Knightsbridge Asset Management, LLC

July 31, 2003

SECOND QUARTER COMMENTARY

"I'm more concerned about the return of my money than the return on my money."

William Penn Adair Rogers
(aka "Will Rogers")
American Humorist & Columnist
1879-1935

In the final analysis, Will Rogers' insightful comments concerning investment risk were trumped by his risk-taking in yet another sphere of life. And so it came to pass that Rogers and his one-eyed pilot friend Wyle Post went down in their private airplane over Alaska in 1935, rendering moot any concerns for the return *on* or the return *of* his capital. Though an unfortunate ending for this beloved part-Cherokee Indian-American and cowboy-observer, it clearly illustrates one of investing's great dilemmas: that it is unlikely to be what one is worried about that will present the problem………it is more likely to be something "out of the blue", something unanticipated, something heretofore not experienced. This is why a generous dollop of paranoia is such a useful characteristic in the management of money. After all, buyers and sellers of stock must by definition have divergent views of the future, and one must wonder what is

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

known or thought to be known by the party on the opposite side of the trade.

Investors are mostly like generals fighting the last war…… they fear whatever inflicted damage most recently, and in so doing construct elaborate defenses against its repetition, only to be blindsided by other factors unanticipated, or factors to which they assigned too low a probability.

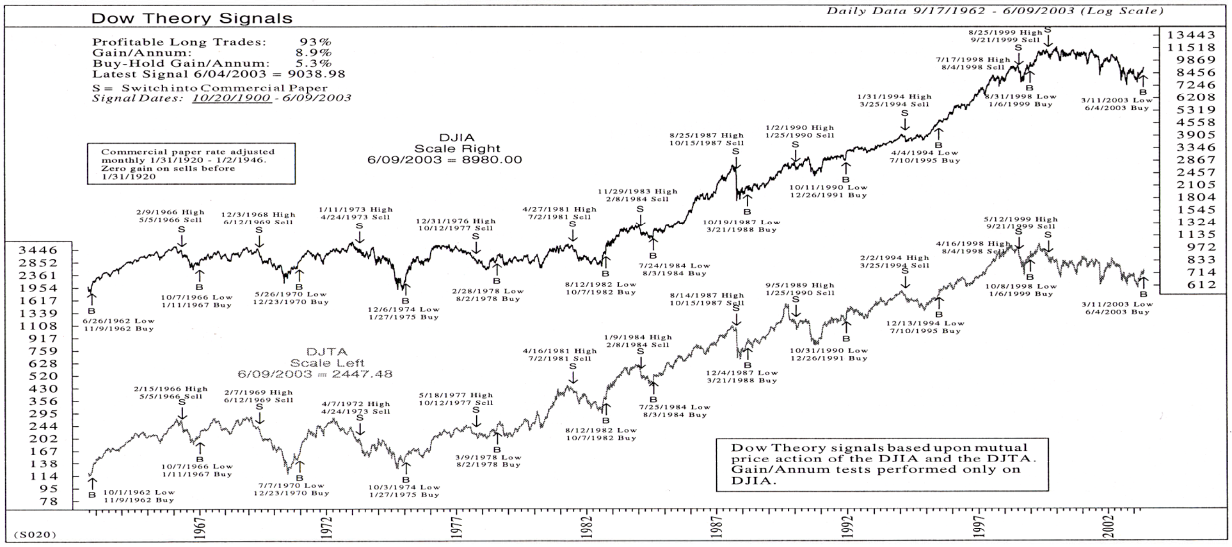
Clients ask, "Aren't you worried"? You damn well better believe we're worried……we're always worried. We never stop worrying. Like the now famous profundities uttered by Secretary of Defense Donald Rumsfeld in his February 12th, 2002 Department of Defense briefing……

**"As we know,
There are known knowns.
There are things we know we know.
We also know,
There are known unknowns.
That is to say,
We know there are some things
We do not know.
But there are also unknown unknowns,
The ones we don't know
We don't know."**

Mostly we're worried that we're worrying about the right things. Because there is a strong streak of contrarianism in our work, we tend not to worry so much about what others are perseverating on and tend to worry more about the things we believe others are neglecting in their investment analysis. And a preponderance of "known unknowns" regarding a stock will make it inexpensive……as they say "there is headline risk", the risk of the unknowns becoming known.

