Knightsbridge Asset Management, LLC

October 24, 2002

THIRD QUARTER COMMENTARY

"One morning Chicken Little was in the woods when an acorn fell on his head. 'Oh my goodness, the sky is falling!' cried Chicken Little. 'I must go and tell the King.' So Chicken Little set off. On the way he met Henny Penny… and Cocky Locky… and Ducky Lucky… and Drakey Lakey… and Goosey Loosey… and Turkey Lurkey. 'Hello you six', said Turkey Lurkey, 'where are you off to?' 'Oh, Turkey Lurkey, the sky is falling!' said Goosey Loosey. 'I met Drakey Lakey, who was with Ducky Lucky, who met Cocky Locky, who met Henny Penny, who met Chicken Little. He was in the woods this morning when the sky fell on his head, so we are going to tell the King.' 'This is very serious!' exclaimed Turkey Lurkey. 'I will come too.' And they set off together. A little way down the road they met Foxy Loxy. 'Hello my seven friends. Where are you off to?' he asked. So they told Foxy Loxy that the sky had fallen on Chicken Little's head and they were going to tell the King. 'Do you know where the King lives?' asked Foxy Loxy. 'No, we don't. Can you tell us, please?' they replied. 'Certainly I can… just follow me' said the fox. But Foxy Loxy took them straight to his den, where his

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significant other and all the little Foxy Loxys were waiting for their dinner. The foxes devoured poor Chicken Little, Henny Penny, Cocky Locky, Ducky Lucky, Drakey Lakey, Goosey Loosey and Turkey Lurkey. So they never did get to tell the King that the sky was falling down."

-Chicken Little
The Random House Book of Nursery Stories
Retold by Helen Craig, 1999
Paraphrased by the authors

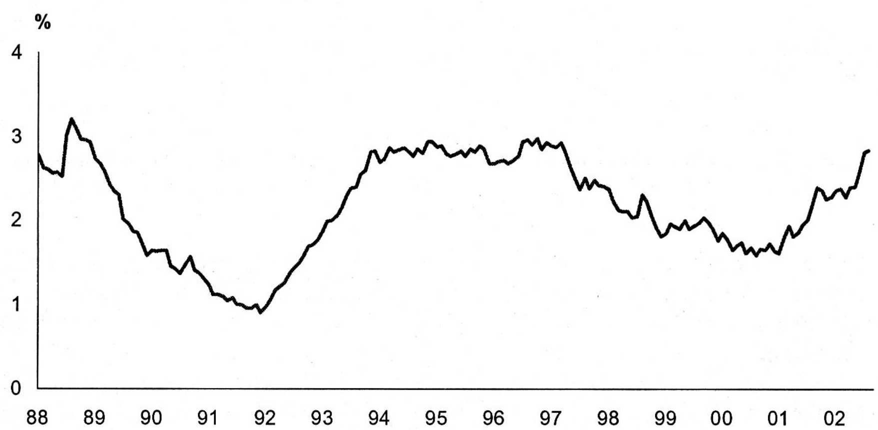
Chicken Little is best remembered for his incorrect conclusion that "the sky is falling." Less well remembered but perhaps more important was his fatally incorrect conclusion… that the fox was a friend who would share his feathered brethren's interest in seeking the King. So presumably the fox knew the sky was in fact *not* falling, and capitalized on the confusion and consternation created by the flock.

Psychology Professor Daniel Kahneman of Princeton was recently awarded the Nobel Prize in economics for studies demonstrating people to be poor judges of randomness, placing too much emphasis on the status quo, and placing greater emphasis on avoiding losses than making profits. In fact, in a Morgan Stanley study of mutual fund investor behavior from 1984 to 2000, the annual return to the average fund investor was just 5.3%, only a third of the 16.3% annualized return of the S&P 500 over that time frame. This study speaks to the Smith/Kahneman Nobel Prize work, and like Chicken Little, provides strong evidence that investor loss-aversion behavior gets in the way of the fully positive return experience.

With the S&P 500 down 17.3% in Q3, down 28.2% year-to-date thru September 30th, and down a whopping 50.5% from index intraday highs in March 2000 (1553 to 769), it is small wonder comparisons to 1929 are prevalent. "The sky is falling" seems to be an appropriate conclusion. Some $8 trillion has evaporated from what was $17 trillion in total stock market value, an amount greater relative to GDP than after the 1929 crash. Leading indicators are pointing down. Most markets have penetrated their July 23rd and 24th lows. "King" Greenspan tells us the Fed could not prevent the bubble, and "King" Bush is preoccupied with Baghdad. Corporations are accusing rating agencies of having changed the rules in the middle of the game… what was adequate liquidity is no longer adequate. The threat of credit

downgrades unless a company is willing to deleverage is so powerful, so punishing and so likely to risk triggering a corporate death-spiral, that disposal of major divisions is often the only option. A few of the most strong, e.g., Duke Energy, are able to raise fresh equity, albeit at stock prices 60% off all-time highs. Others, like Ericsson, must resort to a rights offering and extort fresh capital from their existing shareholder base. Others, e.g., Ford Motor and Texas Utilities (TXU Corp.), chop the dividend. But make no mistake, balance sheet reliquification is the order of the day and "free cash flow" is the new metric by which all companies have come to be judged.

