Knightsbridge Asset Management
division of Canterbury Capital Services, Inc.

October 27, 1998

THIRD QUARTER COMMENTARY

" The ignorant are cocksure and the intelligent are full of doubt"

-George Bernard Shaw
Irish Playwright,
Critic & Nobel Laureate
1856-1950

Cocksure investors were quite certain that Dow 9300 was but a minor steppingstone on the pathway to Dow 10,000. The U.S. market carnage since the July 17th peak has been swift and unrelenting to almost all stocks save a handful of mega-cap issues. The average mutual fund lost 15% in the quarter and even more since quarter's end. We are gratified that we have been able to avoid the severe drubbing most portfolios have taken. Even Warren Buffett, AKA "The Oracle of Omaha", has shed a tidy $10 billion with a 22% drop in his holdings since the market peak. Then there was George Soros of Quantum Fund fame, who dropped $2 billion on a wrong way bet on Russian sovereign debt. Rumor had it he had good company with Julian Robertson of Tiger Management and John Meriwether of Long Term Capital Management. Alluding to the hedge fund run by Meriwether as "Long Term" is a complete joke! Long term for them was tomorrow or perhaps a couple of days in a slow week.

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But the ensuing collapse of the Long Term Capital Management hedge fund only serves to demonstrate the perils of leverage. In this case, $5 billion was leveraged into over $100 billion. These were "smart" people, advised by two Nobel Prize winning economists, Myron Scholes and Merton Miller. No wonder they call economics the "dismal science"! But as bad as screwing up a $100 billion portfolio can be, the fact that Fed Chairman Greenspan was called in to help arrange and negotiate a private bailout, well, that was an even scarier thought with all due respect to Halloween. One would think that a $100 billion portfolio liquidation, almost completely collaterlized, would not upset the world financial stage. But it could have. And that realization was enough to cause all stripes and types of investors to wonder if something was most terribly wrong with the whole precarious system.

Scary Halloween thought number one… **July 17th has marked an important inflection point in the markets. Consider this. In the past 15 years… every time long-term interest rates went lower, stocks rose. The justification for this is that lower interest rates allow for higher P/E ratios. And likewise lower dividend yields on stocks are similarly justified. But at some point lower interest rates are indicative of a weakened economy, which implies lower earnings. And lower earnings then mean lower stock prices. This tug-of-war is where we are now. Fear of lower earnings, a negative effect, has overcome the positive effect of lower interest rates. Lower interest rates will probably not become a positive factor again until such time as a recession has been completely discounted and earnings growth is anticipated to be restored to higher levels. This delinkage of the bond market and the stock market in response to lower interest rates in the U.S. may be a watershed event, and bears watching closely for signs of its reestablishment. A relinking would be key to a new bull market. This is very important.**

Scary Halloween thought number two… **another way of looking at this is to observe that the U.S. equity market has provided rates of return over the very long term of about 10% per annum. This historically, was made up of a 4% dividend yield and a 6% earnings growth rate. These two numbers are additive to arrive at total return under the assumption that stock price appreciation tracks earnings growth in the long run. Now, if the earnings growth component is perceived to have permanently risen to 8%, as many observers recently believed, this allowed for dividend yields to be only 2%, and for stock prices to double, all factors equal. This is exactly what has happened over the past three (3) years. Now here is where it gets ugly. If the earnings growth rate perception is dropping from 8% to, say, 4%, then the dividend yield component must rise from 2% to 6%, again all factors equal. Remember that the sum of dividend yield plus earnings growth is expected to be 10%. This implies a stock price drop of 67% to get from a yield of 2% to 6%. This is simple four-function calculator math, but often overlooked by investors. The market is now adjusting to requiring the dividend yield to be a greater portion of total return. How much, we do not yet know and only the fullness of time will reveal.**

