Knightsbridge Asset Management
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THIRD QUARTER COMMENTARY

> "That men do not learn very much from the lessons of history is the most important of all the lessons that history has to teach."
>
> -Aldous Huxley, 1894-1963
> English author
> Collected Essays, 1959

In the throes of the longest running bull market this century, now having run seventy-two (72) months without so much as a ten percent (10%) correction, we recall Mr. Huxley's observation. In this context, many market mavens believe that a slower economy would bring 1997 earnings estimates down with stock prices following, and conversely, a stronger economy would bring higher interest rates, lower price/earnings ratios, and lower stock prices. A true Hobson's choice! If this is a true, then why is this market continuing to new highs, albeit modest ones?

A plurality of observers seem to believe that prevailing economic conditions are a bit like a page from Goldilocks and the Three Bears… that is, this economic porridge is neither too hot nor too cold… just right, in fact. Even the Federal Reserve chose to leave interest rates unchanged at the much anticipated September 23rd meeting, seeming to lend credence to these views. However, one must be reminded that the Fed, ever mindful of its own desire to remain independent of those politicians who might choose to subvert it for their own political agendas, has only raised rates once within ninety (90) days of a presidential election since its creation in 1913. That

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lone occasion was in 1980 during the Carter re-election bid against Reagan, and such action never helps an incumbent, as was the case then. Especially since Alan Greenspan is a Republican and Clinton a Democrat, it is reasonable to assume that potential charges of partisanship might encourage decision-making to err on the side of not raising rates. And so it was. Evidence, however, points to a significant tightening of labor markets, and one must remember that inflation measurements such as the CPI or GNP deflator are lagging and not leading indicators. With Clinton an assumed shoo-in, eyes have turned to the Congressional balance of power and a possible reversion of House control back to Democrats. Since only one third of the House is up for re-election, a shift in control seems likely. Certainly Dole has not succeeded in measurably closing the yawing gap in the polls, even after the televised October 6th and October 16th debates.

Given that worldwide deflation continues (with selected interest rates in Japan and Switzerland now below one (1) percent), governmental stimulus brought about by lowering of short-term interest rates becomes less viable. It's hard to provide economic stimulus by lowering rates from 1% to zero! Furthermore, although Japan and Germany may be trying to so stimulate their respective economies, once the interest rate option is exhausted, the only remaining remedies for stimulus are currency depreciation (cheaper local currencies to stimulate exports) and deficit infrastructure spending. Japan has already embarked on this path. More may be following. The economic engine of the U.S. is the only one that may have a chance to fight this worldwide trend. Because of this it may be that Fed Chairman Greenspan and Treasury Secretary Rubin may be willing to engage in policies which effectively risk reversing the 1980's legacy of the Volker era (which brought interest rates down from 15% to 6% on long term treasuries). Inflation has run about 2.8% over the last couple of years and appears to be upticking to some number between 3% and 4%. Since real interest rates (that is, nominal rates minus inflation) are high by historical standards, this means the bond market expects rates to be higher and inflation higher, in future years. So what does all this have to do with your portfolio?

Risk. Popular perceptions are that today's market risk is less than previous decades. This belief is bolstered by low historical volatility the past few years and the extraordinary length of this bull market. Quoting James Grant in the October 8th New York Times:

> ***Booms foment error because, in the heat of the up cycle, error is so financeable. Thus in the junk bond market this season certain wireless telecommunications companies have been able to borrow even before they achieve the conventional preliminary milestone of generating a little revenue… No doubt some of these revenue-impaired debtors will succeed. That is not the real issue. The issue is whether the market is pricing securities for anything but the perfect, fair-weather outcome. Up and down Wall Street, the answer would seem to be no.***

Dr. Henry Kaufman, former Chief Economist at Salomon Brothers, spoke recently in New York as follows:

