Knightsbridge Asset Management
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FOURTH QUARTER COMMENTARY

" The greatest deception men suffer is from their own opinions."

-Leonardo da Vinci, 1452-1519
Notebooks C. 1500
Italian Renaissance Artist,
Architect, Musician,
Engineer, Scientist

Swift Fed action on the interest rate front last quarter was just what market participants had hoped for. Never mind that the U.S. market balloon was reinflated in the process. And no longer do we only bail out automakers, defense contractors and banks. Add hedge funds and sovereign nations to the list. It seems that the doctrine of "too big to fail" can apply to just about anyone or anything… like Brazil. And why not, they say. Isn't the perpetuation of the longest postwar domestic economic expansion sufficient justification? Perhaps not. History teaches us, that left uncorrected, substantial excesses creep into the system and that the ultimate unwinding of these excesses can be both painful and injurious. As Leonardo da Vinci reminds us, our own opinions may be producing the greatest deceptions of all. More on this later.

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The fundamentally overvalued U.S. dollar can only progressively cause more devaluations of foreign currency with the passage of time. Once the U.S. trade deficit stops growing we will know the dollar is no longer overvalued. Which brings us to the "euro". Leading up to the historic debut of the euro, the dollar faded against the yen and deutsche mark by as much as 20% from peak values several months ago. The facts are that the euro will challenge the hegemony of the U.S. dollar as the world's reserve currency. Either that, or regional currencies are just around the corner. Treasury Secretary Rubin has carefully left the door open for discussion on that topic. If foreigners become less interested in holding U.S. dollars, the euro is a strong and viable alternative. This will exert a discipline on U.S. monetary and fiscal policy that has heretofore been missing. If the growing trade deficit is not reversed, the dollar could take a further pounding. This slide could require the Fed to raise interest rates to "defend the dollar", and bring with it an end to the current bull market. This warrants close watching.

High consumer confidence and low unemployment continue unabated. Those lonely voices predicting flat earnings in 1999 based on a general slowing of global economic activity, are swimming against the tide of popular opinion. Recession has become a more remote possibility in the past three months due to Fed actions.

The market's 1998 performance was "saved" by Fed actions in the fourth quarter. Monetary growth exploded as can be seen (in chart #6). Since we are in an environment where everything is deflating, one might ask "where is all this money going?" You guessed it! Excess liquidity has spilled over into the U.S. equity market, and particularly S&P 500 funds, the rage of the day. Because many of these investors are not going to be long-term investors they will need liquidity to exit at some future point in time. Indexation is an easy decision. Too easy. And it has produced extreme distortions. Consider that 50 of the 500 stocks in the S&P 500 account for 48% of the index. The total return of the equally-weighted S&P 500 was only +5.0% in 1998 while the capitalization-weighted total return was +28.5%! This says that all of the performance was in those 50 stocks, and the other 450 did relatively poorly. In fact, in 1998, the average NYSE stock was down! Therefore, the liquidity phenomenon is causing extreme skewing of stock price performance, something we should be mindful of when assessing our own results. The average equity mutual fund was up 13.7% in 1998.

The reinflation of the U.S. equity market balloon has become so successful that P/E ratios have moved past last summer's all-time highs and on to new highs at 31.4 times earnings. This has created the "supermoney" for an unprecedented corporate acquisition binge. After all, if one can acquire smaller companies with earnings growth rates of 10% and a P/E if 15 while paying for it with stock whose earnings growth rate is 10% and a P/E of 20, then that truly is a perpetual motion machine.

We have added Genesis Health Ventures to our portfolios. Genesis Health (GHV) is a nursing home company trading at 3X cash flow. Nursing home stocks were severely punished in 1998 as the Medicare reimbursement system was changed to give nursing home operators a less generous deal. Companies in this business responded by diversifying into selling rehabilitation therapy services and/or prescription drugs into their captive resident populations. Most of the large operators have about 1/3rd of their patient population Medicare reimbursed, and it is estimated that the changed system will result in a 17% revenue shortfall for that portion of their business. It costs about $40,000-$42,000 per bed to build a nursing home, and most are trading on the NYSE at the equivalent of $15,000-$20,000 per bed. Since it will be cheaper to acquire capacity by acquisition, very few new homes will be built until the prices rise. Since the "over 65" age group is the fastest growing sector of the U.S. population, replacing Medicare reimbursed patients with private-pay patients will be the preferred response to the problem. Once this problem is digested, we believe Genesis Health can return to its historic earnings growth rate of 20-25% per annum. Genesis should earn $1.10 or so in 1999.
At a price of $9 per share and a P/E of 8X, we believe this is a bargain and that the worst is behind for this industry.

