Knightsbridge Asset Management, LLC

August 7, 2000

<u>Second Quarter Commentary</u>

" Common sense is the best distributed commodity in the world, for every man is convinced he is well supplied with it."

Rene' Descartes
1596-1650
French Mathematician and Philosopher

Decartes attempted to extend mathematical method to all knowledge in his search for certainty. He declared only *one* thing could not be doubted: doubt itself. Cartesian logic, named after Descartes, is that which produces certainty, e.g., 1+1=2. Sounds simple enough. So much for the history of philosophy. Common sense may be well distributed, but we wonder if Descartes thought it equally distributed. We doubt it! Mustering all *our* common sense, we question whether the domestic economic glide path will be as smooth as most would now have us believe.

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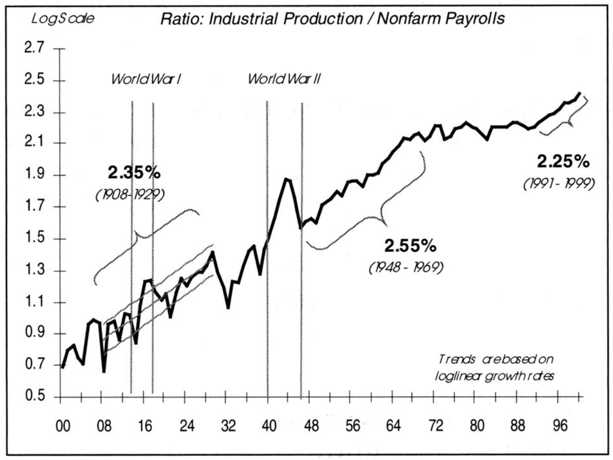
The stock market level in the year ahead may be determined by the degree to which further Federal Reserve Board action is required or not required to cool down what had become a clearly unsustainable economic condition. Recent discussions have centered on whether the U.S. economy will see a hard landing, soft landing, no landing or crash landing.

Productivity Booms during 20th Century

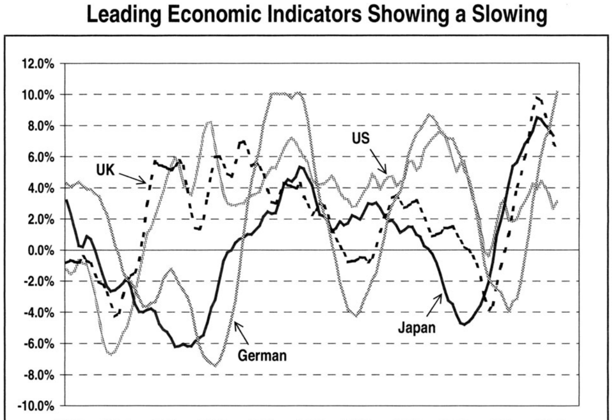


Source: Morgan Stanley Dean Witter Research

Employment and production data would suggest a soft landing is in the works. The stock market is behaving as if a soft landing is most likely. A soft landing would mean that real GDP growth rates moderate from the torrid 5% to 7% rates of the past few quarters, to, say something around 2% to 3%. A hard landing would presumably see GDP growth rates fall to -1% to 1%. Productivity, which has run at an annual rate of 3.6% so far this year, is the poster child for all that is right and good in today's economy. A stunning 2nd quarter productivity of 5.3% annual rate was the highest quarterly rate since 1971. The productivity boom, as illustrated above, has prevented these high GDP growth rates from translating into inflation. Maybe.

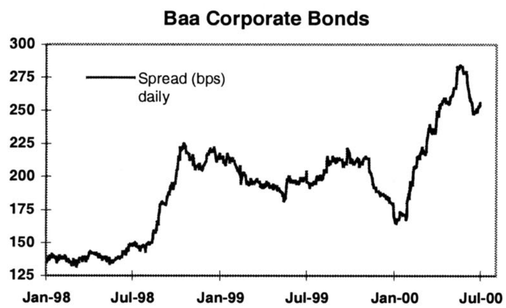
Should we assume that the Federal Reserve has come close to completing it's ugly task? After all, we have seen six (6) interest rate increases totaling 175 basis points (1¾ %) in the past 14 months. Stock market participants are encouraged because economic leading indicators show that the U.S., U.K. and Japan have all turned down. Only Germany remains on an upward trajectory. Furthermore, the Fed took a pass on further raising rates at the June 28th meeting and futures markets are currently pricing in only a 30% probability to a 25 basis point increase at the upcoming Fed meeting on August 22nd.

