Knightsbridge Asset Management

division of Canterbury Capital Services, Inc.

October 24, 1995

THIRD QUARTER COMMENTATRY

> The mental qualities of the individuals composing a "crowd" must not be brought into consideration.
>
> This quality is without importance. From the moment that they form part of a crowd the learned man and the ignoramus are equally incapable of observation.
>
> -"The Crowd", 1895
> Gustave Le Bon (1841-1931)
> French Psychologist

Le Bon's observations ring true yet today. This quarter witnessed both a crowd salivating over release of Windows 95, and a smaller crowd sequestered, anticipating the release of "The Juice". Each crowd, the former supposedly learned, the latter quite the opposite, demonstrated its own illogic.

In fact, Windows 95 copies many of Apple's operating features, and office supply chains such as Staples report decent but nonsensational sales following the initial fanfare. Microsoft's freckle-faced *Wunderkind*, on the cover of every magazine recently, is now about to tackle the media industry we are told. The hoopla surrounding the O. J. Simpson circus could only be described as revolting, and reportedly only two of twelve jurors possessed as much as a high school education.

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But the fact that Microsoft advanced from 58 to 109 this year, only to fall 30 points since July 17th and 18th, now dubbed "Microsoft Monday" and "Technology Tuesday", tells us something about the character of the current market… as well as its most hyped and ballyhooed group, the technology stocks. Although noteworthy that 40% of Americans are employed behind a keyboard, the simple fact is that many technology stocks are simply capital goods companies of the current age. And subject to the same cyclicality of their more prosaic brethren in prior decades. Therefore, one wonders if the average price-earnings ratio of 23x trailing 12 months' earnings for this highly esteemed group, can be sustained. Yet it would appear that the external investment and economic environment is relatively begin, with emphasis on the word "appear".

The first nine (9) months of 1995 has been the third (3rd) most spectacular advance in fifty (50) years. By most measures, this advance did not begin from valuation levels that would have produced such an advance (see chart #1). In fact, what has been produced are valuation levels that have never been seen by some yardsticks, e.g., dividend yield (see chart #2).

What accounts for this phenomenon?

The passage of ERISA legislation in 1974 was a watershed event following the enactment of Social Security legislation in the 1930's. ERISA (officially the Employee Retirement Income Security Act) allowed for the tax-deferred accumulation of capital for private and public pension plans. This capital is siphoned off (or consumed, depleted) only by corporate takeover of over-funded plans or participant retirements. Since the midpoint of one's working life is age 45, these people who were 45 in 1974 at the dawn of ERISA are now 66, just retiring. A plan for the average worker in 1974 has now had 21 years of tax-deferred accumulation at historically unexpected rates of return. More often than not, part of the pension pay-out is added back to capital, or never drawn down in the first place, because realized returns exceeded actuarial expectations over the past 21 years. Remember, 1974 was an extreme bear-market bottom culminating with Nixon's resignation. And so for a host of structural reasons, pension law has created a giant one-way valve… favoring capital accumulation, tax postponed, which only served to

heighten the accumulation rate relative to other taxed investments. Over a 21 year period, this can have a tremendous effect. Add to that a post-war baby-boom population bulge now in their highest saving years… these may be the ingredients for today's price levels.

Just look at multiples to book values (see chart #3). Another interesting slant on historical valuation is the number of hours of labor required to purchase one unit of the S&P 500 (see chart #4). This is at a 35 year high (at least), and has been for 3 years. Furthermore, the Bank Credit Analyst stock market speculation index (chart # 1) shows not only did this bull market start from high levels of speculation, they have since gone ever higher. These are the reasons why we have been cautious all along, holding above average liquidity. This above average liquidity has penalized performance, relative to market averages. However, we are still committed to producing returns that are superior over the long run, which of necessity requires some underperformance at market highs in order to have liquidity at market lows. But Nostradamus we ain't!

