Knightsbridge Asset Management, LLC

October 16, 2000

THIRD QUARTER COMMENTARY

"You should never have to depend on the goodwill of the big oil companies just to heat your home or drive down the highway."

Albert A. Gore, Jr.
1948-
U.S. Presidential Candidate

"The whole art of politics consist in directing rationally the irrationalities of men."

Reinhold Niebuhr
1892-1971
American Religious & Social Thinker
Professor, Union Theological Seminary

Playing to the irrationalities of men with equally irrational statements, Mr. Gore seems to be ignoring half of Professor Neibuhr's observation. Gore's populist and delusional rhetoric may be merely election hype… or worse, the precursor of and a pretext for governmental interference and control in the capital markets. We assume Mr. Gore will become the next president. For what it's worth, in the gambling world, odds makers have had Gore winning the election ever since last January… these are the people who stand to gain or lose money, and cannot afford the luxury of partisan prejudices. Mr. Gore's dislike of oil companies (oil is too expensive) is matched by his dislike of pharmaceutical companies (prescription drugs are too expensive), HMO's (clerks are making medical decisions), tobacco companies (tobacco is evil) and media companies (selling violence and smut to our children). We remember the "windfall profits tax" on oil companies in the early 1980's. Supposedly a "windfall profit" was evil, marked by a sudden and fortuitous turn of events, the results of which were not deserved. This crisis was used as a pretext for an industry specific tax, and to sell the public on solutions they would otherwise reject. After all, why not a "windfall profit tax" on farmers when crop prices go up or on computer chip manufacturers when DRAM prices go up?

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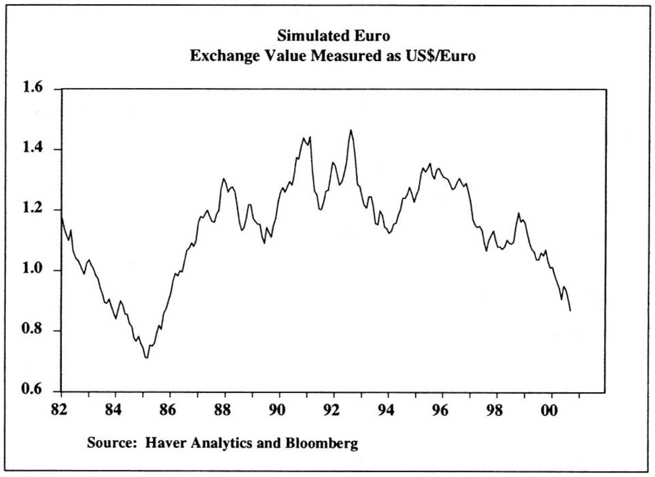
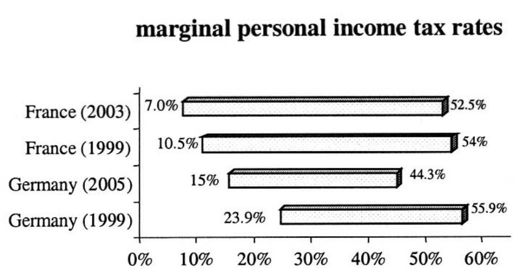
Perception holds sway and governments must ultimately be viewed by the populace as a provider of solutions rather than a creator of problems. Once the people are "in the streets" it's a certain sign of failure. Recent examples of failure were marked by rioting in Seattle, rioting in Prague, rioting in Gaza and the West Bank, rioting truckers in Paris, and rioting in Belgrade. Each of these events is destabilizing to the political regimes in power, and any solutions can have dramatic economic consequences.

Since its introduction in early 1999, the euro has fallen 28% from $1.18 to $0.85. Twelve nations bravely committed to the creation of a regional currency that in theory could challenge the reserve currency status of the almighty American dollar.