Leading Economic Indicators Showing a Slowing

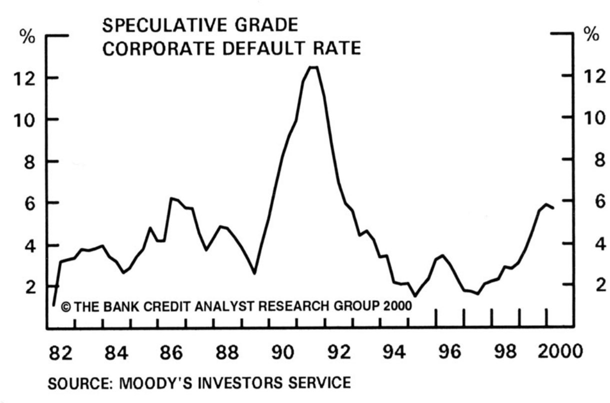


Source: Merrill Lynch, Bloomberg

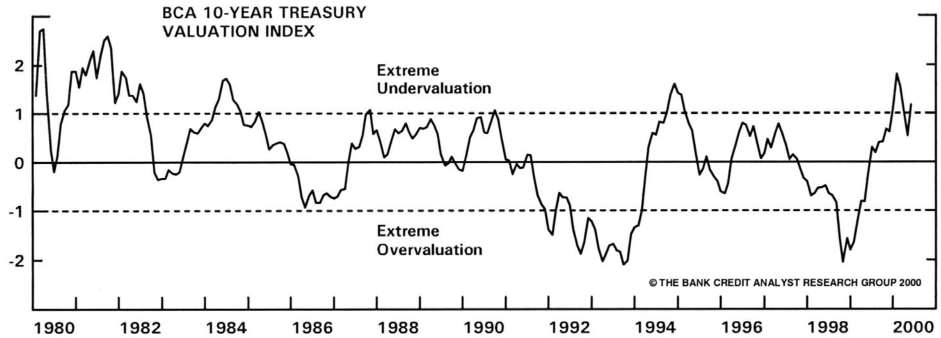
Leading economic indicators (LEI) are not alone in supporting the case for a slowdown. Inverted yield curves are a precursor to economic weakness, and such was the case at, or shortly before, each of the recessions in 1969, 1973, 1980, 1981, and 1990. It is also generally true that bond yields peak coincident with or shortly after the end of Fed tightening cycles. Since we can now observe 30-year treasury yields having peaked in January, some may wonder if this is a sign the Fed has finished it's job. We think this unlikely. Corporate bond yield peaks may be a better measure in this instance. In long maturity bonds, there has been a significant de-linking of treasuries from corporates as can be seen in these charts:



This anomaly is most likely attributable to purchases of long-term treasury bonds by the Treasury spurred by budget surpluses, causing a run-up in prices of long-term treasury bonds relative to corporates, municipals and agencies. Weaker credits below Baa/BBB, or those in the "junk" category most probably have yet to see their peak yields. Moody's predicts the junk bond market will not see peak yields until Q1'01 accompanied by a 7.2% default rate up from about 6.0% currently. Although this event would meaningfully lag a peak in high quality bond rates, it is unlikely the two peaks would be one year apart.

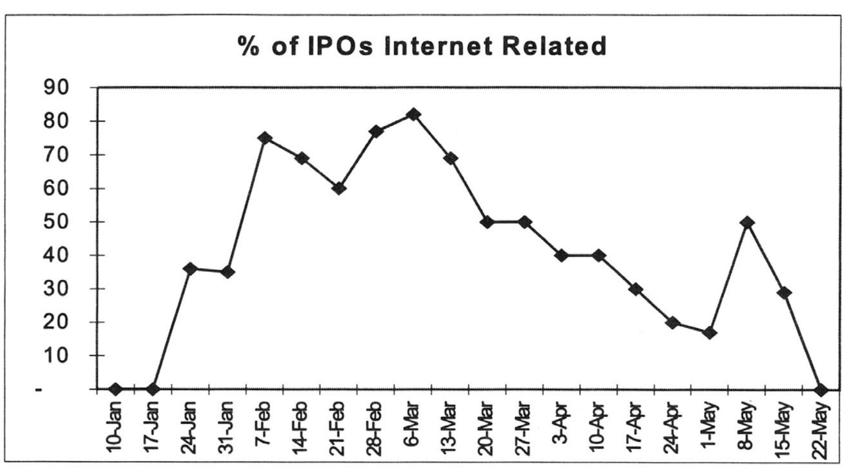


We continue to believe that long-term non-callable corporate bonds are cheaply priced and should be purchased for balanced accounts, even though short-term rates may be going higher. This is because 1) indications are that 10 year treasuries are undervalued, as seen below, and 2) corporate yields relative to treasury yields are thought by us to be unsustainably wide.

