# Knightsbridge Asset Management, LLC

October 18, 1999

## THIRD QUARTER COMMENTARY

*"It is better to have useless knowledge than to know nothing."*

Lucius Annaeus Seneca,
3 B.C.-65 A.D.
Roman philosopher,
statesman, orator

The recent market has witnessed a pitched battle between graybeards armed with "useless knowledge" and neophyte investors who "know nothing". The "know nothing" neophytes appear to have prevailed over their supposedly sage elders. History tells us that Seneca, tutor to the infamous Nero, committed suicide upon being accused of conspiracy against the Roman Emperor he once taught. So much for knowledge.

Events of the past quarter may, however, be calling into question the supposition that the U.S. market can only march forever upward, propelled by a handful of mega-cap names that deserve, by dint of size and linearity of earnings progression, to trade at multiples three times their respective earnings growth rates. Due to their heavy weightings in capitalization weighted indices, they have given the appearance that all is well.

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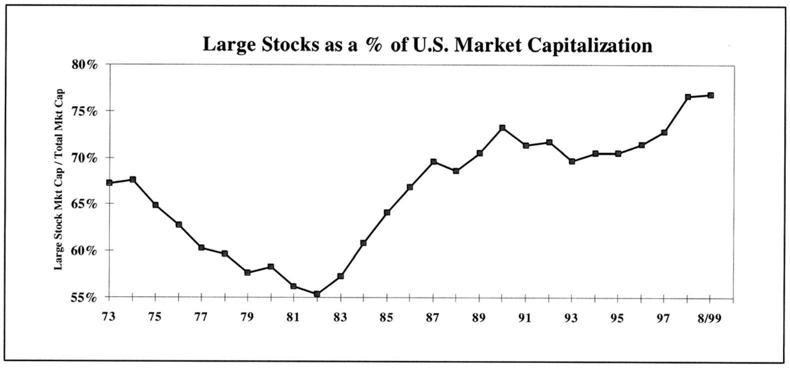
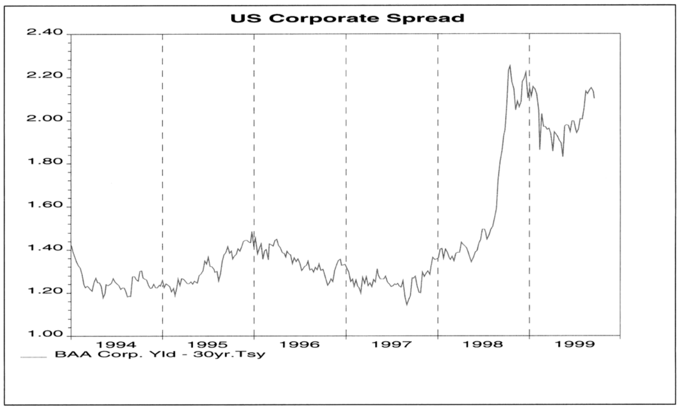



But all may not be so well particularly when viewed in the context of large-cap stock dominance, and it's corollary, non-large cap stock weakness.

