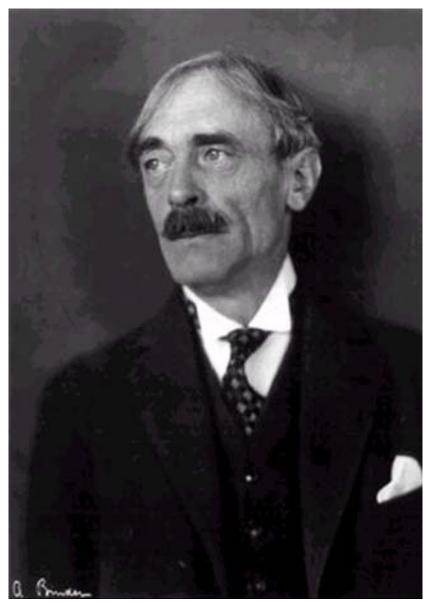
Knightsbridge Asset Management, LLC

July 26, 2006

Second Quarter Commentary



"Our most important thoughts are those which contradict our emotions"

- **Paul Valery, 1871 – 1945**
- **French writer and critic**
- **Author of *Cahiers* (*The Notebooks* – Twenty-eight thousand pages written over fifty years)**

Paul Valery did not live to see the television program "Fear Factor", a program all about thoughts overcoming emotions. Hordes of repulsive insects can be seen crawling over contestants' faces accompanied by squeals and screams from the reviled audience, none of whom could withstand the thought of submitting to such terror. Such is the show's appeal. These modern-day Indiana Jones contestants have conquered commonplace fears through a combination of mental

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discipline and an understanding that everyday fears may be irrational and unsupported by empirical evidence. In short, they have shed the constraints of their own "Temple of Doom" and emerged cleansed of primal fears.

Stock market investors are progressively being required to submit to an accumulation of fear factors in the present environment, which include:

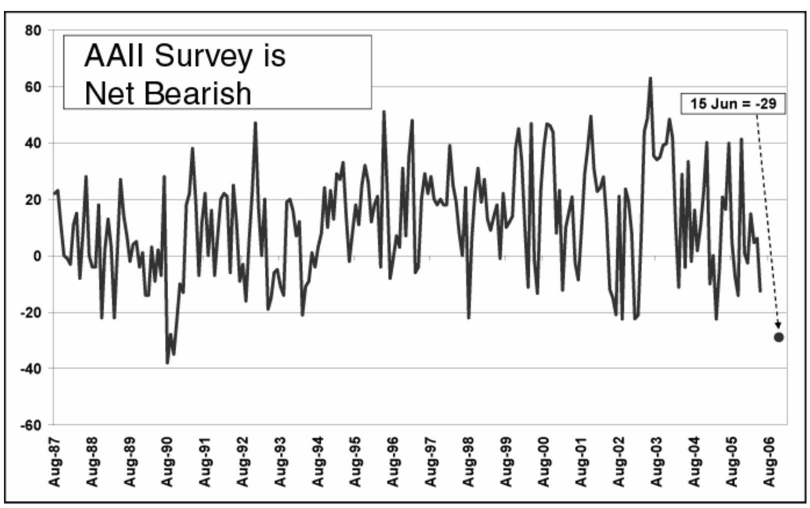
- Rising inflation, particularly producer prices and wholesale prices. Core CPI (Consumer Price Index ex food and energy) is up 2.6% in the past twelve months through June, and CPI is up 4.3%;

- Record oil prices at $78 per barrel;

- Hostile Federal Reserve action with seventeen consecutive increases in the Federal Reserve Funds Rate as of June with the futures market predicting an eighteenth increase in August;

