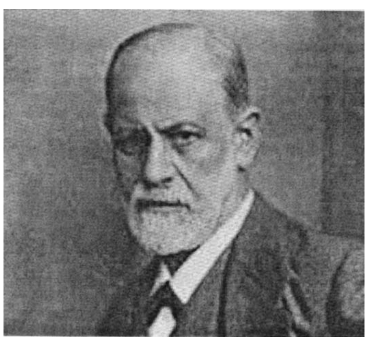
January 29, 2001

FOURTH QUARTER COMMENTARY

"A group is extraordinarily susceptible to belief on uncertain evidence and open to influence… it has no critical faculty, and the improbable does not exist for it. It thinks in images, which call one another up by association… and whose agreement with reality is never checked by any reasonable agency. The feelings of a group are always very simple and very exaggerated, so that a group knows neither doubt nor uncertainty."



-Sigmund Freud, 1856-1939
-Austrian medical doctor and founder of psychoanalysis
-Group Psychology and the Analysis of the Ego
-paraphrasing, Gustave Le Bon

The bursting of the NASDAQ/Internet bubble in 2000 will take its proper place alongside the Japanese real estate bubble of 1989 among case studies at the Harvard Business School. It used to be that we needed to consult history books to recall such events… the South Seas bubble of 1720, (the British Caribbean in those days), the Florida land bubble of 1925 or the Dutch tulip mania of 1640. No longer. Adequate memory suffices.

660 Newport Center Drive • Suite 460 •Newport Beach • California 92660-6405
(949) 644-4444 • Fax (949) 717-5030 • www.knightsb.com

One should not assume that the "best and brightest" are immune to the groupthink alluded to by Dr. Freud. In the excellent 1985 book by Harvard Prof. Daniel Goleman, Vital Lies, Simple Truths: The Psychology of Self Deception, there is a fascinating account of the meetings held by President John F. Kennedy leading up to the disastrous Bay of Pigs invasion of Cuba. Not a single advisor among the group…Dean Rusk, Robert McNamara, McGeorge Bundy, James Schlesinger, Allen Dulles (CIA), Richard Bissel (CIA), and Ted Sorensen… questioned that a rag-tag band of 1400 expatriate Cuban refugees trained in Guatemala might not be able to overcome Castro's army of 200,000.

Schlesinger later wrote…

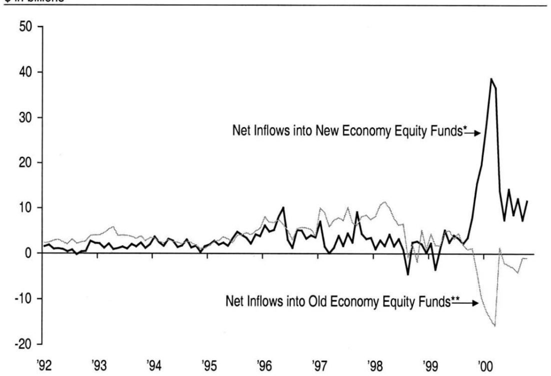
"In the months after the Bay of Pigs I bitterly reproached myself for having kept so silent during those critical discussions in the Cabinet Room, though my feelings of guilt were tempered by the knowledge that a course of objection would have accomplished little save to gain me a name as a nuisance."

Unwilling to play the devil's advocate or to question prevailing orthodoxy, the potential dissenter, fearful of being relegated to pariah status, acceded to groupthink and consensus.

Interesting history you say, but what does this have to do with investing and the stock market?

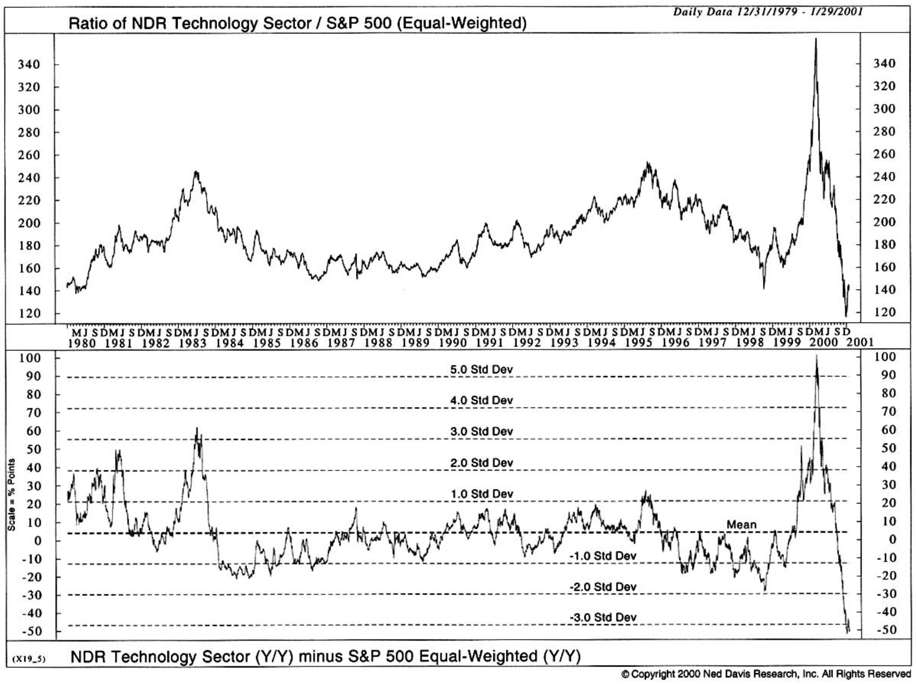
A similar phenomenon occurred last year. The mania surrounding "new economy" thinking is perhaps best illustrated by observing investor behavior leading up to the March 2000 peak. Mutual fund flows into equities show that traditional investing rooted in value underwent a complete capitulation as the mindset accompanying "new ecomomy" investing overwhelmed all other thinking.