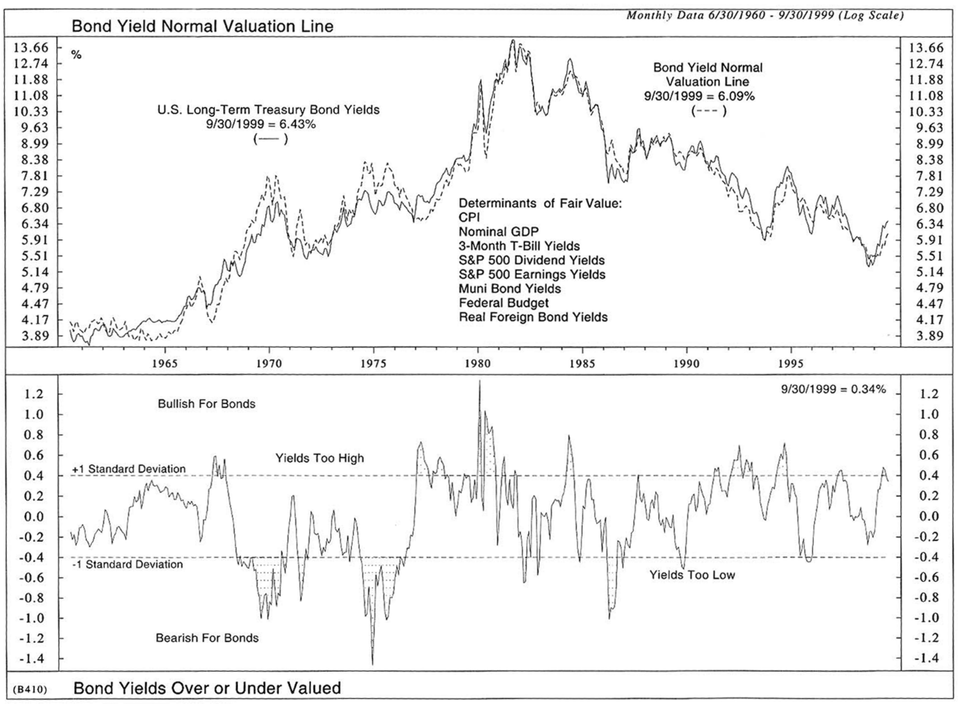
As of quarter's end:

1. the DJIA is off 9% from its August '99 high
2. the S&P 500 is off 10% from its July '99 high
3. the average NYSE stock is off 28% from its 52 week high
4. the average NASDAQ stock is off 35% from its 52 week high
5. 38% of NYSE stocks are down 30% or more from 52 week highs
6. 52% of NASDAQ stocks are down 30% or more from 52 week highs

All of this has a certain familiar ring… like last year at this time… when the market downdraft culminated in three successive lowerings of interest rates by the Fed. This time the backdrop is different. Foreign economies are strengthening. The U.S. trade deficit has further ballooned. Labor cost pressures are apparent, having risen to 4.6% per annum for non-financial hourly compensation. Without offsetting commodity price deflation and/or a continuation of large productivity gains, labor cost increases presage an increase in inflation… not huge, but nevertheless, higher than before. The bond market has adjusted rates higher in response, with 30 year treasuries at 6.3% or so, all in the face of shrinking treasury supply due to strong budget surpluses. Along with an increasing default rate, this has resulted in historically wide spreads between treasury and corporate bonds with some BAA/BBB rated corporate bonds yielding a full 200 basis points (2%) above treasuries in the longer maturities.




**A look at the relative theoretical attraction of owning bonds versus stocks shows bonds clearly favored at this time.**



