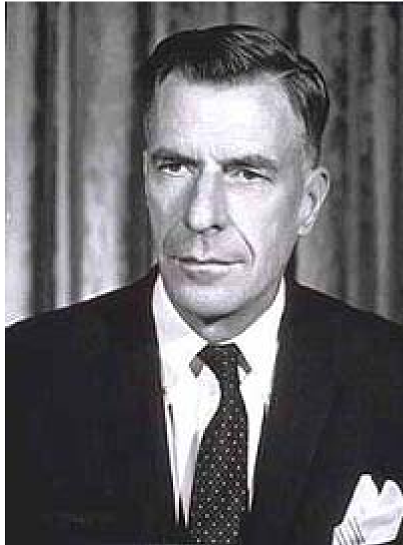
Knightsbridge Asset Management, LLC

August 15, 2005

Second Quarter Commentary

"It is a far, far better thing to have a firm anchor in nonsense than to put out on the troubled seas of thought."



- **John Kenneth Galbraith, 1908-**
- **Author, Economist & Professor Emeritus**
- **Harvard University**
- **The Affluent Society, 1958**

Tongue-in-cheek comment though it is, we pass the dramamine to fellow investment thinkers just in case. Investment "seas" are not necessarily known for being calm, and acceptance of "nonsense" carries its own price, and not a small one at that.

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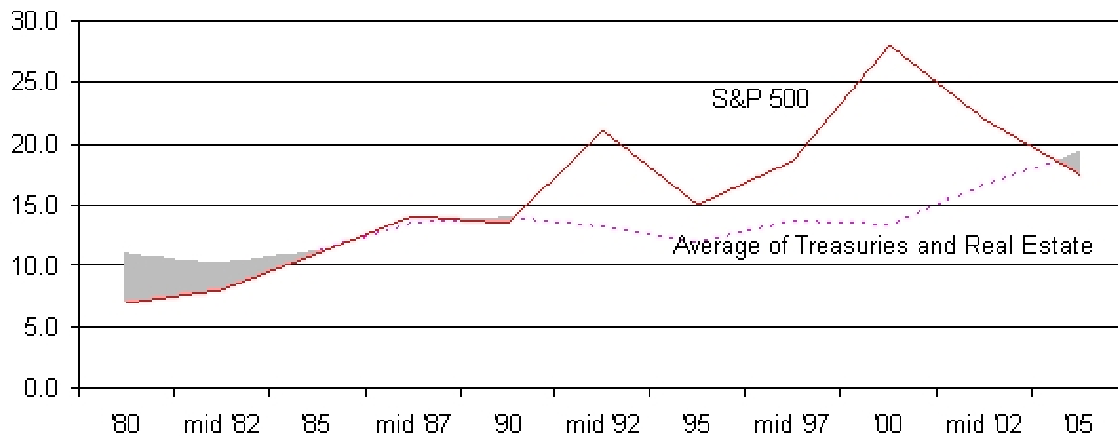
Professor Galbraith, a leader of liberal economic thought, studied under FDR advisor John Maynard Keynes, and was an economic architect of the Great Society programs of Lyndon Johnson as well as advisor to JFK……………sort of a polar opposite to the free-market thinkers such as Milton Friedman, Murray Rothbard, Frederick von Hayek and others. Although we lean toward the economic thinking of the latter group, Mr. Galbraith's prolific writing is eloquent and hugely entertaining, particularly his 1990 book *A Short History of Financial Euphoria.*

And while we're mentioning euphoria, can a discussion of real estate be far behind? In the spirit of being objective and trying to divine which asset classes might be "cheap", we decided to take a look at the three asset classes of equities (stocks), fixed income (bonds) and real estate and invent a price/earnings ratio (P/E) for each to see how they compared over time. Although this gives one a picture of how many dollars need be invested to give one a dollar of return in any of these three assets, it does not speak to the ultimate return as it makes no statement about subsequent price expectation.

Estimated P/E Ratio for Different Asset Classes



S&P estimated from : Ned Davis Research, Inc. S&P 500 Price/Operating Earnings Ratio
Treasury estimated from : Ned Davis Research, Inc. 10-Yr Constant Maturity Treasury Note Yields
Real Estate estimated from : NCREIF 4 quarter moving average cap rates

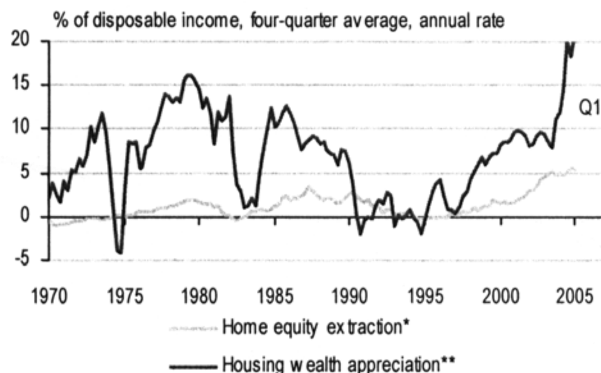
For stocks, we used the S&P 500 index trailing P/E. For bonds, we used the 10-year U. S. Treasury bond yield (inverted), and for real estate the NCREIF (National