It is now cheaper to buy oil on the NYSE than to drill for it for the first time in a decade. In light of this we purchased PennzEnergy (PZE), the exploration and production business of Pennzoil, at $16 ½ per share.
Expectations are for $3.00 per share in earnings and $13.50 per share in EBITDA (earnings before interest, taxes,

depreciation and amortization). At zero earnings, EBITDA is still over $10.00 per share. A year ago Union Pacific Resources offered $84 per share for Pennzoil. Pennzoil management rebuffed the offer and was ultimately taken to court by disgruntled shareholders. This resulted in a decision to split the company into two roughly equal pieces, the JiffyLube chain of drive-thru oil-change franchises and the traditional exploration and production business. Pennzoil's stock price dropped along with all oil producing companies throughout 1998 as the price of crude plunged from $18 to $10 per barrel. However, the JiffyLube business has always been worth about $17 per Pennzoil share irrespective of the price of oil. If we subtract that $17 from the $84 offer made by Union Pacific Resources, we can conclude that UPR was willing to pay $67 for Pennzoil's exploration and production business only one year ago. It is the same business that we have purchased at $16 ½. True, exploration and production industry stocks took a 40% hit in 1998, but a 40% haircut from $67 still leaves $40 and we think $16 ½ is too cheap. Pennzoil was booted out of the S&P 500 at the end of December causing all index funds to unceremoniously dump their shares, depressing the price just before our purchases and causing what we believe will be a temporary valuation anomaly. Pennzoil is no more. PennzEnergy and Pennzoil-Quaker State (JiffyLube merged with Quaker State) are the successors. We believe PennzEnergy is deeply undervalued compared to Apache, Amerada Hess, Phillips, etc. Furthermore, with some recovery in Asia, oil prices may work their way higher giving us an additional reason for optimism.

The current internet mania may be the greatest of all modern-day market deceptions. Consider Amazon.com (AMZN), a prominent poster-child for all that's good in the current market. At $140 per share, up from $9 but down from $200 this past year, AMZN regularly trades 20 million shares per day. That's almost $3 billion per day! IBM trades 1/5 of that. Now Amazon.com sells books and recorded music on the internet. If Amazon.com were to garner 100% of all the book business in this country at the average 3% after tax margin collectively earned by Barnes & Noble, Crown, Waldenbooks, B. Dalton, Brentano's, Borders, etc., the stock would still be trading at a P/E ratio of 50! Not only that, but it is now possible to purchase a portable plastic notebook with a screen into which one can download an entire book's text, negating the need to order the physical book at all. Therefore, the assumed investor

conclusion that has Amazon.com gobbling up the book world in the finest Wal-Mart tradition could be another case of investor self-deception. The internet army of five million on-line trading geniuses is playing a dangerous game… we are told they trade five times as frequently as traditional investors, yet 95% lose money. This mania has the potential to inflict wounds on many investors, even those of us who are not direct participants. Since the current market valuation structure in many ways defies rational expectations, there is a tendency to forget and ignore principles and disciplines that have stood the tests of time and provided reasonable risk protection. When combined with the observation that such extreme behaviors have gone unpunished by the market itself, many conclude there will be no day of reckoning. These forces and similar logic are what allowed the Japanese market to go almost 40,000 on the NIKKEI a decade ago. That market stands at 1/3rd of its former value. Given the S&P 500 at 1260, can anyone say with a straight face that they expect to see the S&P 500 at 420? Yet historical experience would not rule out such on a valuation basis. Instead of 5X book value, we would be at 1.7X book value. Instead of 1.4% yields, 4.2% yields. Instead of 31.4X earnings, 10.5X earnings. Each of these parameters is within the realm of reason and, in fact, have existed throughout most of our lives. Therefore, we must exercise caution where others do not. We must seek strong value where others ignore. We must protect where others expose. And we must avoid crowd mentality at all costs, even when following the crowd is temporarily rewarded. These are difficult conditions, and we continue to do our best to simultaneously protect and enhance your assets. But as Leonardo da Vinci reminds us, we as humans, suffer mainly from self-deception. Time will tell whether the deception is theirs, or ours, but fortunately, time and history are on our side.

Very truly yours,

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