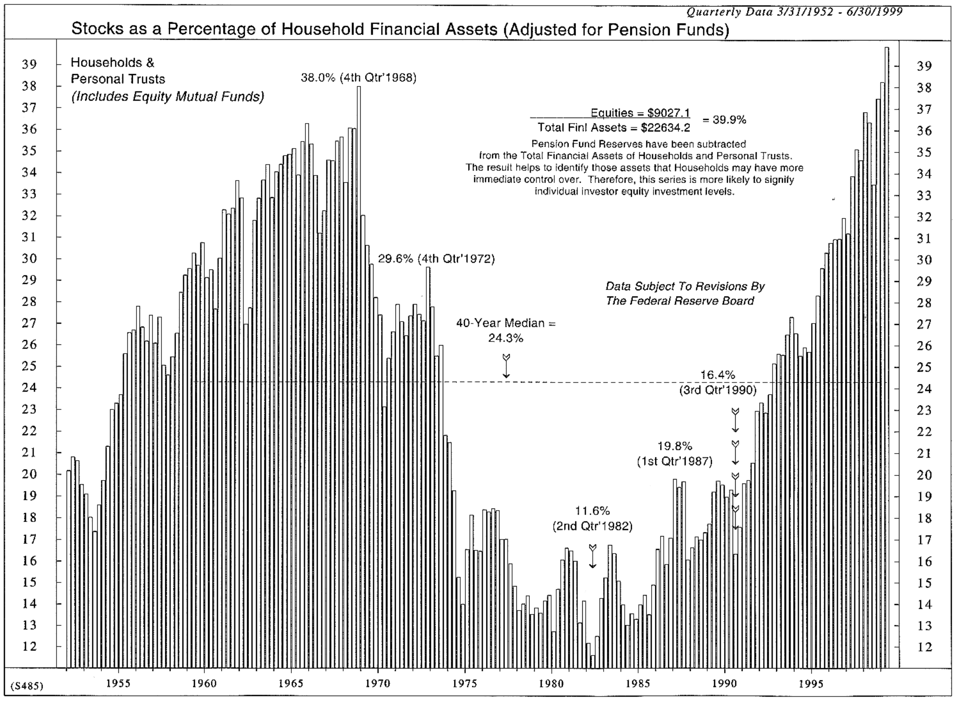

**For balanced accounts, we are buying bonds in this environment. Not only are bonds undervalued relative to stocks, they are undervalued relative to "fair value" by about 35 basis points (.35%) in yield.**

The eye-popping rise (and correction) of Internet stocks is a popular topic of discussion as the magazine covers of *Forbes, Business Week* and *Fortune* confirm. Part of the meteoric rise and ensuing investor feeding-frenzy is explainable by the increasing rate at which "technology" is acquired by the consumer. Consider the following:

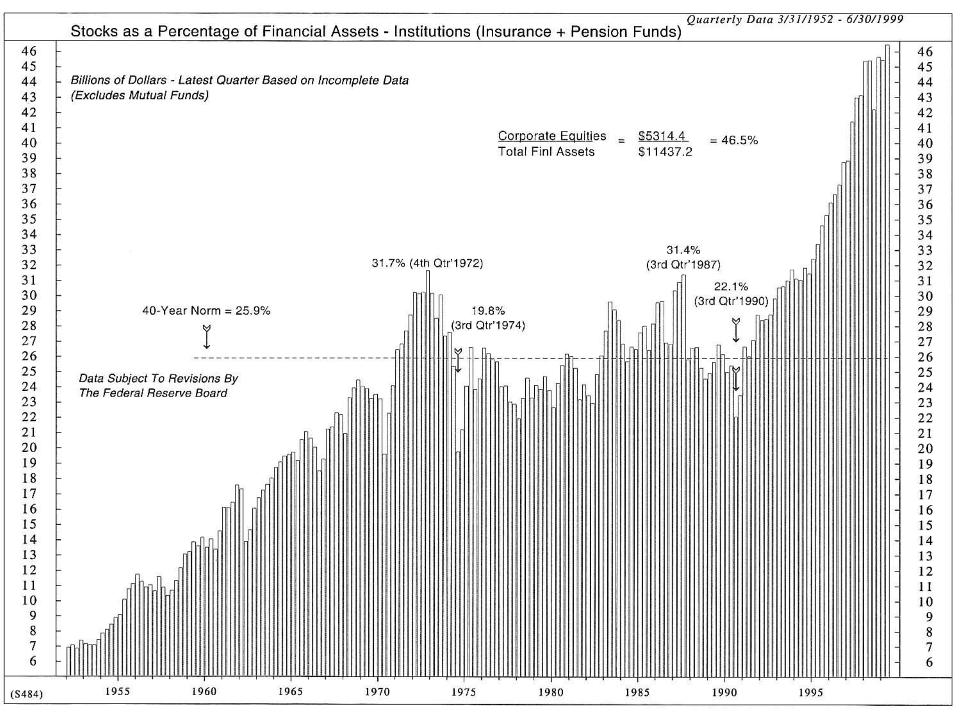
| Technology | Number of Years to Gain 25% Household Penetration |
|---|---|
| Internet | 7 |
| Cellular phone | 13 |
| Personal computer | 15 |
| Radio | 22 |
| Television | 26 |
| Microwave oven | 30 |