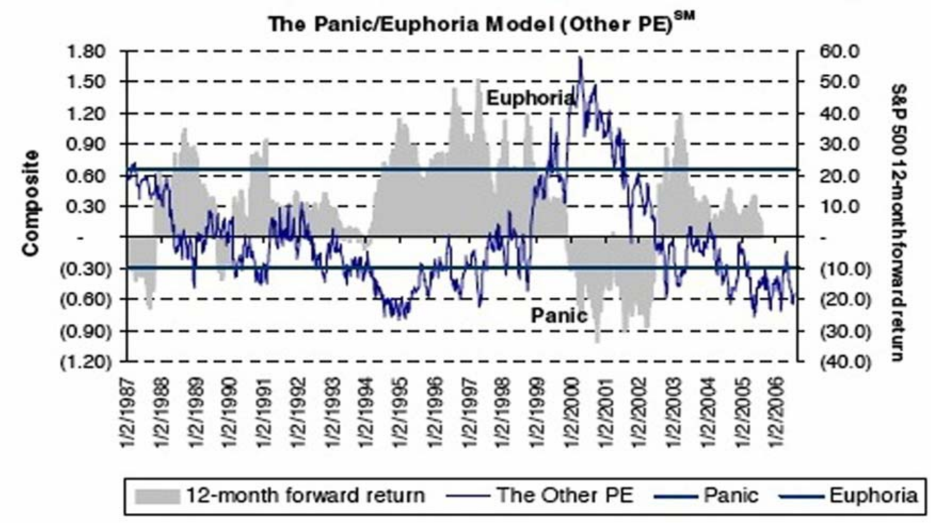
- A renewed flaring of the Middle East tinderbox scarily referred to as the beginning of World War III by former Speaker of the House Newt Gingrich.

U.S. stock market sentiment indicators began to show extreme bearishness in mid-June. For example, the AAII (American Association of Individual Investors) survey showed only 29% bullish, the lowest such number since 1990!



Source: Morgan Stanley Research, Bloomberg

Moreover, the Citigroup "Panic/Euphoria Model" as shown here is showing the market to be deep in "panic" mode, and suggestive of a 90% probability of the market being higher in the upcoming six months.



Source: Citigroup Investment Research - U.S. Equity Strategy

Can this bearish crowd be right? We seriously doubt it, and are willing to put our money where our mouth is. Such sentiment extremes are almost always contrary opinion indicators, and we are willing to lean against this tide of prevailing sentiment. In short, we are bullish because so many are so bearish.

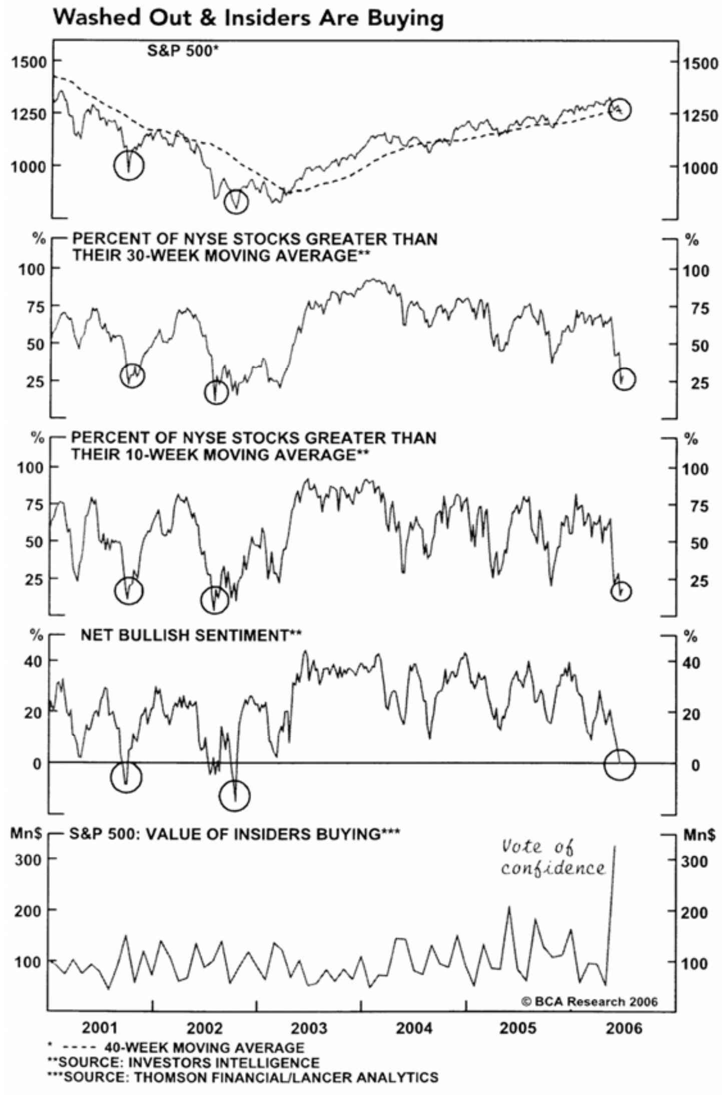
Further fortifying this point is evidence that it is not just individual investors that are frightened by the current climate, but also institutions. For example, BCA Research points out that:

1. Only 25% of NYSE stocks are above their 30-week moving average;

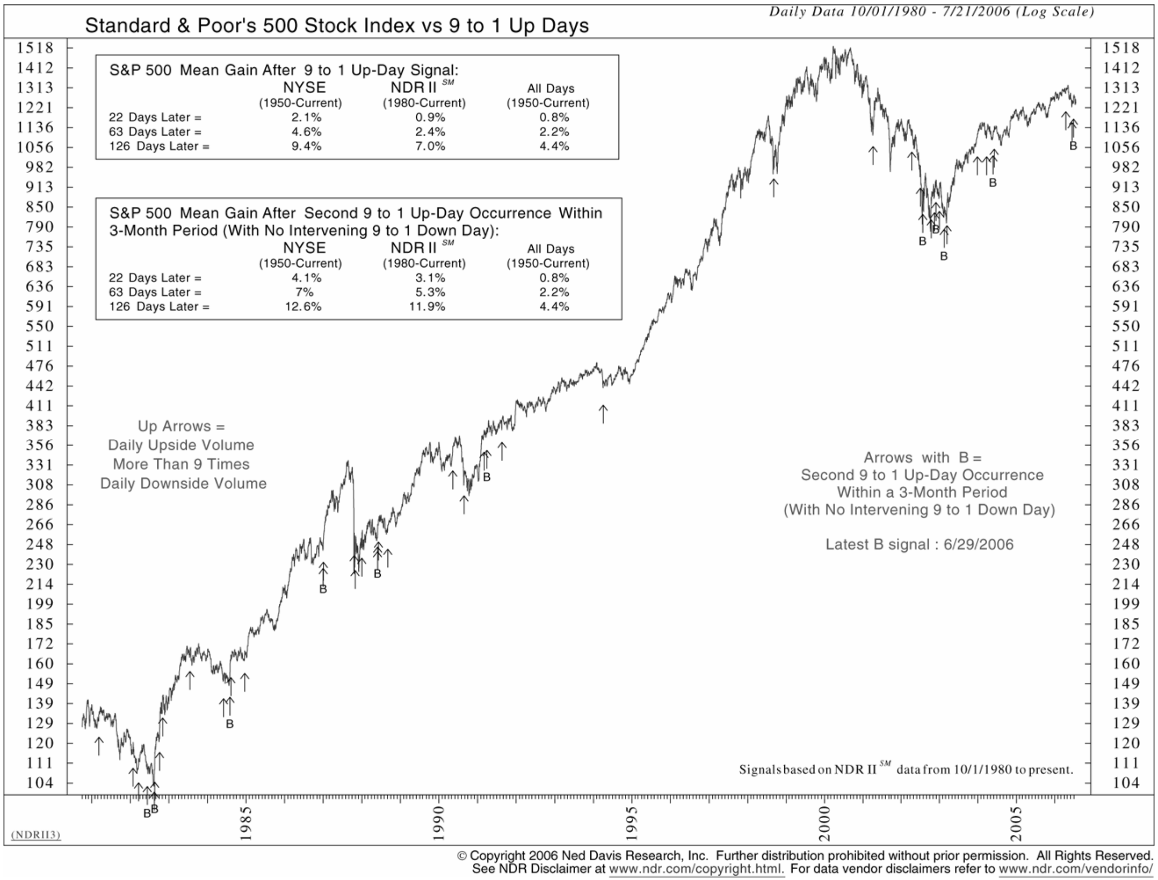
2. Only 20% of NYSE stocks are above their 10-week moving average;