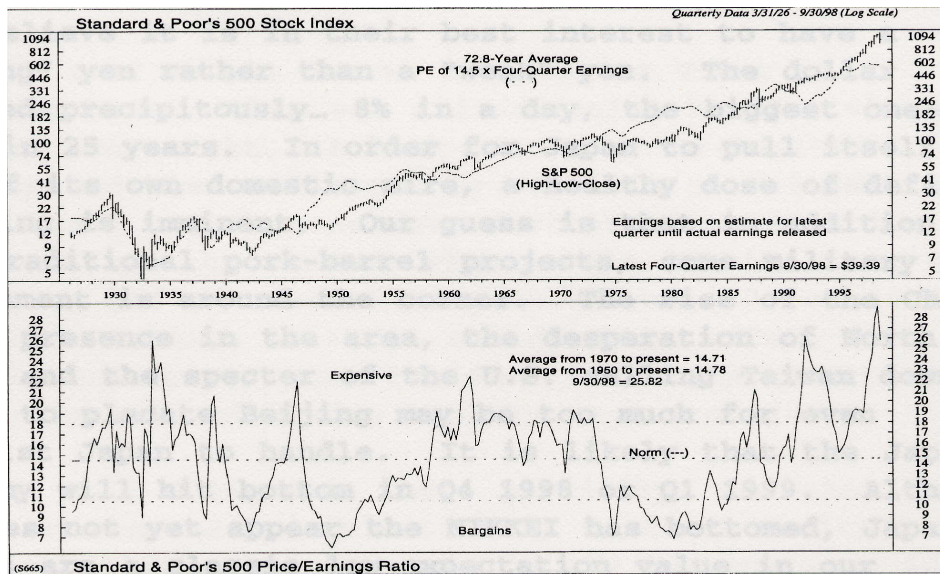
Scary Halloween thought number three… **Last week I attended a conference where the speakers included Mikhail Gorbachev, Henry Kissinger, John Major, Shimon Peres, F.W. de Klerk, et.al. The world monetary system was a hot topic and Shimon Peres stated that the fall of the third world economies was viewed by many of their leaders to be a sort of neo-colonialism. The U.S. is unfazed while the second line and third line nations pay a terrible price. Gorbachev believes the U.S. should send massive foreign and humanitarian aid to Russia and others on the theory that it's unfair to prosper while others are in pain. If, in fact, we are witnessing the beginnings of the death of free capital flows around the world in angry response to the aforementioned injustices, then the collective economic wellbeing of the world will certainly decline from what it could have been. Malaysia has taken such steps. Russia has defaulted. China has signaled a change of heart on joining the World Trade Organization (WTO). The beginnings of trade protectionism are there. Not a good sign.**

The "euro" is destined to be launched by January 1st. They said it couldn't be done and it has been. The "euro" is about to threaten the hegemony of the U.S. dollar and possibly dethrone it from its lofty perch as the world's reserve currency. It's creation has even spurred talk of Mexico abandoning the peso in favor of the U.S. dollar if Canada would do likewise creating a more competitive North American dollar. Is regional currency around the corner? Perhaps so. One thing is certain. The days of the dollar going unchallenged in the world are likely over. With it goes the ignoring of our chronic trade imbalance. This means a lower dollar. Most of the time, a lower currency means a lower stock market.

Recent volatility alone will be sufficient reason for a moderation in U.S. and European stock price levels. Since volatility equates to risk, heightened risk means lower prices must follow to compensate… higher perceived risk means higher returns are required to offset. This past week marked the largest single "up" week in market history. Stimulated by two successive decreases in the Federal Reserve Discount Rate, investors took heart that someone in Washington was listening to their calls for lower rates to ease the market's crisis. We are skeptical of the timing of the second decrease and it looks suspiciously like it was engineered for maximum effect on the stock market rather than the bond market… perhaps also timed to coincide with investors getting their September 401(K) mutual fund statements. The Fed took the unheard-of step of announcing the second decrease when the stock market was open but the bond market closed. Some observers felt this was purposeful as the bond market's reaction would be negative putting a damper on the positive stock market response, and that if done when the stock market was open and the bond market closed, the former could respond positively without the damper of the latter's decline. Why else would it have been timed in this manner? Others tell stories of banks stopping all lending last week for several days.

Since Fed Chairman Greenspan warned us of "irrational exuberance" at Dow 6000, what forces now at play are compelling him to encourage a higher stock market? Could it be that he wishes to make the liquidation of certain hedge funds less problematic? The professional investment community is wondering what he knows that they do not.