Even though the recent Danish vote was 53% against joining the euro currency, we do not believe this "experiment", as it has been dubbed, will fail. The Danes, it would seem, view the euro as a threat to their national sovereignty and the perpetuation of their socialist systems. Rightfully so, we believe, as in Germany, France and the U.K. it can be seen that center-left politicians such as Schroeder, Chirac and Blair are bending to the realities that taxes must be reduced and labor strictures loosened. Even Japan, Belgium and Italy are lowering income taxes. This is viewed as a direct threat to the socialist compact. In a capital-fluid world where businesses are no longer respecters of national boundaries and where billions move with a keystroke, things have changed indeed. European purchases of American companies have been 17 times American purchases of European companies according to DLJ analysts. Corporate cultures are homogenizing, like it or not. And it would seem that the German, French and Italian speaking corporate cultures have no fear of acquiring the English speaking cultures whereas there is some element of apprehension going the other way. Most probably this is because so many of the German, French and Italians speak English as a second language whereas very few Americans speak any second language at all.



The recent riots in Prague concurrent with the meeting of the IMF and World Bank are, as much as anything, about the waning influence of the nation state and the muscle of international corporate entities and institutions. The recent European Union questioning of the Vivendi/Seagrams merger, the Time Warner/AOL merger, and rejection of the Time Warner acquisition of the U.K's EMI Group is a concerted European attempt to rein in this power on a European basis rather than a national basis. Even the Deutsche Telekom proposed acquisition of Voicestream, the acquisition of PIMCO by Allianz, the Vodafone acquisition of Mannesmann and the Daimler Benz acquisition of Chrysler have had serious cross-border implications whereby national interests can no longer be the primary legal or economic consideration. Rather broader regional and coordinated efforts on a worldwide basis are called for. Moreover, foreign companies are even adopting American accounting standards in order to list ADRs (American Depository Receipts) on the New York Stock Exchange.

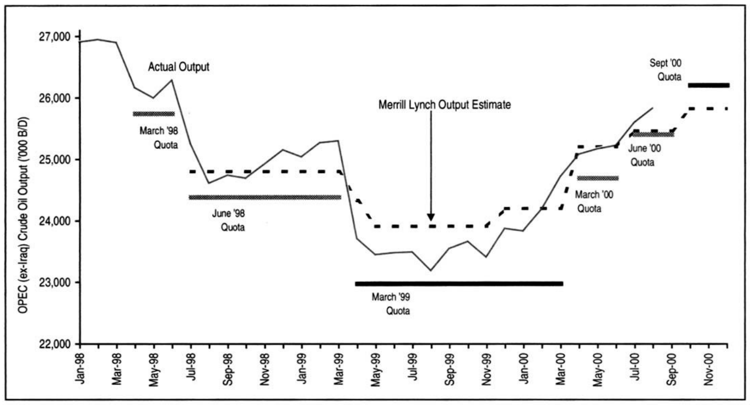
Not only has the anti-trust concept been regionalized, fourteen countries currently use the U.S. dollar as legal tender. This unfolding of "regional currency" has broad economic implications, and is not wholly welcomed by U.S. Treasury and Federal Reserve authorities. Fed Chairman Greenspan is already on record having warned the 13 non-U.S. nations using the dollar that policy in the U.S. will be set with an eye toward what is good for the U.S. only, and that excludes them. Yet with the proliferation of micro-nations, it should not surprise that some choose to anchor to the U.S. dollar or other strong currencies. By way of example, war ravaged Kosovo is using the deutschemark.

For these reasons we believe the euro will succeed. It must. If it does not, then the world will ultimately resort to the U.S. dollar only. Of all foreign reserves held in the world, 66% are held in U.S. dollars today, up from 51% in 1990. This is simply the inevitable evolution of a shrinking and homogenizing world… replete with decreasing speciation, languages facing extinction and cultures struggling for self-preservation and generally failing.

The declining euro has not been without its benefits. European unemployment ran high for two reasons: 1) many of the nations faced unemployed immigration seeping in from former communist block countries to the east, and, 2) many of the socialist systems awarded unemployment compensation that ran 75% of former salaries… not exactly an incentive for seeking reemployment. A cheap euro stimulated export markets making European goods extremely competitive and helping alleviate the unemployment problem.