We recently purchased Gabelli Global Multimedia Trust (GGT), a closed-end fun run by Mario Gabelli that was depressed by a rights offering. This fund was 46% cash before the rights offering, which makes it 60% cash now, and it's trading at a 14% discount to net asset value. It's historically traded on average at a 3% discount. On top of that, the Disney – Cap Cities/ABC deal and the Westinghouse – CBS deal will take the cash percentage of the portfolio even higher. Therefore, a 14% discount is way too high since it implies a 35% (or higher) discount on the stock portion of the portfolio. The $15 billion about to be released to shareholders in the Disney and Westinghouse deals may also take the remaining media stocks to higher valuation levels as institutions rebalance portfolios with that industry sector.

The Morgan Stanley Emerging Market Debt Fund (MSD) is another closed-end fund depressed by the rights offering. Purchased at 11 ¼, the yield was in the neighborhood of 14%. Emerging market debt has been out of favor, and the net asset value of this fund is currently $11.87 with recent cash levels at 25%+ from the rights offering proceeds.

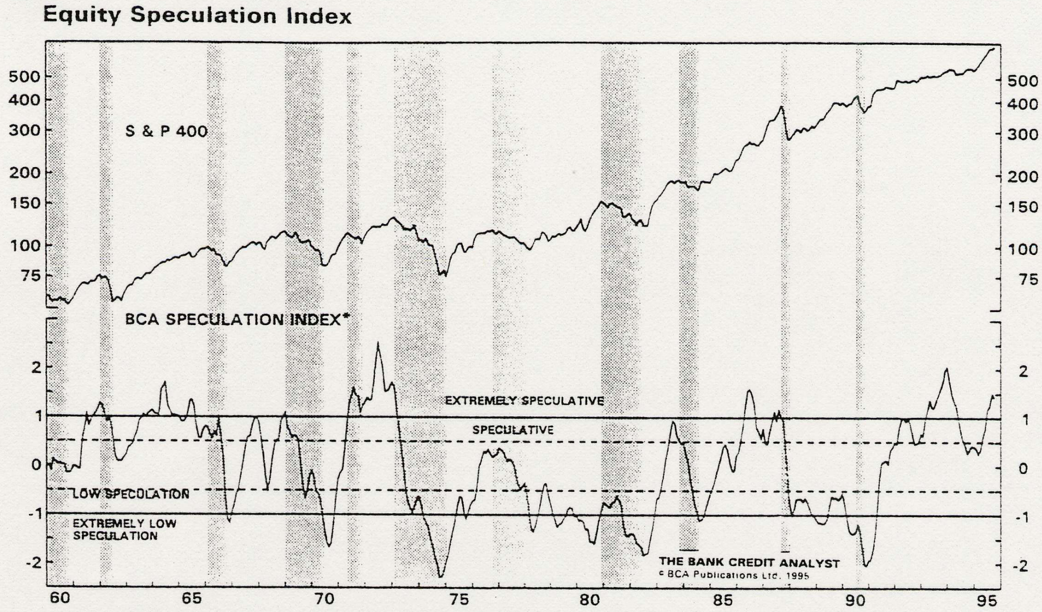
Petrie Stores (PST) has just been added as a portfolio position, and is a discounted way of owning Toys-R-Us. Each share of PST represents ownership in .1919 shares of TOY with some complicated adjustments. These adjustments relate to Petrie Stores' sale of Petrie Retail a year ago wherein certain store leases where guaranteed in the transaction. Since Petrie Retail (not to be confused with Petrie Stores) filed a debtor-in-possession bankruptcy, there is a contingent liability that theoretically could be as much as $77 million. As a positive offset, Petrie Stores has $20 million in cash. Since some stores leases run out to 2004, it is highly likely the true contingent liability is in the $20 million to $30 million range as a worst case. Therefore, with a 52 million shares, PST should be worth about $4.50 each share (.1919 ($24) = $4.61; less 25/52 = $.48, plus 20/52 = $.38; or $4.51). Trading for only 3 1/8, that is a 31% discount. Stated another way, we own Toys-R-Us at 69% of 24, or $16 ½ per share. Petrie Stores will become a liquidating trust in January, and intends to distribute its Toys-R-Us stock to Petrie shareholders.