> ***It is precisely at this juncture when we should step back and consider the risk that the changing structure of the financial markets may be contributing to germination of new financial excesses in the years to come… financial history reveals that financial excesses are recurrent, are generally unforeseen in advance, can do tremendous damage, but are too often quickly forgotten by those who come later… this problem goes beyond mere memory lapse in many instances to no memory at all… we need to go beyond massaging the data, especially in a rapidly changing financial world, one in which many participants lack the prudence that a conscientious reading of financial history would encourage… as some of you here know, I have been concerned for several years about the rapid growth of mutual funds as a potential for future market instability. Mutual funds were 2% of household net worth in 1984 and are now 10%... $100 billion has grown to $1.4 trillion… what is wrong with this picture? Very little if we lived in quieter financial times… but we know that structural changes in the financial markets are tending to magnify volatility. Yet the average investor in equity mutual funds has never experienced a prolonged bear market. That test is still in the future when the economic expansion has***

> ***to contend with bottlenecks and sectoral imbalances, credit demands accelerate, and monetary policy turns toward restraint… at some point… those higher rates will no longer be looked at contemptuously by many investors. New flows into mutual funds will dry up and many individuals may become net sellers. The mutual fund managers have no really viable alternative but to pass through these sales into the market. They cannot take a view apart from their investors… they will have to sell regardless of the impact on prices… I conclude that it is a potentially grievous error to assume that individual investors will always be slow to react to sudden, highly visible setbacks in stock prices, bond prices, or both. Certainly the technology is in place to facilitate massive shifts out of equity or bond funds. I want to emphasize that relatively benign economic conditions such as we now enjoy-namely, moderate growth and mild inflation- do not guarantee placid financial conditions. Far from it. In fact I strongly believe that there is an inherent dilemma for our monetary authorities when confronted with the combination of seemingly unthreatening economic conditions and lofty valuation of financial assets. At some point, the central bank will have to face squarely the larger question of whether to take monetary policy actions that may not be immediately compelled by developments in the overall economy or necessary to nip in the bud incipient inflationary pressures, but may be decisive in heading off an unsustainable financial bubble. This is not an easy policy course, nor one that would readily find widespread public acceptance. But it is consistent with the broader mandate to maintain the well-being of society.***

Normally in this quarterly commentary we hesitate to directly quote the opinions, prognostications and predictions of others. Why? Because it is so easy to fortify one's own opinions with the opinions of others, and because we wish to as plainly as possible state our positions. However, in this issue we wanted to devote some time to explaining why we feel the current risks, which are seemingly remote, are in fact ever present. Henry Kaufman has stated the case with unusual eloquence.

Prudent management of capital requires leaning against the wind and not succumbing to the temptations of the moment. Unfortunately, one can be leaning against the wind a long time as the wind can blow in one direction for a long time. We are going to continue to hold cash equivalent positions of at least 30% because we perceive the equity market to hold an accumulation of risks which have gone unrelieved. Any significant downward movement would serve to reinforce the elements of caution which we believe are healthy and necessary for further and more sustainable advance. It is true that our equity selection needs to be very good to overcome what is hopefully the temporary handicap of lower returns from the cash equivalent position of our portfolios. But the mathematical advantages we will have when the unannounced downturn arrives will be pronounced. This is our plan to keep your capital intact and growing.

The recent Lou Harris poll (see next page) of mutual fund investors asked the question… "Do you think the market will drop 20% to 30% at any time in the next decade?" Only 18% answered affirmatively! History says this will happen once every five (5) years, and furthermore, there has never been ten year period in the last 36 years (see next page) that did not have a drop of this magnitude. Therefore, we conclude that masses of mutual fund investors are poorly informed at best, and that this risk is ever present in today's market.

We take heed of Messrs. Huxley, Grant and Kaufman, vowing to at least be aware of the lessons of history so that we will not be unprepared when it repeats. We thank you for your understanding and wisdom.