Oil prices have moved to occupy center stage of late. Calls for an expansion of OPEC quotas have been growing. Unfortunately, many OPEC members are already producing at capacity. An OPEC quota increase of 500,000 barrels a day would only result in a 220,000 barrel a day production increase, since very few OPEC members have the ability to expand production. The Saudis have been key players in past crises, and

OPEC Production Levels Versus Output Targets

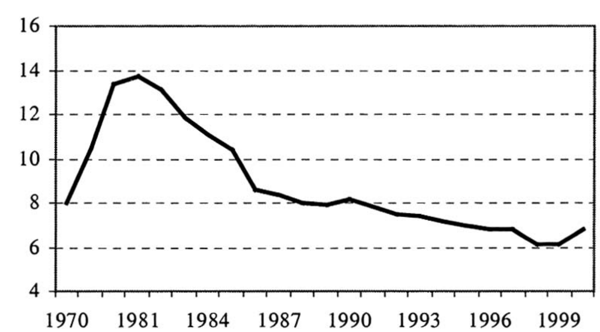


Source: IEA and Merrill Lynch estimates.

extraordinary pressure has been placed on them to bail out the developed world. In fact, Mr. Gore is dependent on the goodwill of Saudi Arabia, not "big oil companies."

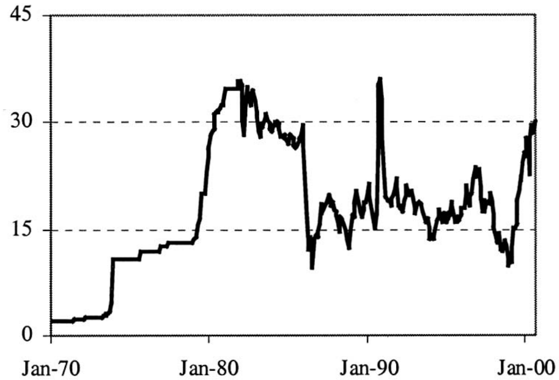
But is oil really all that high in price? On an inflation adjusted basis, given the $35/barrel acquisition cost of the Strategic Petroleum Reserve, created in 1978, oil would have to be selling today at $70 per barrel to break even. Thirty-dollar oil in 1980 is not the same as thirty-dollar oil today. Personal consumption expenditures for fuel, coal, electricity, and gas, as a percent of disposable personal income is a low 4.7% today having been as high as 8% in 1981. And as a percent of GDP, 7% today, versus 13% in 1980-1982. In fact, what is spent today on energy is quite modest by standards of the past thirty years. Therefore, we must conclude that the "crisis" is not so great… yet. The 30 million barrel sale from the Strategic Petroleum Reserve was a poorly conceived and politically inspired

Energy consumption share of GDP
(%)



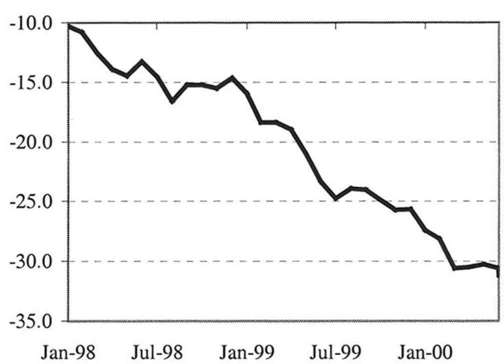
decision in our view. Yes, $30/barrel oil is high relative to $10/barrel oil in the spring of 1999, but $10 oil was the cheapest, inflation adjusted, since the Great Depression in the 1930's. Furthermore, U.S. governmental policies to head off the problem have been largely absent.