3. Net bullish sentiment is at zero, again typical of past market bottoms, and

4. Insider buying is running rampant, suggesting insiders see extreme value in their own company stock. Surprisingly, this is running higher than at the market bottoms in October 2002 and March 2003 both periods of intense bearishness following a drop of 48% in the S&P 500 from its March 2000 internet bubble top.



In addition to this evidence, one of our favorite technical indicators has just flashed a "buy" signal for the market. This indicator (two days of 9:1 upside volume/downside volume uninterrupted by an intervening 9:1 downside volume/upside volume day within a three month period) has given eleven "buy" signals on the market in twenty-six years, none of which has ever resulted in loss if viewed six months later. The average S&P 500 gain in these six month periods has been a substantial 12.6%! Granted, eleven data points are not necessarily incontrovertible proof, but it is a strong track record in an imperfect world.



On a fundamental basis, it would appear that barring economic forces significantly bringing earnings estimates lower in 2007, the market is trading at an unreasonably cheap multiple - 13.5 times 2007 estimated earnings of $92.00 on the S&P 500, 14.6 times 2006 estimated earnings and 15.3 times twelve months trailing earnings. We also observe that corporate cash on the balance sheet is way above norms - 20% of market capitalization, whereas a number below 10% has been the historical rule. Another way of looking at this would be to say that if companies were to pay out their excess cash to shareholders (cash equivalent to perhaps 10% of capitalization) then the P/E ratios would be reduced 10% for the purchaser of these stocks. Instead of an estimated P/E of 13.5 on $92.00 of 2007 earnings, the P/E ratio would be reduced to 12.2 times earnings. Even if one were to challenge $92.00 of S&P 500 earnings in 2007 as being an unreasonably optimistic estimate, the 10% cash corporate cushion paid out would allow for earnings to drop to $83.00 and still be maintaining a P/E of 13.5. This realization, we believe, is the fundamental underpinning for stocks moving higher.

Paul Valery may not be well known, but he was friends with Albert Einstein and Michael Faraday. In 1896 at age 25 he

worked for Cecil Rhodes in London, founder of DeBeers Diamond Mines, namesake for Rhodes Scholarships which his fortune funded, and for whom the African nation of Rhodesia was named (Zimbabwe since 1980). Valery relinquished writing for twenty years to concentrate on science. One of his life's conclusions was that one's emotional flow obscures more rational thought, as in "Fear Factor".

This is how we see it at the moment, and believe investors have taken to "throwing the baby out with the bath water". Fear is running rampant that the Federal Reserve's drive to tame inflation will sacrifice upon its altar the health of the U.S. economy resulting in recession. Markets took Bernanke at his word…..1 ½ to 2% core CPI….and after 17 successive interest rate increases, the Fed is further from that range than they have ever been since starting this crusade eighteen months ago. We reiterate our belief that transparency is not always good and that Bernanke put himself in a straightjacket from which he is now trying to wriggle free. We expect to see statements that 2% CPI is still attainable, just a year or two down the road. We do not believe that the Fed will raise interest rates so high as to crush the economy, given that both autos and housing, the most credit sensitive parts of the economy, are in retreat already.

Very truly yours,

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