Very truly yours,

Alan T. Beimfohr

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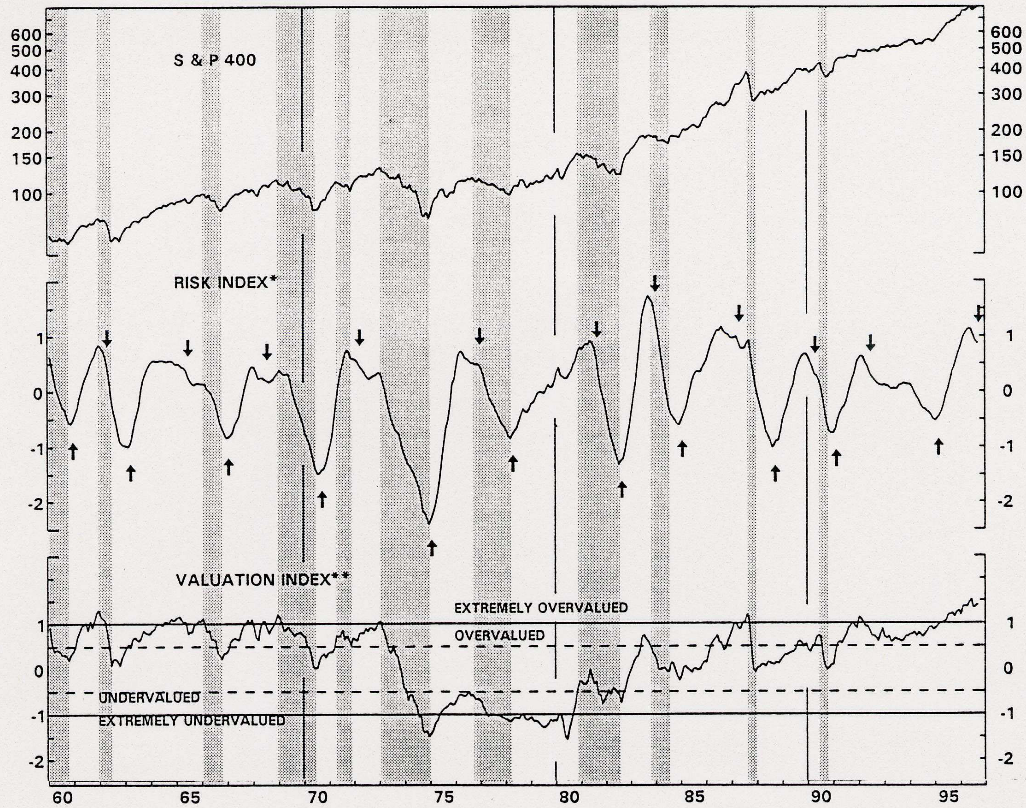
In accordance with these regulations, this is our regular annual offering of this material. We will forward a copy of this document at your request.

Stock Market Indicators



Market levels are high on an absolute basis

Valuation levels are higher than at previous market tops

Fund Investors Optimistic

■ **Securities:** Survey shows they have few worries about the stock market over the next decade—an outlook that flies in the face of history.

By TOM PETRUNO
TIMES STAFF WRITER

Mutual fund investors have fairly glowing expectations for stock market returns over the next 10 years, and they don't expect many bumps in the road—at least if you believe a new survey.

Liberty Financial, a Boston-based mutual fund manager, commissioned Louis Harris & Associates to poll fund investors on a number of questions. The survey of 1,014 individuals showed:

• Only 5% think the stock market will drop more than 30% in any one year between now and 2006. Only 18% think the market will drop between 20% and 30% in any year in that period.

The majority expect much smaller declines. Forty-one percent think the maximum annual decline in the stock market over the next 10 years will be less than 10%. Thirty-seven percent see the maximum decline at between 10% and 20%.

That optimism flies in the face of market history: In the severe bear market of 1973-74, blue-chip stock indexes sank 17% in 1973 and 30% in 1974.

• A stunning 85% of investors surveyed believe that stocks over the next 10 years will match or beat the 14% annualized return of the last 10 years. Only 14% think the market will produce annual returns below those of the last 10 years.

Yet the stock market's average annual return over the very long term is about 10%.

"I think everyone should be a bit concerned about the relatively high level of optimism among investors," said Porter P. Morgan, investment strategist for Liberty.

• The majority of fund investors, 62%, say they would hold their shares if their fund fell 20% in value, and 22% said they would buy more. Only 15% said they would sell at that point.

At the same time, 31% of stock fund owners said they would consider selling their shares if the stock market overall fell 25%.

• Fifty-two percent of fund investors expect to use the Internet or online services for investment purposes in the future, although only 6% use such services today.

The telephone survey covered fund investors who own mutual funds other than through an employer-sponsored plan, such as 401(k) retirement plans.

Liberty Financial owns such fund companies as Stein Roe, Colonial Group and Newport Pacific.

These beliefs are totally unrealistic and at odds with history