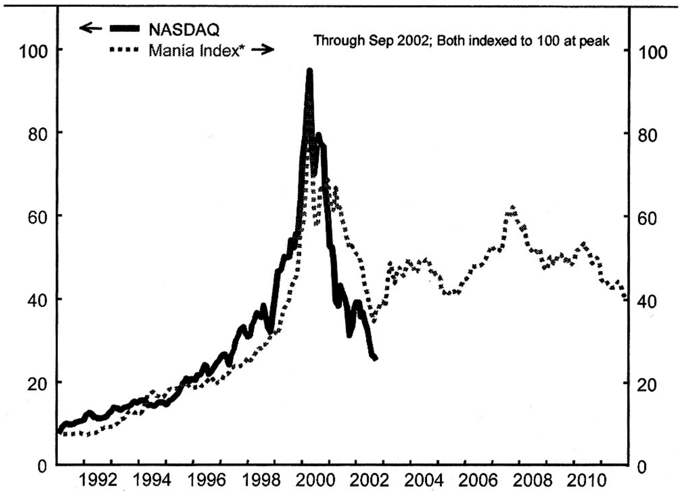
Figure 1: Global Free Cash Flow Yield (%) Since 1988



Free cash flow is defined to be net operating cash flow minus capital expenditure, but before dividend payments.
Source: Lehman Brothers, Worldscope

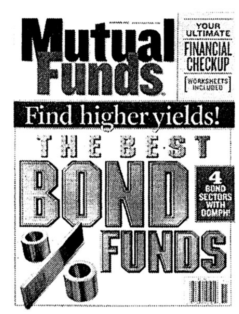
And speaking of "free cash flow", global free cash flow as seen above appears healthy and rising. This is a surprising phenomenon in the face of falling earnings, and perhaps indicative of contracting capital expenditures since any "cap-ex" reduces free cash flow. For free cash flow to be rising at all while operating earnings are falling means cap-ex must be falling faster than earnings are falling, absent other factors. Moreover, this metric could be considered quasi-proof that artificially low "reported earnings" (after write-offs) do not tell a true tale, but that "operating earnings" (which ignore write-offs), do. This recently has been a topic of intense debate.

The IT Bubble in Perspective



Note: Concept courtesy Bank Credit Analyst; Composite index of peaks in Gold & Silver (1980), Nikkei 225 (1989), and Dow Jones (1929). Source: DRI, MSIM Asset Allocation Research

The stampede for the exits last quarter was highlighted by July's $52 billion equity mutual fund net outflow, the worst outflow on record in dollar terms and as a percentage of stock market capitalization. The mirror image of these outflows from stock funds was inflows into bond funds. In fact, July was also a record month for bond inflows at $28 billion, eclipsing the prior $17 billion record, and providing us with a fresh example of "irrational exuberance". It seems the stock market bubble has become the bond market bubble… and maybe a real estate bubble too. And speaking of bubbles, if one compares NASDAQ (down from 5100 to 1100) to other collapsed manias like gold, Japanese stocks in 1989 and the Dow Jones Industrials in 1929, it can be seen above that the current NASDAQ implosion has substantially exceeded the corrective moves seen after these other manias. Nor is this confined to NASDAQ… in Germany, the Neuer Markt is closing down! And NASDAQ has so many stocks trading for $1.00 per share that there is extreme pressure to relax the listing requirements so as to avoid the revenue loss NASDAQ would experience from their delisting. It's so bad that Merrill Lynch just announced they will no longer make markets in 7500 OTC stocks… that's over half of all OTC stocks. In another sign of the times, both *Mutual Funds Magazine* and *Red Herring Magazine* are shutting their doors, and *Forbes Magazine* is closing down it's *Forbes ASAP* publication. *Red Herring*, a trade rag for the IPO market said advertisers' pages had dropped 72%.



