Knightsbridge Asset Management, LLC

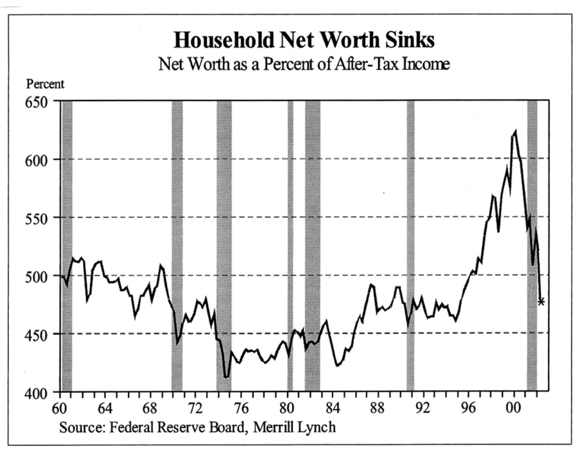
August 6, 2002

SECOND QUARTER COMMENTARY

"In life, perception and reality are frequently at odds"

-Plato
Greek Philosopher, Founder of "The Academy"
427-347 B.C.

Revelations of corporate malfeasance, accounting fraud and executive self-dealing have created perceptions of pandemic corruption in corporate America. The average investor is reacting to the experience of net-worth loss, the first for many, and a certain lynch-mob mentality has taken hold. And the reality is that average household net worth has dropped nearly one-quarter, a stunning statistic.



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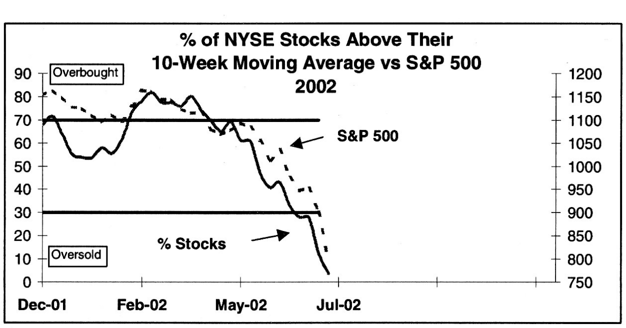
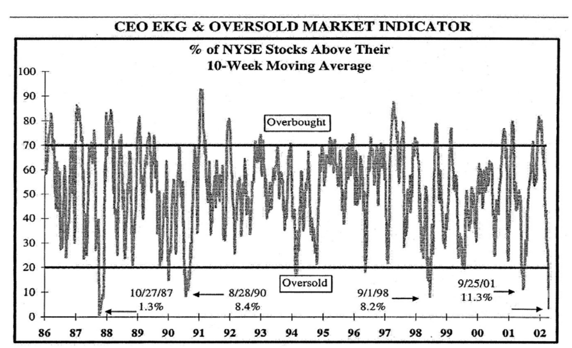
Most governmental institutions were born in reaction to crises… the Federal Reserve in 1913 in response to two banking panics in the prior decade… the Securities and Exchange Commission in 1933 in response to the crash of 1929… the IMF and World Bank in 1945 in anticipation of the disorder created by the fall of Japan, Germany and Italy following WWII. It remains to be seen whether the Bear Market of 2000-2002 will reorder the corporate regulatory landscape, but such an outcome should be expected. The very first SEC Chairman, Joseph P. Kennedy, was a 'bear raider' extraordinaire. Since there was no 'uptick' rule operative in the market, 'bear raiders' could short-sell a stock (sell without owning, with an attendant obligation to buy back later at hopefully lower prices) into the ground, and cover their obligations as despondent shareholders gave up. Since Kennedy was intimately familiar with all the street shenanigans having been a participant, the Pecora Commission, named for Senator Ferdinand Pecora, deemed him uniquely qualified to clean up Wall Street, and so the SEC was born.

The bankruptcy filing of Worldcom, the 7th largest issuer of corporate bonds in the U.S., has coincided with the market lows of July 24th. Soon thereafter the handcuffing and arrest of John Rigas, Chairman and founder of Adelphia spurred the confidence-starved market to a 488-point one-day gain on the DJIA, the biggest one-day gain in 15 years. Following a vicious 29-month bear market which has sent the S&P 500 down 50% and NASDAQ down 77%, fear is running high.

The ultimate paradox of the stock market is that when most participants are most fearful of loss, that is when the risk of loss is least. We believe we are now at such an inflection point. The following are reasons which we believe support this conclusion.

1. The percentage of stocks on the NYSE above their respective 10-week moving average got down to 3.7%, exceeding all important market bottoms of the past 15 years, going back to 1987.