But, the second quarter was terrific for the entire equity market as the gathered clouds of gloom from the three year bear market started to part. The S&P 500 advanced 15.4%.

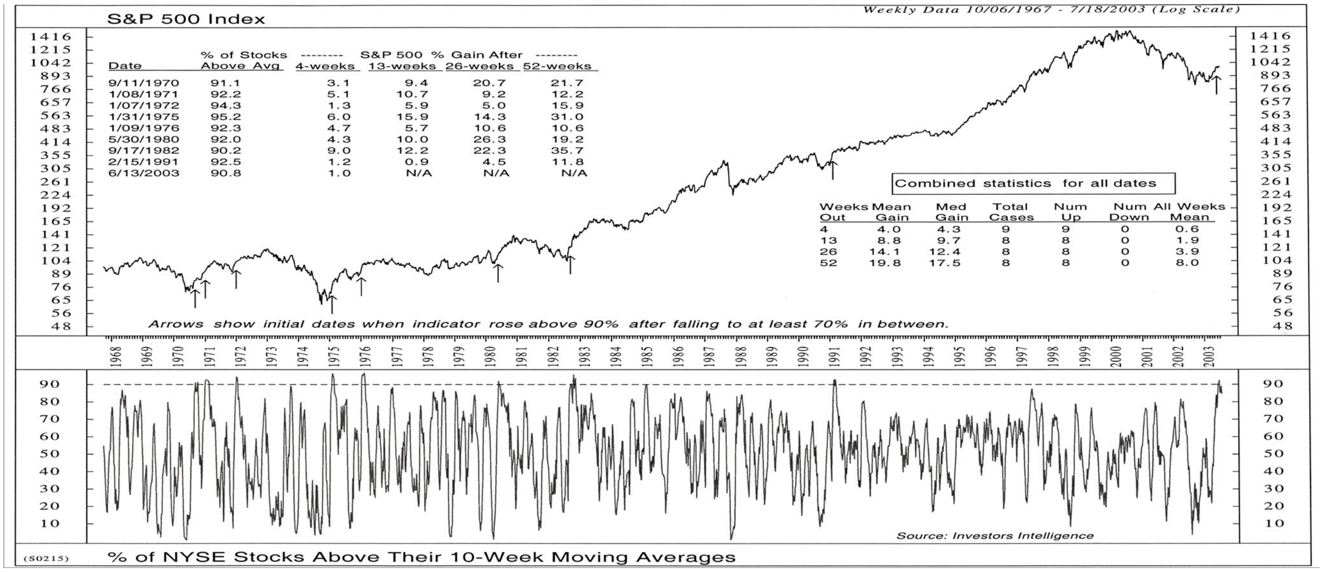
It was one of those rare quarters when everything went right, and even diehard market bears were forced to evaluate fresh information pointing to the emergence of……a bull market. Even the "Dow Theory", notorious for being late to call a market turn, signaled a fresh bull market on June 4th.



Courtesy: Ned Davis Research

And even more breathtaking was market "breadth", the plurality of advancing issues, signaling that this move was not to be mistaken for a "bear market rally". For the week ending June 6th, the NYSE set a new record with 1082 issues reaching 52 week highs while 92% of NYSE stocks traded above their 10-week moving averages. Moreover, fully 30% of all NYSE stocks stood at 52-week highs, a statistic not seen since 1986!

This powerful breadth thrust has historically signaled many more months of positive market action, and the 92% figure has been exceeded only three times since 1976……………1982, 1991 and 2003, the first two signaling a bull market.