Council of Real Estate Investment Fiduciaries) capitalization rate (inverted). This latter index is comprised of 1500 apartment, office, industrial and retail properties. Although we make no claim as to the appropriateness of comparing the absolute numbers since each of these assets carry different risk characteristics, we think comparing the numbers on a relative basis tells an interesting story, as seen in the chart on the previous page.

Our conclusion is that stocks are actually cheap on a relative basis to real estate and bonds, and have only been cheaper in the early 80's looking back at the past 25 years. Therefore, those who would make the claim that "P/E's are high" must defend their statement contextually. In an era when it would appear on the surface that there are no cheap assets anywhere, one must either resign oneself to accepting the meager returns of cash equivalents, whose returns are admittedly rising, or playing a relativistic game in search of higher returns. We believe stocks as a whole are acceptably priced in the context of prevailing interest rates to provide returns higher than most investors seem to be expecting, barring a severe economic downturn.

And speaking of downturns, we continue to believe that "real" GDP growth, that is, GDP growth after inflation, will be slowing into the second half of '05 and '06, implying slower profit growth for corporate America. Leading Economic Indicators (LEI) have been generally falling since peaking in May 2004. Mr. Greenspan and the Fed seem undeterred by all arguments to stop the persistent rise in the Federal Reserve Discount Rate, and by now it is becoming apparent that the real objective in their role as risk manager is to put the *kibosh* on real estate speculation, particularly housing.

As former Fed Chairman William McChesney Martin defined his job 50 years ago, it was the role of the Fed "to take away the punch bowl just when the party starts to get good". In this case, the housing party. South Beach condo flippers, take note.

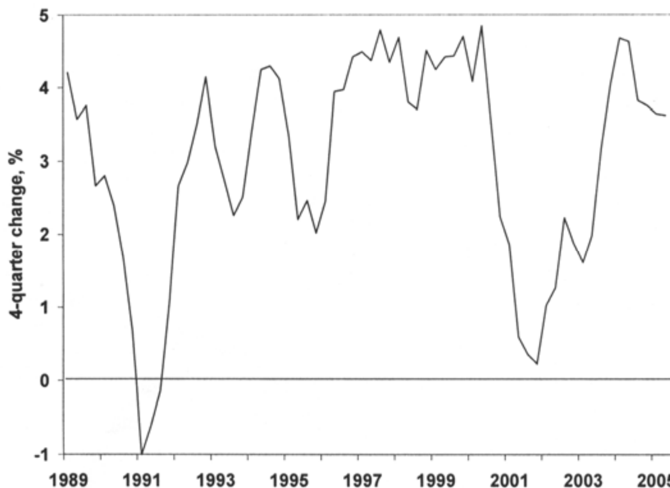


* Home equity extraction calculated as increase in mortgage debt minus all new residential investment other than home improvements (additions and alterations and replacements); ** Housing wealth appreciation calculated as increase in nominal value of housing stock minus new residential investment
Source: Federal Reserve Board and UBS estimates

We observe that the current rate of home equity appreciation is running a record 20% of national disposable income, the prior record being in 1980 at 16%. Not only that, home equity extraction (the process of refinancing and removing some of one's equity in the process) is running almost 6% of national disposable income as seen in the chart at left.

We believe the Fed will take their cues from the recent British experience and raise short term rates until such time as the rate of appreciation of housing has slowed to about 7%, and hold rates at that level while the 7% rate of appreciation declines toward zero. Since it is estimated that home equity extraction is adding 1% to real GDP growth at this point, this action would reduce real GDP growth from its current 3.5%, as seen here, to 2.5% absent other factors.

Real GDP Growth



Source: Commerce Department.