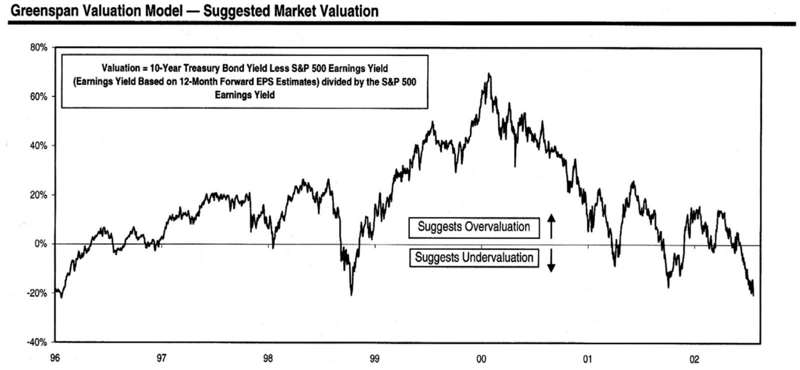




The VIX index, a measure of volatility, has so far peaked out at 57. This volatility measure spikes when prices are falling the fastest, and is therefore very helpful in spotting market bottoms. A reading of 57 has only been exceeded twice in the past 20 years.

2. The Federal Reserve Valuation model is suggesting stocks are about 25% undervalued with forward S&P 500 earnings of $56. Although critics argue this model is forward earnings 'guessing' dependent, even pessimists must concede stocks could be fairly valued with only $42 of forward S&P 500 earnings.

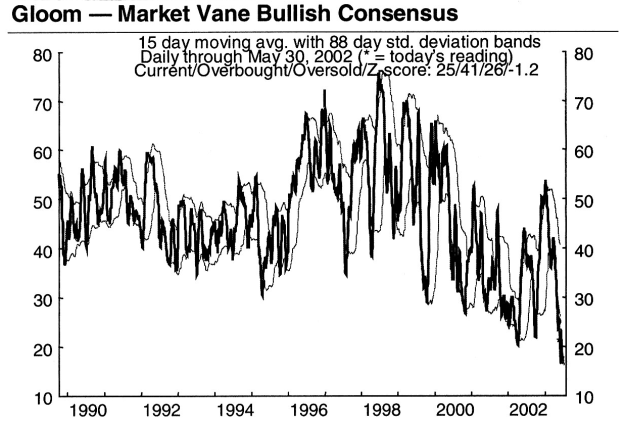
Greenspan Valuation Model — Suggested Market Valuation



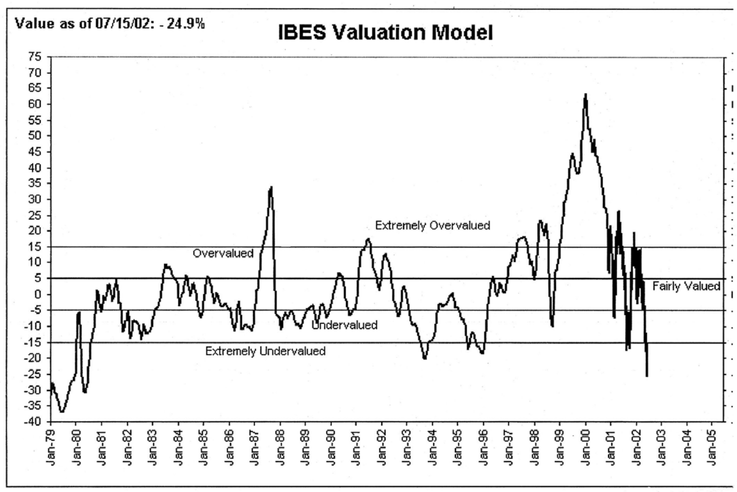
Source: Thomson Financial; Federal Reserve; Bear, Stearns & Co. Inc.

3. 'Market Vane' bullish consensus has dropped to only 16% bullish. The all-time lowest number ever recorded was 14% in June of 1982, immediately preceding the beginning of the greatest bull market in U.S. history.