And regarding "Dow Theory", even though "late", the average signal has presaged a further rise of 48% (on average since 1897 as reported by Martin Pring in his book <u>Technical Analysis Explained</u>), before running afoul another bear market. Furthermore, the rate of advancing issues to declining issues was positive for 11 consecutive weeks, a bullish feat seen only 10 times in 40 years, the latest of which was in 1997. Those extremely bullish statistics indicate that the market may be due to "take a breather" in the short run, and a 5% to 10% correction should be anticipated. But the longer term should be up.

We hear the comment, "Aren't you still worried about the bubble? After all, isn't the market P/E ratio terribly high by historical standards?" Our retort is that P/E ratios "appear" high due to hangover write-offs of bubble-era acquisitions done with bubble-priced stock. These write-offs are 1) an after-the-fact accounting recognition used to lower corporate tax rates, and by definition backward-looking, not forward looking, and 2) diminishing rapidly with the passage of time as the bubble peak recedes on the historical timeline. In fact, we are more concerned about the rotation of the bubble into the bond market and the real estate market.

We are concerned that the combined effects of economic recovery alongside investors "chasing yield" will conspire to produce losses for many investors in the fixed-income arena. In fact, as of this date, 10-year U.S. Treasury bond yields have moved <u>UP</u> from 3.2% to 4.4% in just the

past six weeks, and 10-year Japanese government bonds have moved from 0.4% to 1.4%.

Ten-Year Treasury Yield

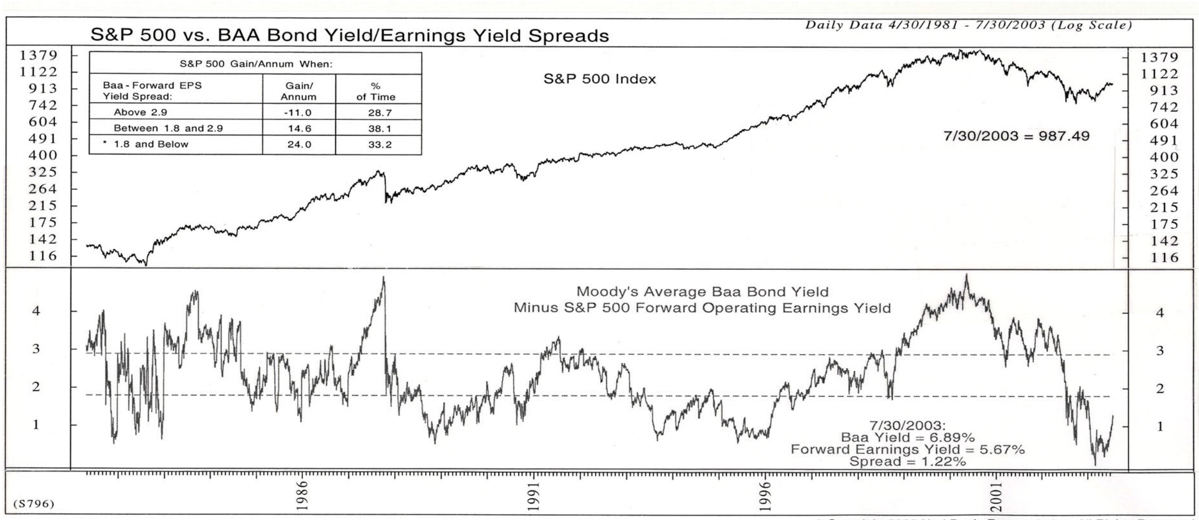
Source: Federal Reserve Board.

This move in 10-year Treasuries is the swiftest increase in rates since May of 1987. The good news is that this is an extraordinarily positive signal for economic recovery in the US and Japan. The bad news is that interest rates on the rise mean bond prices declining. Just as most investors had come to believe the real weapon of mass destruction was deflation, along comes a whiff of inflation expectation. Certainly this is exactly what the doctor ordered……Doctor Greenspan, that is. And Fed Board Governor Ben Bernanke in comments this week virtually assured investors what they suspected all along……that if the Fed is to err, it will be on the side of keeping short-term interest rates too low too long.