The market is now sufficiently "oversold" to generate a healthy rally. This rally should not be interpreted as the U.S. markets being "out of the woods". Why? For starters, there has never been a bear market in this century, of which there have been 31 in number defined as declines of 13% or greater, which ended with a market P/E ratio above 18. Never. Given that the market P/E ratio was 30 at its peak on July 17, we have corrected down only to a P/E ratio of about 24 so far and as of this writing we are at a P/E ratio of 27.



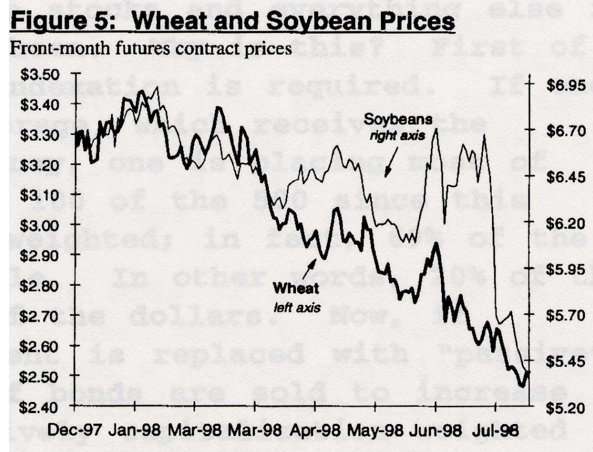
This allows for two possibilities, 1) We are not in a bear market anymore having established a new bear market bottom P/E ratio of 24, or 2) we are in a bear market that has not finished going down. The Dow Jones Industrial Average would have to go to about 5600-6000 to get to a P/E ratio of 18 times earnings, depending on when and how much intervening earnings growth or earnings decline transpired in the interim. The bullish argument against further

decline is that just because something never happened in the past 100 years doesn't mean it can't happen ever. Maybe trees do grow to the sky, just infrequently.

All of this brings us to our current portfolio strategy and the Asian markets. For a number of years Japanese institutions invested heavily in short term U.S. Treasury securities. Under the protective policy umbrella of their government's stated intention to allow the yen to depreciate against the dollar, currency risk was minimal. This meant they could safely "borrow" locally from depositors at, say, 1% and "lend" to the U.S. Government at, say, 5%, and pocket the 4% difference. This only works if you are assured that the 4% you think you are pocketing does not evaporate with the yen appreciating against the dollar. With the recently approved $500 billion rescue of their banking system, the Japanese have reversed course, repatriated their funds with a simultaneous announcement that they now believe it is in their best interest to have a "strong" yen rather than a "weak" yen. The dollar dropped precipitously… 8% in a day, the biggest one-day drop in 25 years. In order for Japan to pull itself up out of its own domestic mire, a healthy dose of deficit spending is imminent. Our guess is that in addition to the traditional pork-barrel projects, some military rearmament is around the corner. The rise of the Chinese naval presence in the area, the desperation of North Korea and the specter of the U.S. selling Taiwan down the river to placate Beijing may be too much for even pacifist Japan to handle. It is likely that the Japanese economy will hit bottom in Q4 1998 or Q1 1999. Although it does not yet appear the NIKKEI has bottomed, Japanese stocks are a classic low-expectation value in our opinion. We want portfolio participation in Japan, which is a good part of the rationale for owning M.S. Asia Pacific, the heavily discounted closed-end fund that has 46% in Japanese equities.

Korea Electric Power, another of our Asian holdings, has moved up strongly from 7 to 10 in the past three months. Korea may well be the first of the countries heavily hit by currency devaluation to pull itself out. Recent positive trade surpluses are a good indication of their progress.

We sold Earthgrains. Earthgrains was a classic deflation beneficiary stock. Wheat was the largest ingredient cost component for this bread baker. When purchased we thought wheat prices to be unsustainably high, and they have in fact dropped 51% in the past two years, fattening Earthgrains margins. Unfortunately we believe that these conditions are ephemeral, accentuated in the past year by the cancellation of grain purchased by Asian countries. Therefore we believe that the earnings growth exhibited so far is not sustainable. Earthgrains was a big winner; it quadrupled in value in 3 years.