Observation: as the timeframe for acceptance becomes shorter and shorter, the companies' corresponding success or failure is telescoped accordingly along with stock price. This brings with it incremental risk as momentum players pile on and off and speculation leaves fundamental analysis in the dust. Rationality gives way to faith and hope. In order to justify the price, say, of Amazon.com, we must have "faith" that they will be able to successfully export their business model from just books and CD's to every product sold by Sears Roebuck and Walmart. If they are successful, Sears and Walmart are in big trouble. If not, Amazon.com is in even bigger trouble. Since e-commerce is only 3% of total commerce the jury is still out. Real estate tycoon Sam "The Grave Dancer" Zell states that Internet stock expansion is a result of recycled IPO (Initial Public Offering) proceeds and not corporate earnings… "this phenomenon is totally artificial and unsustainable, and when the IPO window finally slams shut, and it soon will, I expect it to trigger a nasty correction in the U.S. economy."

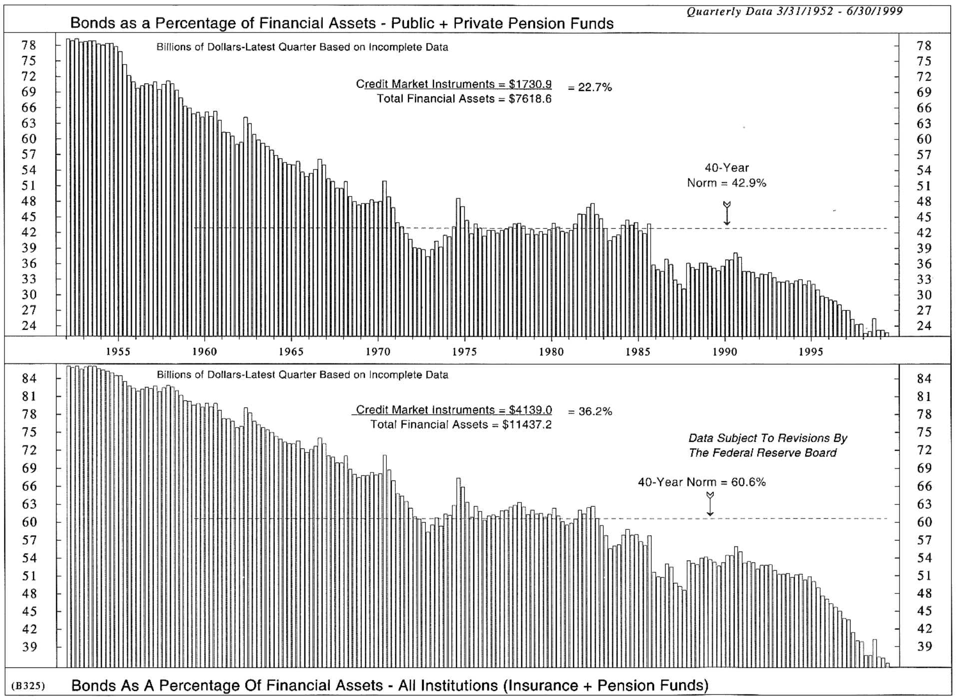
But, valuations be damned; the popularity for the tech stock dominated cap-weighted averages continues unabated. The last quarter set records with stock accounting for 40% of household assets for the first time in recorded history. This exceeds the 38% record set in 1968.




The love affair with the U.S. stock market is not confined to households alone. Institutions have piled on this bandwagon too.



And the flip side of this coin is that bonds are relatively unloved and underowned.