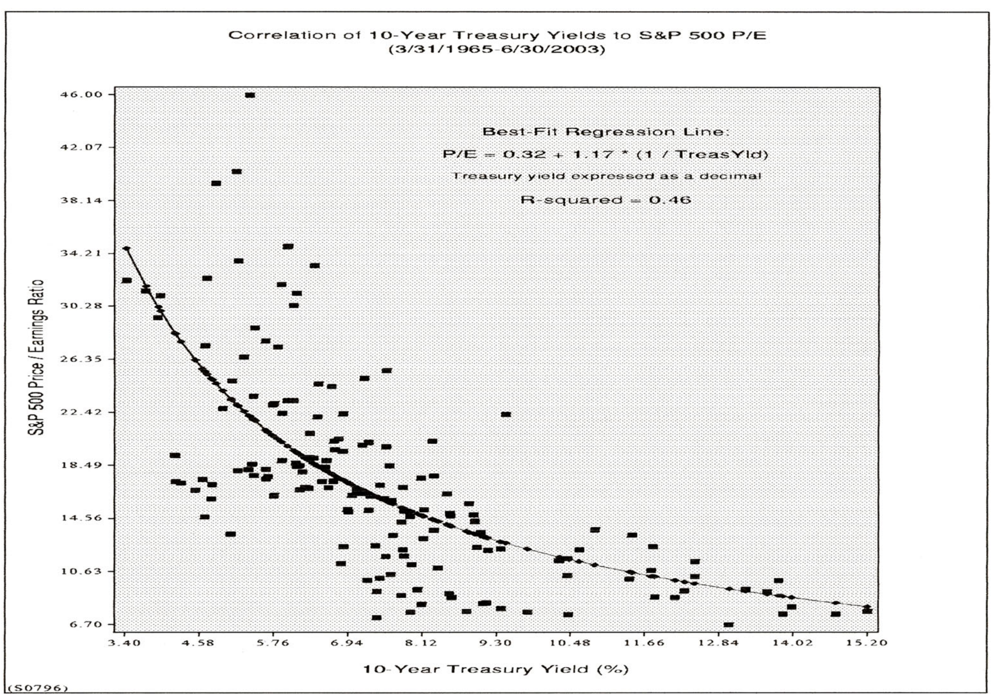
One might logically wonder if the recent rise in rates might be sufficient to choke off either the stock market or economic recoveries. We think not. The bond market move as exemplified by 10-year Treasury yields going from 3.2% to 4.4% is sufficient to shave perhaps ½% from 2004 GDP growth. However, with consensus expectations at 4% for GDP growth in 2004, and Dallas Fed Governor McTeer mentioning 5% GDP growth as an '04 possibility, a ½% lowering is not fatal.

As far as influencing stock market valuations, we can look at historical P/E's for stocks in comparison to Moody's BAA Corporate bond yields, (the average rate at which domestic corporations are able to borrow). The theory here is that one can compare forward operating earnings yields (the inverse of forward operating P/E) to BAA Corporate bond

yields, and that if the difference is small, stocks are cheap, and if the difference is large, stock are expensive. As can be seen in the chart below, stocks are still cheap.



Likewise, if we view P/E ratios and 10-year treasuries in a scatter plot, we can see that a P/E of 18 is common for 10-year treasury yields anywhere from 4% to 6%. Therefore the rise in yields so far should not be too much of a restraining factor on equity valuations.



In the investment of one’s capital, the return of one’s money need always take precedent over the concern for return on one’s money. That is to say, avoiding losses is the first order of things. Making a positive return is the second order. So Will Rogers’ comments, though thought to be humorous, are, in reality, seriously appropriate. Ten-year Treasury bonds have dropped 10 points (or 10%) in value in the past six weeks, no doubt alarming those who thought the ultimate safety for one’s capital was 1) in bonds, and 2) among bonds, certainly in Treasuries. But like all investments, popularity breeds excess and excesses always eventually correct.

We wish to thank our clients and friends for their support and look ahead in these challenging times.

Very truly yours,

Alan T. Beimfohr   John G. Prichard, CFA