We sold Petrie Stores Liquidating Trust at a moderate loss. This was a frustrating holding where nothing went right. A back-door play on Toys-R-Us, TOY went up and then collapsed to new lows as Wal-Mart ate their lunch. It's gone down further since we sold. Additionally, the workout with Petrie Retail, Inc. only went from bad to worse having shuttered 1000 of 1600 stores. Although this did not directly affect the liquidating trust, some residual lease guarantees did, eating into an otherwise healthy cash position.

We sold Allegiance Corp. partially, and then fully after an announced acquisition by Cardinal Health. We purchased this at 19 and sold in the aggregate at 60 (30 after a 2:1 split). A nice ride. Given that the Cardinal Health deal might not be consummated until as late as June of 1999, we were uncomfortable with a surrogate Cardinal Health holding in that time frame for presumably modest gain.

We would like to offer some observations on what we see internally within the U.S. market. We have written extensively in the past about the unprecedented extreme valuation levels in the U.S. market. Yet we observe the remarkable phenomenon of the S&P 500 being up 6% year- to-date, and, at the same time, the "average" stock is down 37%! What is going on here? The valuation difference between mega-cap stocks and everything else is as extreme as it has ever been. Why is this? First of all, an understanding of indexation is required. If one invests in the S&P 500 average, which receives the majority of all indexed money, one is placing most of one's money in the largest 100 of the 500 since this average is capitalization weighted; in fact, 69% of the money is in the top quintile. In other words, 20% of the average accounts for 69% of the dollars. Now, if "active" portfolio management is replaced with "passive" portfolio management, or if bonds are sold to increase equity exposure in a passively capitalization weighted portfolio, then the peculiar result is for most of the money to flow into just a handful of portfolio names… the largest names. And if an existing equally weighted portfolio is sold off to be reinvested in an indexed portfolio like the S&P 500 which is cap-weighted, then this is a de-facto liquidation of most stocks with reinvestment into only the mega-cap names. So one might logically ask, when will this trend reverse? Good question. A good question because in a declining market, typically the smaller cap names get hit the hardest. On this basis, we would not expect any closing of the valuation gap until we've seen a bear market bottom, at which time the mega-cap names would presumably underperform. However, mega-cap underperformance most likely would occur before a bear market bottom. Why? Well, if asset allocation decisions are made in response to a deteriorating economic environment, then selling indexed funds to raise cash or buy bonds would then disproportionately cause mega-cap stocks to be liquidated. This disproportionate liquidation would hit the mega-cap especially hard, and would most likely occur in the final phase of a bear market liquidation. Until that phase, we look only for more of the same.

The natural constituency for smaller-cap stocks among individual investors no longer exists… for two reasons. First, individual investors have largely abandoned stocks in favor of mutual funds. Second, Wall Street over-the-counter market making is vastly shrunken. Firms that used to make markets in 1500 stocks now do so in 300. And the information flow is reduced accordingly. The only remaining constituency is smaller-cap mutual funds. But they are already invested. Therefore, it is likely that indexation must become less popular for this trend to reverse. This has implications for the cost of capital to mid-sized businesses, and makes stock for stock acquisitions by the mega-caps very attractive.

Our judgement is that the odds of a recession in 1999 are 50/50. If there is one, most U.S. stocks will go lower. There has never been a rising equities market during the first half of a recession. That combined with extraordinary P/E ratios is a potentially toxic combination for investors of U.S. stocks. Accordingly, we will have considerably below-average U.S. equity exposure in the coming months. Conversely, as Asia begins to pull out of its slump, the timing will be ripe for further commitments there.

Canterbury Capital will celebrate its tenth (10th) anniversary on December 11th. I have managed both the business and the asset management effort of Canterbury since 1988 during which time the firm has grown from 7 to 36 employees. Both have grown to a point where I felt it important to restrict my activity to one or the other. Since asset management has always been my "first love", I plan on turning over my administrative duties for the balance of Canterbury to others in order to concentrate fully on asset management only. I will head up the asset management business under the name Knightsbridge Asset Management. This is an exciting prospect, and one I am looking forward to with great anticipation. You, my clients, have made all of this possible, and I am genuinely grateful, for it is you for whom I work. Few things are more rewarding for me personally.

We thank you once again for your understanding, patience and sponsorship. Rest assured we are investing your capital as we invest our own. We look forward to navigating another financial sea of uncharted waters, as we reflect upon the comment from George Bernard Shaw.

Very truly yours,

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