Monsieur Le Bon published his observations on crowd behavior exactly 100 years ago. The constancy of human behavior remains in an otherwise ever-changing world. We thank you for your support.

Very truly yours,

Alan T. Beimfohr

CHART #1



*INCORPORATES INDICATORS OF MARKET LEVERAGE, SUPPLY AND SENTIMENT.
NOTE: SHADED AREAS SHOW BEAR MARKETS.

CHART #2

S&P 500: Yields
1926 to Date

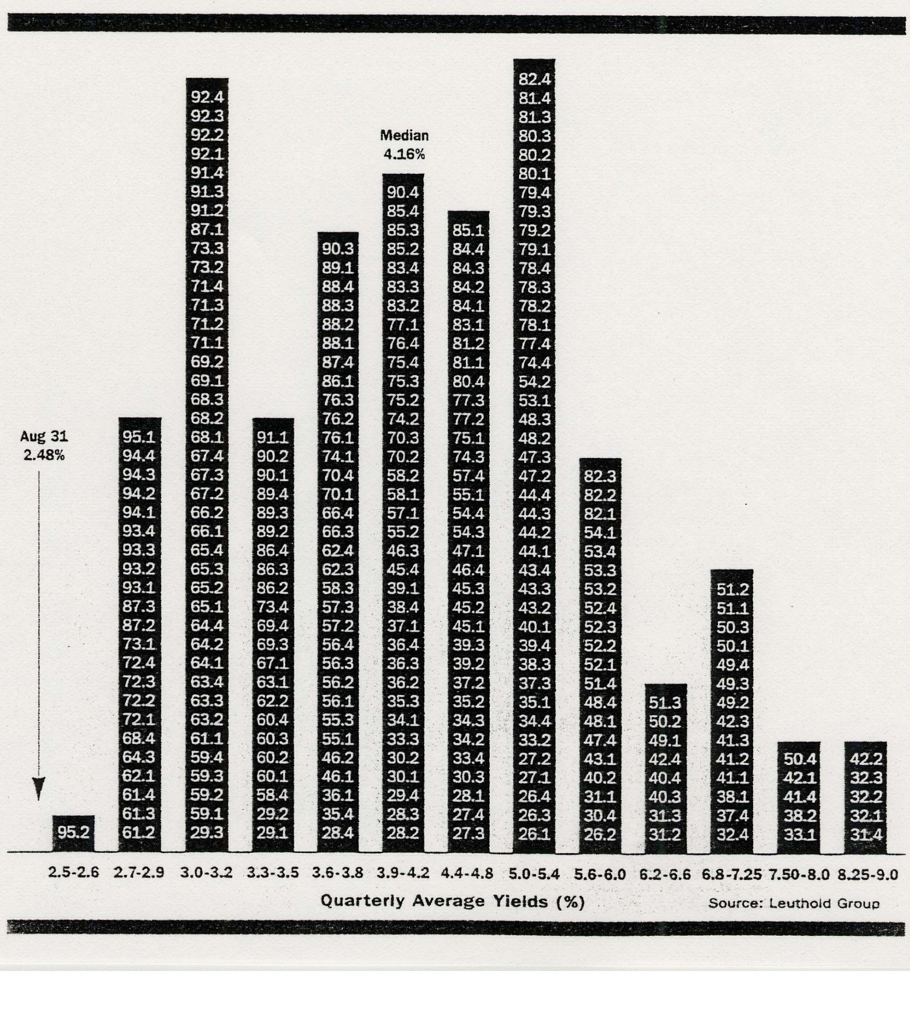


CHART #3

Price to Book Valuations for the S&P 500 and Industrials, 1960-3Q 95E

Return on book value is unsustainably high.