The news that PIMCO Total Return Bond Fund had eclipsed the Vanguard 500 Stock Fund in total assets surprised many. Bond market guru Bill Gross would now occupy the throne formerly held by John Bogle, the titan of index funds himself. We freely confess to enjoying the

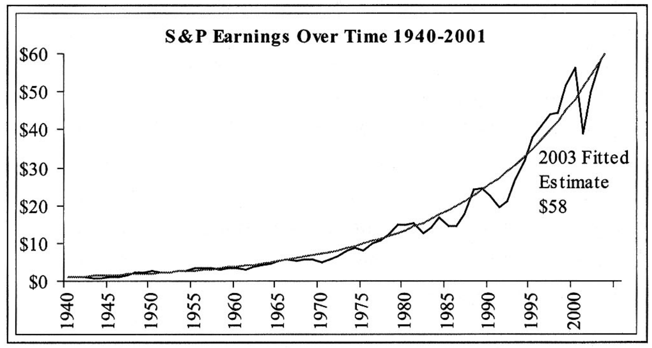
investment letters written by our neighbor, Mr. Gross. It's always good to have a closet Cassandra in your midst, lest one get carried away with bullishness. Any bond manager worth his salt must surely be a bear, because we all know, truly bad news on the economy is truly good news for the bond market. But the "Dow 5000" letter was really over the top… which made it such a great read. We've been advised by others to leave it alone… don't go there… PIMCO is too respected, too powerful, too resource-deep, and after all, don't those Bavarians at Allianz pay him an unheard-of annual stipend? Okay. We won't. But call us if you're really curious!

In our last letter (August 6th) we enumerated reasons why we felt the bear market was ending… to recap:

- **Percentage of NYSE stocks above 10 week moving average had fallen to 3.7%, a 15 year low,**
- **VIX index, a measure of volatility, had spiked at 57 (very high),**
- **Fed valuation model suggested stocks 25% undervalued,**
- **Market Vane bullish consensus had dropped to 16% (vs. all-time low of 14%),**
- **IBES valuation model showed stocks most undervalued since 1980,**
- **CBOE volatility index spiked to 51 (normal is 20-30)**
- **S&P 500 P/E ratio compression exceeded all but 1973-74 and 1930's,**
- **Headlines in the popular press carry the bear market story,**
- **P/E ratios are not high any longer if distorting write-off adjustments are removed,**
- **Adequate cushion exists in the market price structure to allow for a "double dip" recession without taking the market to new lows,**
- **Accounting issues in the aggregate may only subtract a few percent from earnings overall.**

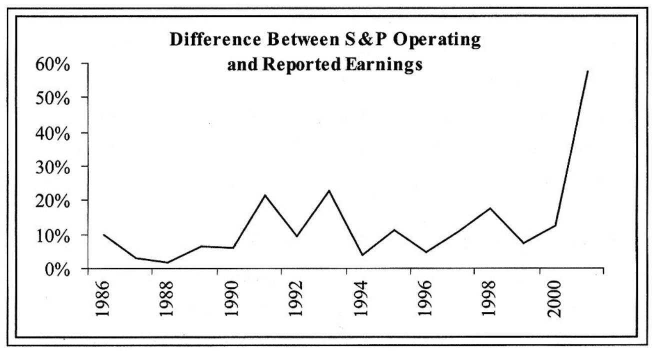
In a topic we touched on in our last letter, we discussed how "reported earnings" were artificially low relative to "operating earnings" as can be seen in the second chart at right. This has resulted from a historically high level of write-offs. Our thesis is that write-offs will be lessening dramatically as we further ourselves from the bubble-induced acquisition spree, and the difference between reported earnings and operating earnings will shrink back to perhaps only a 5% difference from the current 60% difference, largely through a dramatic increase in reported earnings as operating earnings rise more slowly. As we've said before, $56 worth of earnings on the S&P 500 is a P/E of about 16X, well within "normal" levels, and possibly too low at current inflation levels.

Exhibit 1
S&P Operating Earnings Long-Term Trend



Source: S&P, Morgan Stanley Research

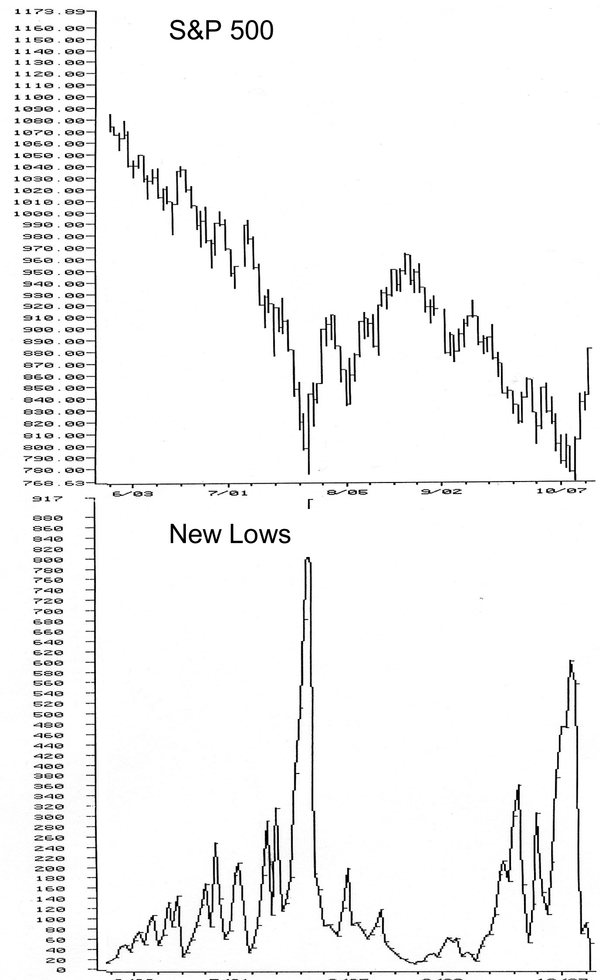
Exhibit 2
Gaps Between Operating and Reported Earnings Are Widest Around Recessions