Mutual Fund Flows into Equities: Old Economy versus New
$ in billions



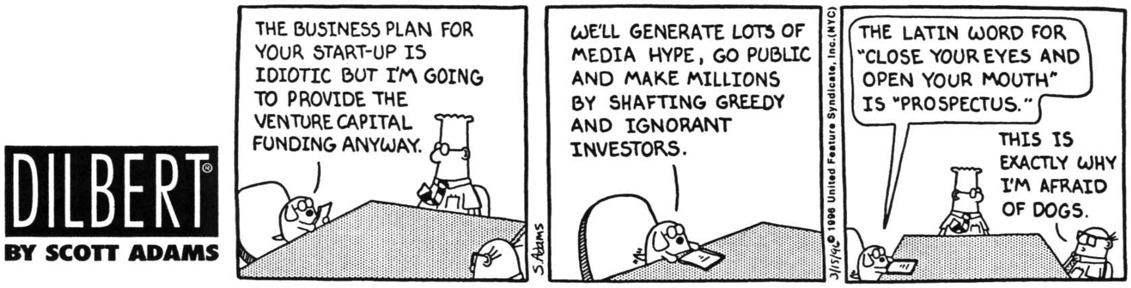
*New economy = inflows into aggressive growth and sector funds.
**Old economy = inflows into growth and income, and income funds.
Source: ICI, CSFB.

It was two years ago in our quarterly letter that we first spoke of the extraordinary event wherein the P/E ratio of NASDAQ had breached 100. One year later, we again raised the subject. NASDAQ was up a stunning 85% in 1999 while most of our accounts were up a paltry 20%. NASDAQ was a "pupil-dilating 200 times earnings". We opined that the performance of the tech sector had deviated six standard deviations from the S&P 500! But of course,



few of the new economy proselytes paid heed to any of this banter, ours or others, because after all, hadn't these types of comments been made for many, many months? Yes. And until March of 2000, we and others had been wrong to be so cautionary, right? Right. So like Peter in Prokofiev's Peter and the Wolf, we'd cried "wolf" too often and that became grounds for ignoring the obvious.

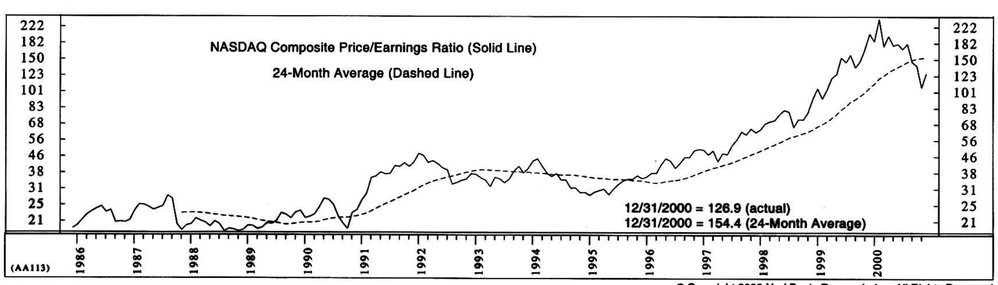
So it was with anyone whose drumbeat was out of synch with the market. The new economy was to bring untold advances to humankind. Technology was the wave of the future… who could deny that? Furthermore, wasn't technology responsible for the extraordinary productivity increases which kept inflation low and employment high? The virtuous circle. And justification for paying any price. Never mind that a P/E of 200 would require one to believe that the earnings of the entire index would have to be growing in perpetuity at a rate somewhere between 50% and 100% per year! Some even believed the very existence of earnings to be a negative because it meant the company's stock could be compared to others on a P/E basis, which would inevitably lower valuations, and that price to sales ratios were an acceptable substitute. We salute Scott Adams of Dilbert fame for so succinctly capturing the mindset…