In our last letter we discussed the extremely negative sentiment readings on gold. We often say that identification is not prediction. If we identify a sentiment extreme, that says nothing about how long a change in sentiment may take to occur. This time we got lucky. In the short span of a few weeks gold surged from $254 per ounce to over $320. Short sellers scrambled to cover their short positions on the announcement by 15 European central banks that they would sell no more than 2000 metric tons of gold in the next 5 years. We think this behavior by the gold market makes it more likely that the Fed will be raising interest rates yet again because the Fed views rising gold prices as a leading indicator of inflation. If not in November, then in the next year after Y2K concerns have elapsed. The central fact is that the economy continues strongly overall. There is always the occasional anecdotal evidence to suggest that things are slowing down. But overall, conditions remain economically robust. Further interest rate increases, particularly short-term interest rates, promise to place greater pressure on the U.S. stock market.

We believe that although sufficient market damage has been done to produce a rally from currently "oversold" levels, that further work must be done at lower levels to generate a capitulation. Such capitulations almost always follow periods of extended deterioration such as the current one. It should also be mentioned that a characteristic of early-phase bull markets is that they become "overbought" and stay that way only pausing briefly to catch a breath. Likewise, incipient bear markets become "oversold" and stay "oversold" as they rally a bit only briefly to catch their breath.

And while we're speaking of breath we'll mention bad breadth. The breadth of the current market is terrible! We remain cautious as we have been for some time in anticipation of further corrections to what we view as a market whose large-cap technology stock leadership is largely overvalued. Microsoft President Steven Ballmer states, "There is such an overvaluation of tech stocks that it's absurd… I would put our company (Microsoft) and I would put most companies in that category." Those honest comments cost Mr. Ballmer $1 billion the next day as his 240 million shares of MSFT dropped four points. And those were just *his* shares! Poor Mr. Gates!

We have constructed our portfolios to benefit from a change in environment. To the extent that the past environment is perpetuated, we will underperform. We believe we are best served by being anticipatory rather than reactive. We believe that the recent moves by the Fed and the bearish tape action are early evidence that we are on the right track. Our portfolios are characterized by a heavy and defensive cash equivalent position and significant positions in the Asian market which have low directional correlations to the U.S. market. Each of our positions is characterized by a valuation anomaly that has made them cheap… heavy selling coming from a spin-off, a fixed price rights offering, or concentrated insider buying, etc. In addition, we are mindful that markets seldom stray from fundamentals for extended periods and that valuation metrics must eventually be rational. Accordingly, our participations in the current U.S market are deliberately a small percentage of the total portfolio.

We recently purchased SK Telecom, the leading wireless telecommunication service provider in South Korea. SK Telecom has a 43% market share and is the largest CDMA (code division multiple access) digital cellular provider in the world. CDMA technology is superior to the AMPS technology commonly used in the U.S. With 8 million customers, SK Telecom (ticker symbol SKM) had moved aggressively from analog to digital systems and is about to embark on "third generation" technology (3G) which will provide the downloading of video and high-speed data as well as voice communication into one handheld device. A recent controversial rights offering raised enough capital to render this company completely debt free. The news that SK Telecom was going to go ahead with the high capital investments required to pursue 3G along with the depressive affect of the rights offering, afforded us the opportunity to purchase.

SK Telecom trades at half the enterprise value to EBITDA ratio of its U.S. counterparts, and has revenue growing at 20-25% per annum. NTT DoCoMo, the largest Japanese cellular company, plans to have 3G technology commercially available in 2001. They will be the first in the world to offer this technology in scale. It will not be available in the U.S. until 2003 at the earliest. SK Telecom may be second only to NTT DoCoMo. They will need to work closely with the Korean government and Samsung, who will provide the hardware. We made most of our purchases at 11 ¼ or so, down from 18 ½ in July. We expect $.65 in earnings in calendar year 2000; some estimates are as high as $.84 per share. Earnings growth predictions on the street vary widely between 12% and 34% per annum over the next five years due to uncertainty regarding the spending rate on 3G technology. SKM is not a small company at $7 billion in capital. We believe it represents, at 7X cash flow and 4.8X EBITDA an unusually low valuation in a technology leader.

The September 27th cover of *Time Magazine* blared "Get Rich.com". Historically, when *Time, Newsweek* and *U.S. News & World Report* speak of the stock market, it represents an extreme of sentiment and should be taken as a contrary opinion indicator.