Nominal oil prices
(dollars per barrel)

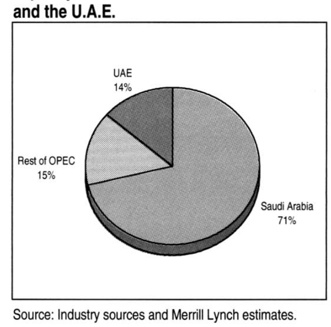


Although the release of oil from the Strategic Petroleum Reserve will provide a temporary palliative, we believe it may be short lived. The OPEC goal of $22 to $28 oil has little hope of being achieved without a more serious economic weakening in Europe, Asia or the Americas to dampen demand. A second and less discussed danger is that high and sustained imported oil prices are threatening to balloon even further the $30 billion/month U.S. trade deficit. A weakening of the dollar could be the inevitable result. And a third danger is the pressure on Saudi Arabia to use oil to benefit Muslim/Palestinian goals… particularly since Mecca, the holiest of places and birthplace of Muhammad, is within Saudi Arabia which annually receives hundreds of thousands of fundamentalist pilgrims from outside it's borders. The recent rupturing of the Israeli-Palestinian peace process does not bode well for cooperation between the U.S. and various Arab oil exporting countries, nor does the initiation of commercial flights into Baghdad by Russia, France and Turkey, the latter two supposed NATO allies. The bombing of Arafat's Gaza headquarters and the Yemeni suicide attack on the USS Cole only exacerbate the scene, and beg for retaliation. None of this is conducive to lower oil prices.

Trade Deficit ($ bn)



Only 15% of OPEC's spare capacity is held outside of Saudi Arabia and the U.A.E.



Source: Industry sources and Merrill Lynch estimates.

Third quarter profit warnings took a toll on more than a few of the big name stocks. The most common attributions centered around higher oil prices and the declining euro. These twin factors are closely related as the euro price of oil had quadrupled, and the dollar price tripled, in 18 months. Although the U.S. is uncomfortably dependent on imported crude, most of Europe, Japan and Korea are 100% dependent on imported crude. It is useful to remember the Asian meltdown began with excessive trade deficits aggravated by a strong dollar. Rising oil prices aggravate trade deficits faster than anything. We would speculate that Treasury and Fed officials would appreciate some weakening of the dollar accompanied by a weakening oil price, contrary to Treasury Secretary Lawrence Summer's recent obligatory pronouncements regarding the desirability of a strong dollar. In fact, the recent coordinated efforts of Japan, the U.S. and Europe to prop up the euro is evidence of this. Furthermore, Wim Duisenberg, head of the European Central Bank, is spearheading a raising of European interest rates, the latest on October 5th, to strengthen the euro while risking that business already somewhat weakened by higher oil prices might become disastrously weakened by layering-on higher interest rates.

Although higher real interest rates may have slowed the economy somewhat, with 3.9% unemployment, a 30-year low, it is difficult to conclude unequivocally that things have slowed enough. Higher oil prices are taking some steam out of the economy, in effect helping the Fed do its job. A declining euro slows the U.S. economy from the standpoint of making their imports more competitive with our domestic production. And negative political rhetoric raises the specter of industry specific taxes, price controls, or other forms of free market interference.

In summary, recent stock market weakness can be attributed to four interrelated factors:

1) higher real interest rates
2) higher oil prices
3) a declining euro
4) negative political rhetoric

Although the percentage of earnings pre-announcements that have been negative is no higher than usual, the current environment has raised the fear level.

One of our conclusions is that NASDAQ is close to being washed out. The realization has set in that too-high prices were paid for ephemeral earnings growth, which should restore some much needed and overdue caution to equity markets. We still look for a NASDAQ bottom characterized by a climactic sell off, further margin liquidation, and one day where downside volume exceeds upside volume by 10:1 or 15:1. Stay tuned. It hasn't happened yet, but may have by the time one reads this.

During the third quarter we maintained our defensive posture, defined by above average cash holdings, exposure to Asian stocks that are relatively non-correlated to the U.S. market, and defensive sectors of the U.S. market such as energy, gold and defense. Clients were rewarded with generally positive returns in equity accounts despite a difficult market environment. Year-to-date investment returns ending September 30th for equity accounts are generally above ten percent, well

ahead of the S&P 500 which is in negative territory for the year. Balanced accounts have experienced slightly lower returns due to widening corporate spreads and subsequent declines in the prices of corporate bond holdings.