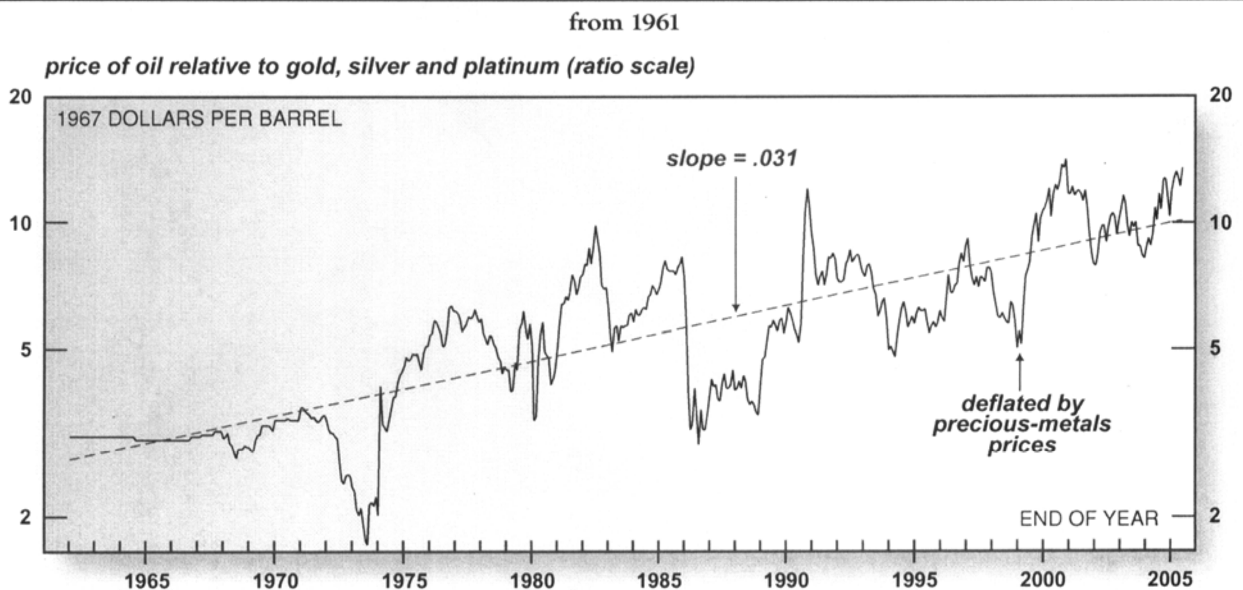
Unfortunately, other factors will conspire to take real GDP growth even lower as higher short rates apply the brakes to more than just housing. Therefore we should not be surprised to see real GDP growth rates below 2.5% which is the level at which shrinking unemployment spills over into expanding unemployment. This is not predictive of recession, but it is predictive of slower profit growth.

Bolstering this conclusion is the observation that a 175 basis point (1.75%) increase in short rates has produced a slowdown in profit growth 100% of the time since 1980.

In the meantime, current data on employment shows the economy to still be fairly robust, and the observation that $67 oil prices have yet to meaningfully slow the economy seems anomalistic.

Nevertheless, it would appear that the equity markets may be discounting all of this already, looking out to the spring of ’06 when profits could be resuming higher growth rates. Certainly new four-year highs on the S&P 500, though still well below 2000 peak levels, fortify this thought.

Oil Prices Deflated by Precious-metals Prices



Data: Monthly averages of daily prices for oil, gold, silver and platinum. The oil price is for West Texas intermediate crude (*Wall Street Journal*). For a description of the precious-metals price index, see “What if the commodity price boom has crested?” *Interest-Rate Outlook*, H.C. Wainwright & Co. Economics Inc., May 20, 2004.

In our musings we came across a fascinating depiction of oil prices since 1960. Not just your ordinary everyday chart, but one showing oil deflated by precious metals prices. Such a chart has an advantage over more prosaic representations because it gets away from using dollar denominated pricing, which begs the question as to how the dollar was priced relative to a worldwide currency basket. It also gets away from the hedonic pricing debate, an argument that posits that the CPI (consumer price index) is artificially low because product improvements are dictating

that prices be actually deflated causing the CPI to be understated. We won't get into a deeper discussion of this because it warrants more space than we have here at the moment, but suffice it to say that avoiding these two factors goes a long way towards eliminating distortions over long periods of time that can render conclusions meaningless.

The conclusions from the graph on the previous page are that:

1) **Oil is becoming scarcer (or more valuable) at a rate of 3.1% per year in "real" terms**

2) **The current rational price for oil is about $45 per barrel**

3) **The extremes of fluctuation about the rational price are anywhere from 50% less than to 100% greater than the rational price.**

Based on this presentation of data, one might conclude that oil could go as high as $85 to $90 per barrel if the extremes of 1982 and 1990 are to be reached once again.

In the late 1970's, I availed myself of a chance opportunity to speak to Professor Galbraith in the lobby of the Riverside Hilton in New Orleans where we were both checking in……..he was hard to miss at 6' 7" in height. He asked me where I had studied economics. I replied that I'd studied engineering at a competitor ivy institution, a response he found mildly bemusing. Having this brush with a man so influential in the historical evolution of economic thinking in America, I promptly went home and read a couple of his books. But there I stopped lest I put out on the troubled seas of thought.

Very truly yours,

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