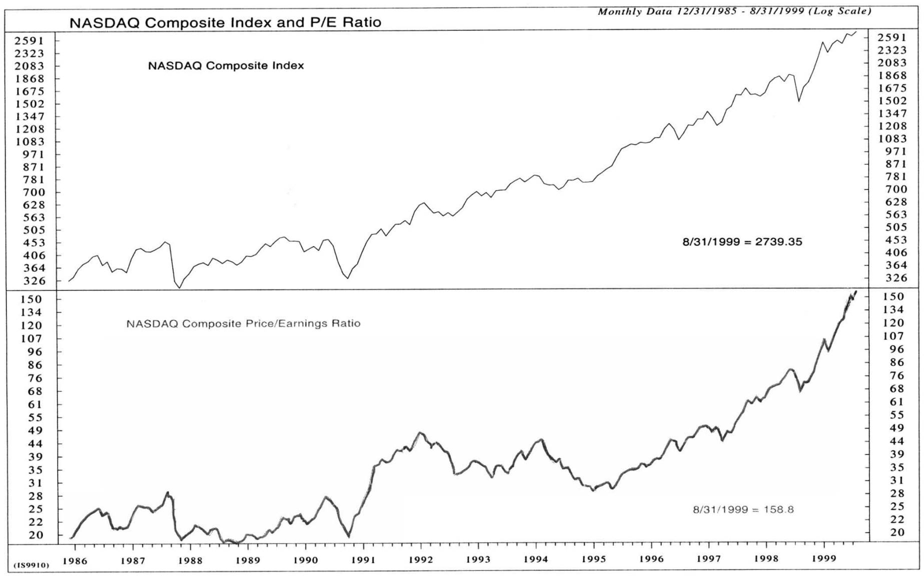
We also observe a spate of recent book titles:

*Dow 36,000* by James Glassman and Kevin Hassett
*Dow 40,000* by David Elias
*Dow 100,000* by Charles Kadlec

Pity the poor publisher! Since books must be sold, they encourage titles and topics to catch the imagination of the buying public. Engaging in a little hyperbole is par for the course. After all, Dow 20,000 just isn't sensational enough!

This time however, we wondered if there weren't some non-bullish titles out there we just hadn't noticed. A quick browse through Borders revealed that the cautionary Professor Ravi Batra had written yet another tome, *The Crash of the Millenium.* Those with elephantine memories recall the good professor having written *The Great Depression of 1990.* Unfortunately for Dr. Batra, there was no "great depression" in 1990, and his earlier book soon found it's way to the $3 discount shelf. One year from today we will likely find some of the aforementioned titles on the discount shelf sharing space, along with the Ricky Martin 16 month "year 2000" calendar.

One might recall that in our April 1999 "Quarterly Commentary" we made reference to Japanese Vice Minister of Finance Eisuke Sakakibara, who coined the term "bubble.com" when referring to the U.S. economy and stock market. Mr. Sakakibara was quoted in the July 3rd *Australian Financial Review* as having told an acquaintance that the reason he chose not to avail himself for yet another year in his post was that he "expected Wall Street would crash during that time, and he did not want to be around to deal with the consequences for Japan." Apparently Mr. Sakakibara has read neither the aforementioned books on the Dow nor *Time Magazine.* Rather, perhaps he is looking at the chart of P/E ratios of NASDAQ stocks, an astounding 158 times earnings as of August 31st.




And so we reflect upon whom it is that has "useless knowledge" and whom it is that "knows nothing". A cynic might suggest that Mr. Sakakibara's opinions are colored by the difficult Japanese experience of the past decade and the American economic juggernaut. Nevertheless, we would suggest it is Mr. Sakakibara who has, perhaps, "useless knowledge" and *Time Magazine* who "knows nothing." As it is said, all will be revealed in the fullness of time.

We thank you for your support.

Very truly yours,

Alan T. Beimfohr John G. Prichard, CFA