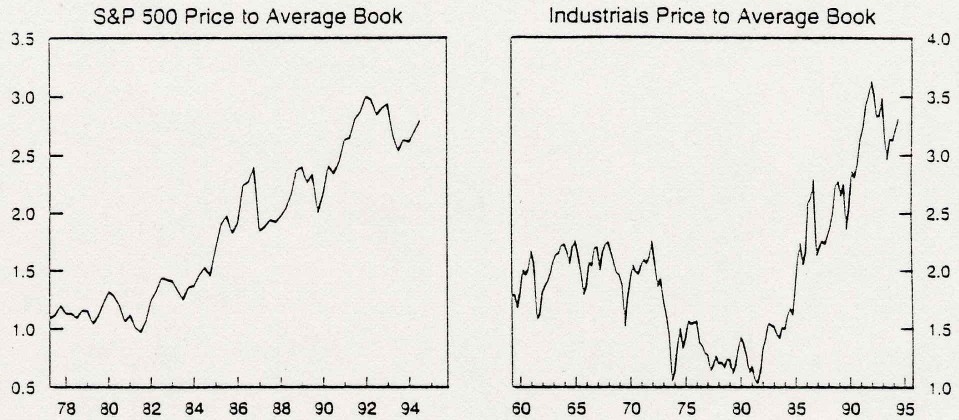
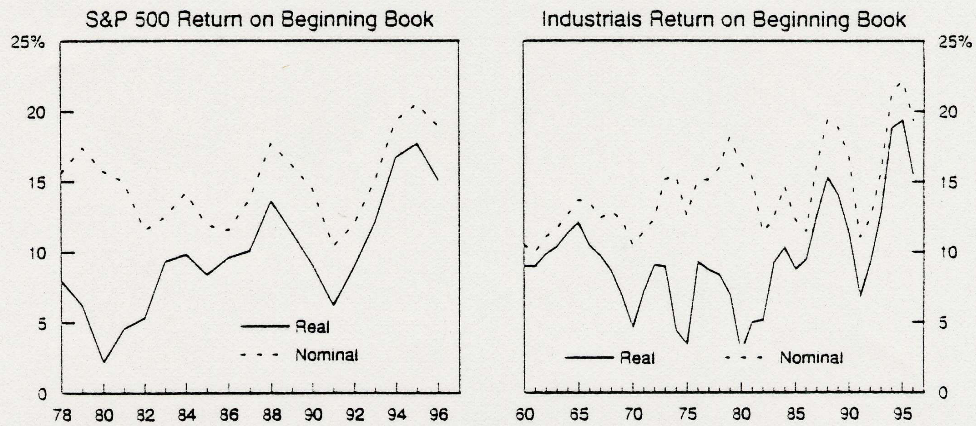
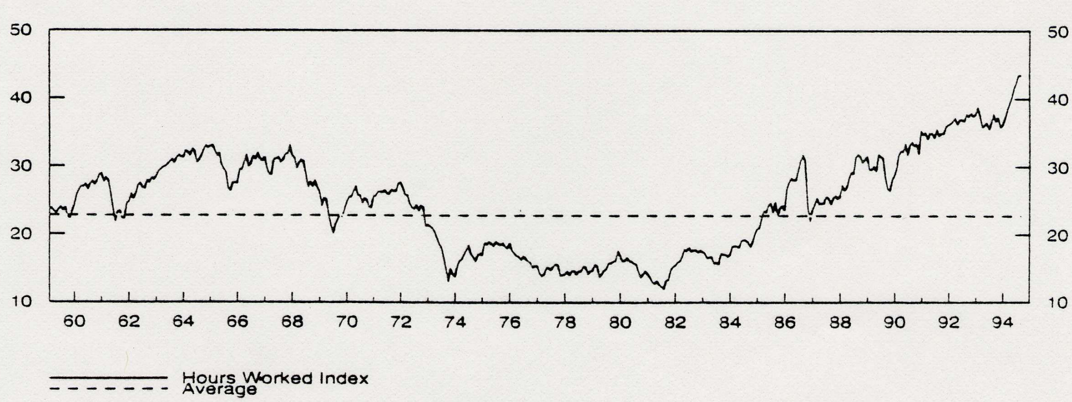


CHART #4



E Salomon Brothers Inc estimates.
Sources: Standard & Poor's and Salomon Brothers Inc.

Figure A2. Hours of Work Needed to Buy One S&P Unit, 1960-Aug 95



Sources: U.S. Bureau of Labor Statistics, Standard & Poor's and Salomon Brothers Inc.