During September we sold a quarter of our position in Teledyne Technologies, purchased in December of last year near $8 per share, at just under $30. The stock has been a big winner after being 'discovered' by investors as cheap based upon earnings generated from defense sector business while also growing profitable commercial applications such as radio frequency and wireless broadband, fiber-optics, and fuel cell technology. The securing of a manufacturing contract by Teledyne's OptoElectronics unit to produce fiber-optic components for Corning Inc. and a touting by the manager of the growth-oriented Firsthand Funds in Barron's, reinforced Teledyne's appeal and potential for continued P/E expansion.

Mattel, Inc. was added to portfolios during the quarter at prices around $10. Despite management's best efforts, led by the infamous Jill Barad, to destroy the company through the ill-advised purchase of the Learning Company, Mattel still possesses powerful brands, including, Fisher Price, Hotwheels, Matchbox, and Barbie, the most successful toy of all time. With these core brands and a renewal of investor interest as time provides distance from recent stumbles, the company should be able to return to earning $1.25 to $1.50 per share (the case from 1995 to 1998) and a modest price-to-earnings ratio of 15, facilitating a double in share price. Positive catalysts include the addition of Robert Eckert, respected former CEO of Kraft Foods; a strong product pipeline which includes toys and games based upon the popular Harry Potter and Survivor themes; resolution of the Learning Company debacle through sale (giveaway actually); and open market purchases of over 800,000 shares of the company stock during the last year by numerous directors and officers at prices above our purchase price.

Asian exposure has hurt portfolio performance this year. SK Telecom and Korea Electric Power, South Korean-based portfolio holdings, were not immune from the forty percent (40%) decline in the South Korean market this year, caused largely by dependence on more expensive imported oil but also by political waffling on economic policy, government regulation, and restructuring efforts as well as the uncertain implications that reunification with North Korea might bring.

Korea Electric Power is trading at a low seven (7) times next year's forecasted earnings and an amazing forty-five percent (45%) discount to book value. This is too inexpensive for a monopoly that is expected to grow earnings at greater than twenty percent (20%) annually for at least the next few years while monetizing valuable assets. The company sold ten percent (10%) of it's much sought-after cable network operating arm, Powercomm, in August, and plans to sell an additional fifty percent (50%) by the end of this year. Additionally, despite governmental delays, Korea Electric Power is in the process of selling power generating assets, thereby reducing capital demands and improving efficiency and profitability levels. We expect asset sales to be a powerful catalyst over the next year for the stock.

Concerns about the impact of higher input costs (oil) on Korea Electric Power seem overblown, as they will likely be passed on to Korean consumers in the form of higher electricity rates. In fact,

rates paid by consumers are expected to be increased by five percent (5%) over the next year while higher oil induced costs would only increase for the company by two percent (2%) given $30 per barrel oil.

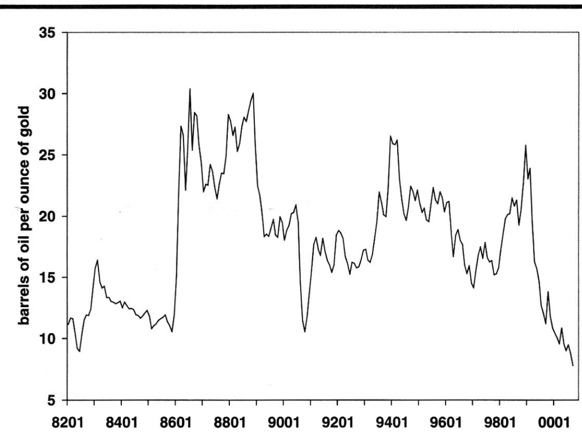
SK Telecom's stock price declined during the quarter, suffering from a governmental ruling that the company must curtail South Korean wireless market-share to 50% (currently 57% after the purchase of Shinsegi Telecomm). The company still possesses tremendous opportunity for growth from wireless data technology and a possible investment by Japan's NTT Docomo.

