashimoto in Japan is but the latest. In reality, this produces opportunities much like high wheat prices produced the opportunity in Earthgrains

early in 1996. Earthgrains quadrupled in the following 2 ¼ years. From such adversity is opportunity made. Although the timing may be uncertain and rough, a strong belief in the process and the ability to understand the true proximate worth of a business enterprise, will carry the day.

I am pleased to announce that John Prichard, CFA has joined our portfolio management team. John, a graduate of U.C. San Diego and a Chartered Financial Analyst, joins myself, Karen Riccio and John Rozenbergs, Ph.D. Together we hope to deliver to you the best in risk-adjusted performance and service. These are unusual times, which call for keeping a level head and a firm hand on the tiller. We thank you for your many referrals, sponsorship and understanding.

Best regards,

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

Postscript: I am indebted to Lee Cooperman of Omega Partner, and formerly Chief Investment Strategist at Goldman Sachs, for the following commentary on performance:

To hear it told by the popular media, 1998 is proving to be another in the skein of good years for equity investors. But this is mostly due to "index myopia", a focus on the headline benchmarks such as the Dow Industrials, the S&P 500, and the NASDAQ composite. The S&P500 has risen almost 18% since December 1997, 3% in the April, May and June quarter, and a decline of -1% in July. But the Value Line index (which gives each of its 1700 component companies - regardless of size- an equal weight in determining performance) actually declined 2% in the second quarter of 1998 and decreased another 6% in July. Needless to say, portfolio performance isn't just a matter of what you own, but in what proportions you own it.

This seemingly relentless trend toward narrower leadership is but one troubling aspect of the U.S. stock market environment. An increasing number of stocks have fallen upon rough times -many, indeed, struggling with their own bear markets- yet the major averages persist in scaling new heights, driven by the ever expanding values of their largest, most liquid component stocks.

Taking the 1500 companies which are members of the three main S&P indexes (the 500, the Midcap, and the Smallcap), it's clear that the smallest companies offer more value - using traditional benchmarks- than the largest ones. This discount widened substantially over the past three months, as the smallest group underperformed the largest group by over 12%. Of these 1500 companies, in the top quartile of market capitalization, one pays $1.48 for a dollar's worth of sales. In the bottom quartile of market capitalization, one pays only $0.57 for a dollar's worth of sales. Each dollar invested in the smallest group buys you -on average- and extra dollar of actual revenues as compared to the largest group. The market's recent behavior has been to reduce the capitalization of companies doing more business, in favor of companies which are doing less.

Despite this yawning valuation and performance gap, we are uncovering fewer attractively priced companies than at any time I can remember. In general, these companies are not to be found among the largest capitalization stocks where P/E ratios are higher than at any time since the early 1970's. Back then, while many of today's portfolio managers were struggling with geometry and geography, the "New math" on

Wall Street held that some businesses were so attractive that you could pay any price and expect to make a good return over time, because growth would bail you out. Needless to say, this thesis proved false. Rather than being willing to pay any price for just a few attractive stocks, we are willing to buy almost any stock at the right price.

Many observers agree that the valuation gap which has risen between the average company and the "Nifty 50", which dominate the top tier of market capitalization, will somehow converge. Bullish observers are anticipating a period of catch-up for the small-caps, while the bears hold that the large-cap leaders will be especially hard hit during an upcoming correction, erasing the premium while simultaneously reestablishing a more traditional valuation framework for the entire market. As far as we can tell, convergence of this gap probably requires an economics upshift. Renewed earnings momentum would likely favor the average company, and any associated uptick in higher interest rates should impact the large-cap leaders more acutely. Unfortunately for the convergence crowd, at this stage, economic acceleration would quickly bring the Federal Reserve into play, spoiling the trend.

Over the past several months, more and more companies have been forced to admit that investors' profit projections were too high. In most cases, the ensuring carnage is swift and substantial. The magnitude of the price drops seen after these negative reassessments indicates that market-wide expectations are probably still excessive, give the extent of the damage to Asia economies and the potential for further deceleration in the U.S.

In one sense, the market's recent frothiness may have been somewhat self-perpetuating. The rising number of profit warnings have encouraged investors to place a higher premium on earnings reliability, helping to drive up the prices of the "Nifty 50" stocks which dominate the popular indexes. The ability of the S&P 500 to achieve a new closing high has emboldened investors, who appear now to be more concerned about opportunity losses that risks to principal.

Likewise, the tendency of some investors to "buy what's worked" has diverted a substantial flow of new monies toward indexed funds and away from those emphasizing stock selection. But index fund popularity is not solely to

blame; note the sharp divergence between the S&P 500's Value and Growth sub-indexes.

We are concerned that professional sentiment has also become more complacent. The Quantitative Analysis group at Merrill Lynch warns that Wall Street strategists have been steadily boosting their recommended equity weightings. The average recommendation is now over 56%, close to the levels that existed before the '87 break and the '90 bear market. (By comparison, the average recommendation was only 48% at the end of 1994… when the Dow Jones Industrial traded 5,500 points lower than today's level).

Mutual fund managers are also less worried about downside risks. Aggregate cash reserves held in equity funds has fallen from almost 9% of assets at the end of 1994 to 5.5% today. Over the past 15 years, the S&P 500 has returned 18% per annum, significantly greater than the 10% to 12% long run averages for equities. What we've experienced is a substantial rise in P/E multiples, only some of which can be attributable to lower interest rates. The balance of the multiple expansion is the result of a euphoric attitude on behalf of investors regarding the risks and rewards of owning stocks, the sustainability of the current level of profitability, and a traditional business cycle.

As interest rates continue their downward journey, the market has become even more cognizant of the earnings risk of the average company. While it's easy to determine how a lower discount rate increases the present value of a future stream of earnings, it's more of a challenge to ascertain how those earnings may be affected by hazards like technological obsolescence and heightened competition. Challenges such as these become more dangerous as interest rates decline, raising the importance –and value- of our intensive research effort.

Our primary investment goal –achieving attractive absolute return- precludes our chasing the myriad "relative values" available in today's market. We intend to maintain a conservative posture regarding financial leverage, while simultaneously pursuing various alternatives to minimize portfolio financial damage when the inevitable downward adjustment occurs. Candidly, we are finding very few attractive stocks to buy and an ever increasing number of our holdings have become fully valued. Where this has occurred, we are harvesting our gains.