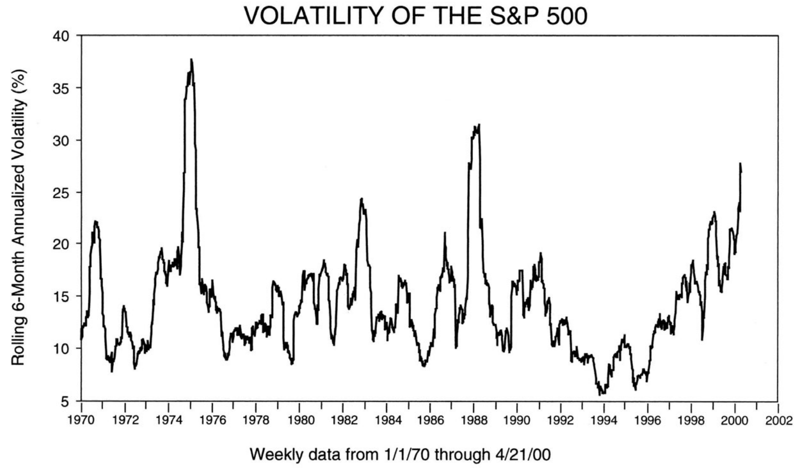


NOTE: THE TREASURY MODEL ESTIMATES THE EQUILIBRIUM LEVEL OF YIELDS ON THE BASIS OF LONG-RUN TRENDS IN INFLATION EXPECTATIONS AND REAL RATES

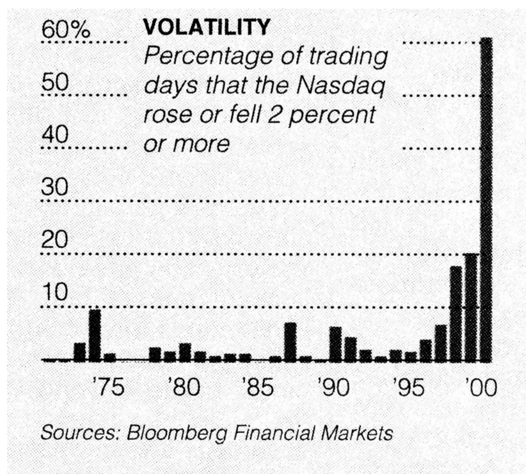
The most notable event of the second quarter was the meltdown of the Internet sector. The bursting of the Internet bubble was overdue and took NASDAQ averages from 5100 on March 10th to 3000 on May 24th. Subsequently, NASDAQ has rallied to 3800 or so as of this writing. Internet stalwart Amazon.com has declined from 113 to 29 in the past 8 months, Ebay from 127 to 50 since March, and Microsoft under it's own peculiar legal cloud from 120 to 67 so far this year. In fact, an indiscriminate screening on NASDAQ for any stock whose name began with "cyber" (as in CyberCash) found the group down 64% from yearly highs; if the name began with "e" (as in eToys), down 73%, if beginning with "i" (as in iTurf), down 68%, and if beginning with "Net" (as in NetZero) down 65%. Rough sledding! Moreover, the percentage of IPO's (initial public offerings) that are Internet related has gone from 80% in March to 0% in May!



Volatility has also increased to a notable extent on both NASDAQ and the S&P 500. As can be seen on the "Volatility of the S&P 500" chart below, volatility spikes in 1974 and 1987 occurred as major bottoms were made in popular averages. From this standpoint, one might be encouraged that the end of the market correction is within sight, and we are mindful of this important piece of evidence. However, frequently the most severe part of a bear market correction occurs at the very end, and therefore, being early can be a very unpleasant experience indeed. We are reminded by Barton Biggs, global strategist for Morgan Stanley "The incredible volatility we are experiencing means that in the long run, the risk premium for equities is going to be higher not lower." Translation: lower prices.