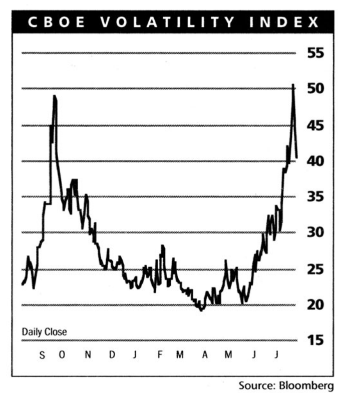
Gloom — Market Vane Bullish Consensus



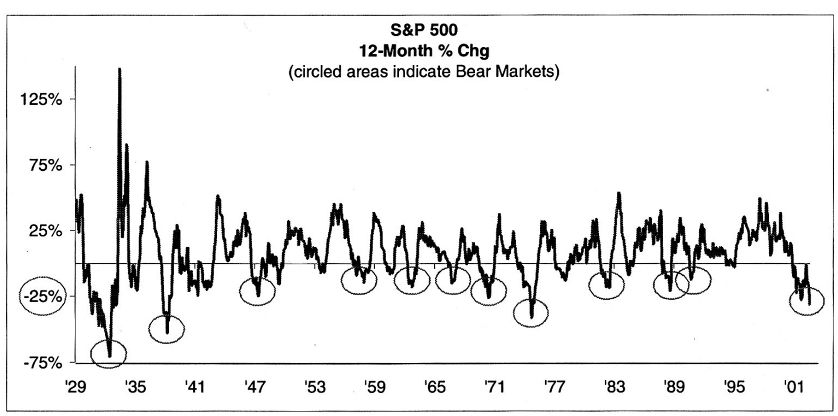
4. The International Brokers Estimate System (IBES) valuation model shows stocks to be 25% undervalued, the most undervalued since 1980. This methodology is similar to the Federal Reserve Model above, so again, assumed forward earnings on the S&P 500 of $56 allows for downside estimation errors to $42 to still be fairly valued.



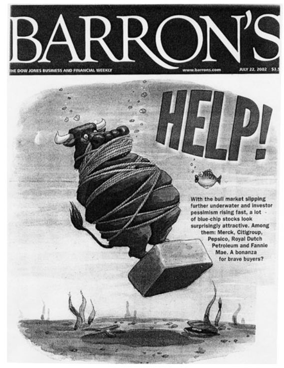
5. Chicago Board Options Exchange (CBOE) Volatility Index has exceeded volatility levels last seen in the post 9-11 market.

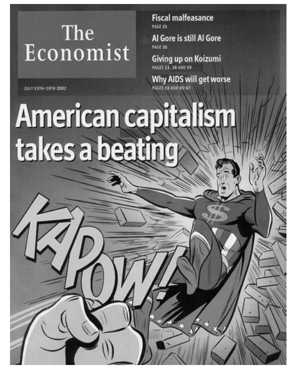


6. S&P 500 Price Earnings Ratio compression has exceeded all but the 1973-4 bear market and the 1930's.



7. **The popular business press has finally made the market decline headline news, a sure sign it's soon to be over, or already over.**





Lehman Brothers recently compared the current market to the period from 1958 to 1972. This period was chosen because it was a long period of low inflation. Of eleven (11) metrics measuring market overvaluation, fair value or undervaluation, 9 of 11 metrics show the current market to be at fair or undervaluation. The only two metrics to show overvaluation were 1) price to replacement book value and 2) price to dividends. We make the following observations about these two metrics… price to replacement book is heavily affected by whether the company is a manufacturing-asset or a service-oriented business. Since the 1960's, the U.S. economy has become substantially less manufacturing oriented, making replacement book value comparisons very much 'apples and oranges'. As for dividends, a much smaller percentage of cash flow is paid out today, primarily because the aggregate shareholder constituency is heavily biased toward tax-exempt accounts created by 1974 ERISA legislation (IRA's, 401K's, Pension, Profit Sharing, 403B's) which are accounts that do not 'spend' dividends. If one were to observe that price to cash flow ratios were higher today, then that would be a valid case for arguing that the market was overvalued. Indeed, we have made that very point in past years. Now, however, that case can no longer be made. The average price to cash flow multiple in the 1962-1972 timeframe was 14.5X, and is currently 14.7X, down from 17.9X at the beginning of the year.

We now argue that the market is no longer overvalued. It has been many years since we could say this, and we are oddly uncomfortable being so bullish! This is new, and in some cases we find ourselves arguing against others and some clients who have become convinced

the U.S. is surely 'going to hell in the proverbial hand basket'. We would like to take this opportunity to rebut some of the most commonly heard reasons given for why the market must go lower:

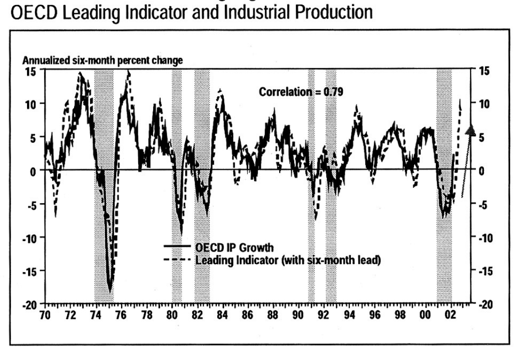
A) "<u>P/E's are too high</u>" – Just where were all these market sages 2 and 3 years ago? These are the same people that said technology (at any price) was wonderful (it was, but the stock prices weren't). To get a handle on P/E's, allow us to digress into a discussion of 'write-offs'. Write-offs are an accounting recognition of, basically, acquisitions gone sour… which is to say, almost all acquisitions. Since the seller of a business knows more about it than a buyer who is a relative stranger, guess who is gonna get the short end of the stick! Acquisitions are motivated by executive compensation, product hole-filling, slow-growth industry consolidations, and last but not least, a desire to use a highly valued stock as payment currency, particularly if the acquirer's stock is valued more highly than the acquiree's stock. We can look back and see a great many acquisitions, particularly in areas related to telecom and the internet, that occurred because the pressure was on in a rapidly changing environment to achieve 'critical mass' perceived to be a prerequisite for survival… otherwise you could be swallowed up and lose your job, or not swallowed up and go bankrupt as your larger competitor is cutting prices… cuts which you cannot match and still stay profitable. So… bottom line… a great number of acquisitions have spurred an enormous number of write-offs… all of which are transient and going away, now that most of the players have been gobbled-up or gone bankrupt, and now that the payment currency (stock) is worth less or worthless. Therefore, the write-off depressant to earnings is destined to become a much smaller factor. The AOL/Time Warner write-off in Q1 'eliminated' all of the earnings of the S&P 500 that quarter. That 'boosted' the P/E of the S&P 500 by 33%! Therefore, to assume the entire S&P 500 should decline 25% for that reason is preposterous. Maybe AOL Time Warner should be lower, but not the other 499 stocks in the S&P 500. This is the argument for looking at operating earnings rather than reported earnings, which is necessary to strip out the distortions caused by write-offs. Today, we are looking at a trailing 12-month P/E on the S&P 500 of 18X, down from 35X to 40X at the peak. Remember that the S&P 500 is down

50%, peak to trough. On a forward earnings basis, using $56 of earnings for the S&P 500 without write-offs, the P/E is 15.8X (884/56). Probably the P/E should be about 17X. Therefore the "P/E's are to high" argument is simply no longer true.

B) "The recession is double-dipping" - It is certainly true that this is a possibility. However, we must not leap to this as a forgone conclusion just because the market is down. It could be that Q1's positive numbers were simply a snap-back from the post 9-11 depressive effect, and without 'legs'. However, we remember some said the crash in 1987 was predicting a recession, but there turned out to be none. So we allow that as a possibility, especially in light of world economic leading indicators showing a continuation of recovery as of July 26th.

Global Production Trending Higher

OECD Leading Indicator and Industrial Production



Source: OECD.

C) "Expensing Employee Stock Options will reduce earnings" - Yes, it will, by approximately 10% for the S&P 500. But remember that the abolition of goodwill expensing is pulling in the other direction, about 7% on the S&P 500. Therefore the net effect is only about a 3% reduction.

D) "Undervalued Pension Expense created by a lower stock market will depress any earnings growth" - The thesis here is that overzealous pension plan return assumptions need to be anchored in the new reality, i.e., a lower than 9% return assumption. This subject is considerably more complex than it first appears, but the upshot is that envisioned changes would subtract 2% from earnings in 2002 and add 1% to earning in 2003… a non-event.

We believe there is adequate valuation cushion in the U.S. market at these levels, allowing even another recessionary period to be tolerated without further stock price markdown. We also observe sentiment data on the market pointing to the lows having been reached on July 24th. Furthermore, we believe it is probable that a new bull market has already begun, signaled by 1) the upward

breadth thrust (up volume 9 times down volume on a single day) seen on July 29th, an occurrence of rarity which has signaled the start of 18 out of the last 19 bull markets, 2) two days of DJIA up 400 to 500 points with record setting volume on the first of these days, and 3) a total paucity of believers. We do acknowledge that the July 24th bottom will need to be tested, but now is the time for thinking to be adjusted.

We have written quarterly letters for eleven years now. As our readership knows, we have assailed the outrageous behaviors and flamboyant assumptions underlying the market bubble of the past five years, forewarning any who would listen to eschew the contemporary *zeitgeist*. We had been criticized by some for being too bearish, and carrying too much portfolio cash. It's accurate to say that we first began to feel discomfort with the market price/earnings ratio in 1995 when it became apparent that P/E levels were headed north of 21X for an extended period. Now that the market P/E has retreated to, perhaps, 14X forward earnings, it is incumbent upon us to take a fresh look. It is our opinion that the requisite adjustments have now been made to afford investors a healthier balance between risk and reward. Sir John Templeton once said, "to buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude, even while offering the greatest reward." And so Plato's observation that perception and reality are frequently at odds is absolutely 'on point' and appropriate to the current environment. It is highly unlikely investors will be rewarded for throwing in the towel on stocks at this point, and all indications are for the opposite. Although we have tried to spare our clientele all pain attached to the bear market experience, we have failed in this regard. Nevertheless, we live to fight another day, and although we've taken a few body blows in this battle, we still have all our limbs, and we move resolutely forward. In times like these, we are reminded of how terrific most of our clients are, and how fortunate we are to deal with such quality people. Rest assured that though we lack perfection, we are assiduously working on your behalf and truly appreciate your ongoing votes of confidence.

Very truly yours,

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