Morgan Stanley Asia Pacific Fund, our closed end fund holding, remains stuck at a steep discount (currently 28%) to net asset value. However, we still believe Asia is cheap relative to the U.S. and Europe and will experience positive returns going forward, having been through a protracted bear market.

Devon Energy, our largest portfolio position, finalized the $3.35 billion purchase of Santa Fe Snyder during the quarter and in doing so became the fourth largest publicly traded U.S. oil exploration and production company. The company is benefiting from higher oil price expectations, admission to the S&P 500 Index, and a strong track record for integrating company purchases. Despite these positive factors and strong performance for the quarter and year, the stock is currently priced at a discount to peers with similar oil production and reserve levels.

Newmont Mining received clearance for the purchase of Battle Mountain Gold during the quarter. The prospect of becoming a bigger gold company only seemed to represent an increase in pariah status. Despite being very well run and the largest domestic company in the industry, the stock is now trading at five (5) times cash flow, significantly below historical cash flow multiples of ten to fifteen times cash flow. Furthermore, the ratio of the price of gold to oil is at an 18 year low. We believe current prices and an almost total lack of investor interest will quickly improve should the U.S. dollar show any signs of weakness.

Gold-Oil Price Ratio



Source: Haver Analytics; Bear, Stearns & Co, Inc.

While this letter was being written, the ever explosive Mid-East has erupted anew. International politics aside, the economic outcome from higher oil prices, which act as a consumption tax, reduce GDP growth. Corporate earnings growth is thereby reduced which causes a lowering of P/E ratios. In fact, the prices of stocks in cyclical companies such as

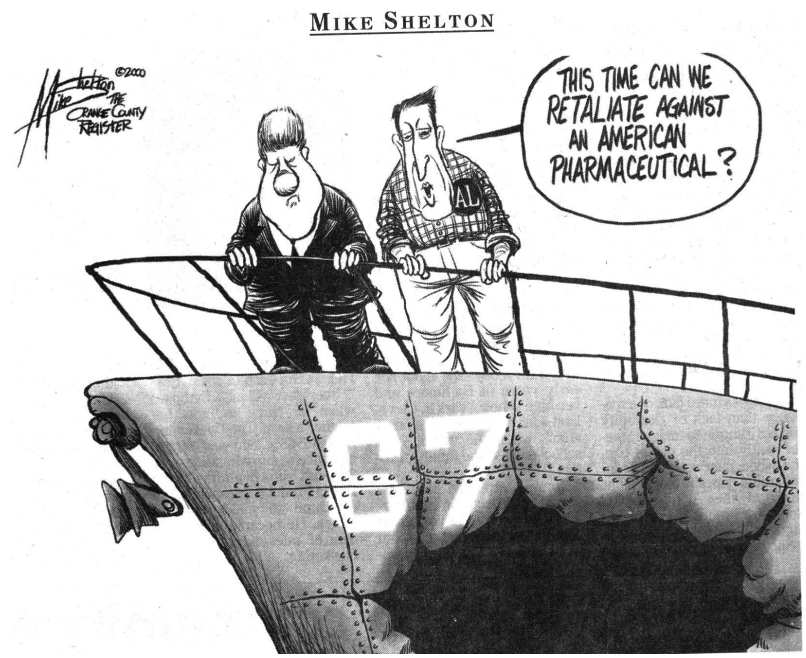
Georgia Pacific, Alcoa, Caterpillar, Weyerhaeuser, Ingersoll-Rand, Honeywell, Deere, Phelps Dodge, DuPont, Dow Chemical, Motorola and International Paper are all selling at half price… half, or less, of prior all-time highs. This is predictive of a "hard landing" rather than a "soft landing." If so, this presents the paradox wherein the Fed may be lowering interest rates soon, a 30 year low in unemployment notwithstanding. A "hard landing" would also most likely bring lower oil prices with it.

We remain cautious in the belief that the market catharsis has yet to run its full course. Thank you for your sponsorship, patience and understanding during a difficult year.

Very truly yours,

Alan T. Beimfohr

John G. Prichard, CFA



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