Source: S&P, Morgan Stanley Research

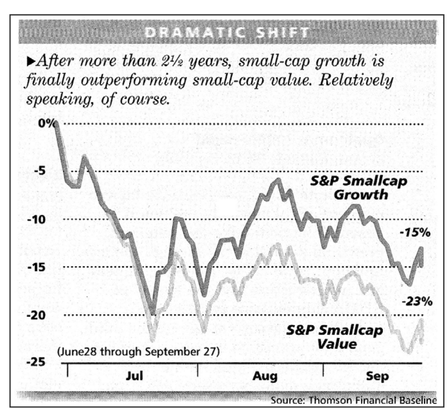
It is assumed by many that market valuations reached in 1999 and early 2000 were a function of an internet-driven mania and lack of an intervening corrective market move to readjust irrationally exuberant expectations. Although we view these as contributing factors, we believe 401K legislation was the major contributor. While we will not attempt to "prove" that in this letter, we will amplify on this theme in subsequent letters. But the reason we raise this issue here is that we must allow for the possibility that the P/E structure may have become stretched higher across-the-board as a result of the 401K capital infusion, and may remain so until such time as bond holdings become even more popular, and/or, a large percentage of 401K account holders are retiring (should be beginning in 2010 or so). Certainly, bonds *have* become more popular, and have outperformed stocks by an astonishing 60% or so over the past couple of years. Therefore, the P/E's we see now may in fact be among the lowest we will see for several years. This runs counter to the currently bearish popular thinking that says mean reversion to 14X or 15X along with an "overshoot" probability is the most likely scenario.

We still believe the bear market is ending. We add four more reasons as follows:

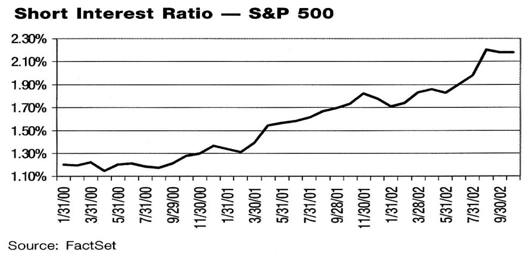


Slightly lower lows have been made October 9th & 10th relative to the lows made July 23rd & 24th. As can be seen from the charts at left, as the S&P 500 has basically "double bottomed", the number of new low being made has diminished… from 917 on the first July 24th spike to 604 on the second October 10th spike. This signals diminishing negative intensity, and is crucially important to a healthier market.

Moreover, it is well known that "value" stocks tend to outperform "growth" stocks in a declining market, and conversely, "growth" tends to outperform "value" in an advancing market. Therefore, we should be looking for evidence of growth pulling away from value if we believe we are starting a new bull market. This is exactly what we see in the chart at right.



We observe record short sales in August on the rally after July 24th… this shorting increases demand for stock ultimately and is a bullish sign.



And lastly, the ratio of insider selling to insider buying is very bullish and at a seven-year low.

We believe now is the time for thinking to be adjusted, to look ahead and past the Iraqi situation and November elections, to accept a weakly but nevertheless growing economy, and prepare for a healthy equity market in the statistically powerful and positive third presidential year.

In the story of Chicken Little, no one stopped to question the crowd's thinking and ask the critical questions:

1. Do falling acorns really constitute falling sky?
2. Given that we want to tell the king, how do we find him?
3. If we do find him, what if he can't do anything about the falling sky?
4. What reasons do we have for trusting a fox anyway?

So the parable here might be that Chicken Little and others are investors who have never experienced a bear market. The king is the Fed. The falling sky is the economy or the stock market. And the fox represents fear and greed. Enough! Though tempted, we won't carry it any further than that.

These have been most difficult times. They have tested the patience and fortitude of all, ourselves included. We thank you for your unwavering support and look forward to a brighter day ahead.

Very truly yours,

Alan T. Beimfohr   John G. Prichard, CFA