Source: GS Equity Derivatives Research Group.



Sources: Bloomberg Financial Markets

The New York Times

It cannot be conclusively assumed that the Fed is finished with the raising of interest rates. While it is true that the August 22nd Fed meeting is their last chance to do this at a regularly scheduled meeting prior to the November 5th elections, and that it is less likely they would take action prior to the Christmas holiday season, this combination of events brings special risks.

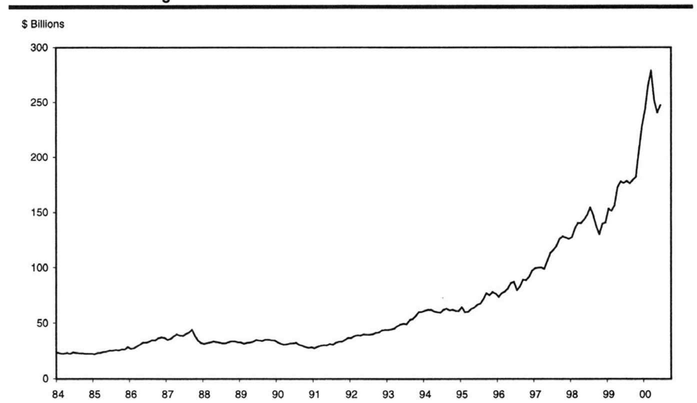
Fresh evidence reported July 27th indicates that the economy may in fact be again gaining strength. Durable goods orders advanced at a 10.0% annual rate in June and the May numbers were revised upward to 7.0% from 6.1%. These are the largest gains since July 1991! Furthermore, unemployment data… first-time claims for unemployment benefits… dropped to a 3-month low in the week ending July 22nd, with initial claims *falling* 40,000 to 272,000.

Lurking in the background is the Employment Cost Index (ECI), up at a 4.4% annual rate in June, the highest year-over-year rise in 9 years. Claims that inflation is of no worry may be premature. Consumer confidence remains at near all-time highs at 101 on the University of Michigan survey. Our "common sense" tells us the economy cannot possibly be weakening much if consumer confidence is this high.

Combined, the durable goods, unemployment, ECI and Consumer Confidence data suggest that "soft landing" conclusions are indeed premature, and that the Fed actions to date may be wholly inadequate to accomplish their mission. Simply stated, it is too early to pass judgment, and we are of the opinion that continued caution is warranted. If in fact the Fed waits until January to act, it may be seen at that time to be too little too late, and truly stiff medicine could be required. We do not view this as a friendly environment for equities, and therefore, our posture remains defensive.

We believe that the equity markets are in the midst of a process of reassessment which will result in a further release of air from the NASDAQ balloon. Margin debt is off about 10%, but in truth, needs to be off about 25% to be in line with previous NASDAQ washouts. We are partway there, but not there. We were recently reminded of a 1960's study

Debit Balances in Margin Accounts at Broker-Dealers



Source: NYSE; Bear, Stearns & Co. Inc.

that concluded "there is no known instance of a (publicly owned) company that has been able to achieve a 25% compounded growth rate over a 20-year span." Forever up to a challenge, we took it upon ourselves to disprove the statement. In fact, Intel did just that, so there is at least one instance of refutation. But investors seemingly persist in believing the rarely doable is frequently doable. This is a sign of the times, and we believe that this fuzzy thinking will need to be put to rest before it is all said and done. There is some evidence of this as the TMT (Telecom, Media and Technology) sectors of the market had been priced by March to expect an earnings/share growth rate of 19%…by late May the expectation had been reduced to a more realistic 14% by the NASDAQ decline.

We have great respect for former Treasury Secretary Robert Rubin. On May 11th he stated "I think that there are fairly substantial and real risks that are probably underweighted in most peoples' thinking"… and that the stock market was "certainly by any conventional measure quite high." We make note this comment was made after, not before, the recent NASDAQ plunge. One week earlier it was hedge fund impresario George Soros who stated, "In some ways I think the music has stopped, only most people are still dancing." Like Descartes, Mr. Soros and Mr. Rubin find value in "doubt", and seem to be saying that caution is preferred in the environment that mismatches opportunity, price and probable outcomes. Although we are inclined to believe our caution has been somewhat vindicated, we also believe it's perpetuation is required under current circumstances.

We thank you for your support, patience, understanding and sponsorship.

Very truly yours,

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