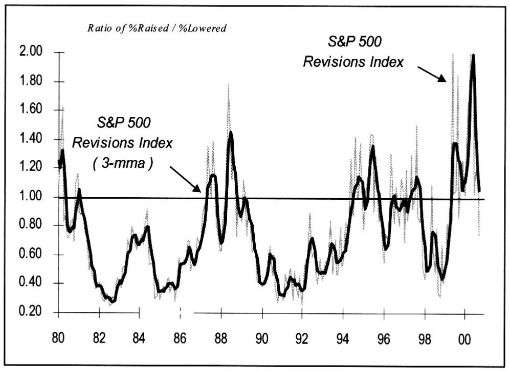
And so one must ask the question whether most market participants, particularly on NASDAQ, were not falling victim to the same groupthink that overcame the Kennedy advisory circle… analysts and investors alike.

In the year 2000, NASDAQ declined 39% and was off a paralyzing 52% from its March peak. The S&P 500 total return was -9.1% for the year. Can one assume that adequate damage has now been done to provide what Dr. Freud referred to as "reasonable agency"? If we look at NASDAQ as of 12-31-00, trading at 2500 or so and 33 times trailing 12 months earnings, can we safely assume that enough earnings growth will transpire in the future (current analyst estimates are for 18% earnings growth… and falling) to justify this P/E? We think not. Here's why:

1) A P/E of 33 assumes one jettisons from the average stocks whose earnings are negative. Include them and the P/E becomes 126!



S&P 500 Year-Ahead Earnings Revisions Index



2) Individual analyst estimates are notoriously optimistic; their information comes from corporate managements whose outlooks are also notoriously optimistic; and there is a long history of a plurality of downward adjustments as a given year progresses. The chart at left shows that on the S&P 500, the majority of revisions throughout history were downward and not upward. Furthermore, Wall Street recommendations cannot be trusted as there is always an excuse to "buy", but never an excuse to "sell"! Since the companies they research are the purveyors of the very information they must have to write their reports, any action to anger corporate managements, like a stock-option-deflating "sell" recommendation is looked at very unkindly.

Ratings of Top 10 Brokerage Houses

BROKERAGE HOUSE	BUYS	SELLS
Merrill Lynch	940	7
Salomon Smith Barney	856	4
Credit Suisse First Boston	791	9
Goldman Sachs	780	4
UBS Warburg	696	8
Morgan Stanley Dean Witter	670	0
Lehman Brothers	705	8
Banc of America Securities	557	6
Deutsche Banc Alex. Brown	513	9
Bear Stearns	525	2

FORTUNE TABLE / SOURCE: FIRST CALL / THOMSON FINANCIAL

3) If we look at the S&P 500, the 75-year average P/E ratio is about 15 and the 75-year EPS growth rate is about 7% per annum. Crudely applying this approximate 2:1 ratio to NASDAQ would only "justify" a P/E ratio of 36, not 126, even assuming the optimistic 18% earnings growth. Even if we speculate on "forward" P/E's instead of "trailing 12 month" P/E's, it still would not justify a forward P/E of 106 times earnings, which is the equivalent of 126 times trailing earnings, given 18% EPS growth. Furthermore, even assuming one conveniently discards all negative numbers from the calculation, the EPS growth rate of NASDAQ stocks over the past 7 years is only 9% per year! On this basis, one must conclude further downside risks still exist for NASDAQ. Bear in mind these calculations assume we need not worry about 1) and 2) above.

The macroeconomic numbers currently being released all show that a weaker economy is unfolding. The purchasing managers survey released the first week of January showed

substantial deterioration, the largest such drop since the recession of 1990-91. Although the economic optimists still see a "soft landing", one must remember that all "hard landings" started out as "soft landings". Therefore, the existence of "soft landing" conditions may be only transient, as they were in the 1969-70 and 1990-91 periods, on the pathway to a full-blown recession.

The unprecedented length of the economic expansion of the 1990's has left uncorrected many excesses which are now only beginning to be made apparent. We had remarked in the past that the technology stock sector within the S&P 500 average as a percentage had gone to 34%… and that this was reminiscent of the energy group in 1980. The excesses of the energy sector took almost two decades to work through, and it is possible that the current excesses may require a lengthy period to correct.

Let us not forget that the fuel for the excesses of the T-M-T sector (technology-media-telecom) came from primarily two sources: venture capital and debt financing. Both have dried up.

The January 21st *New York Times* declared 61% of all 390 ".com" companies to be trading for less than $5 per share. With the venture capital community severely chastened by last year's experience, with venture-funded .com deals that would presumably have been taken public and can't be, with monthly "burn rates" that cry out for further cash infusions for survival, the venture people face the painful choice of letting them go under or run the risk of throwing good money after bad.

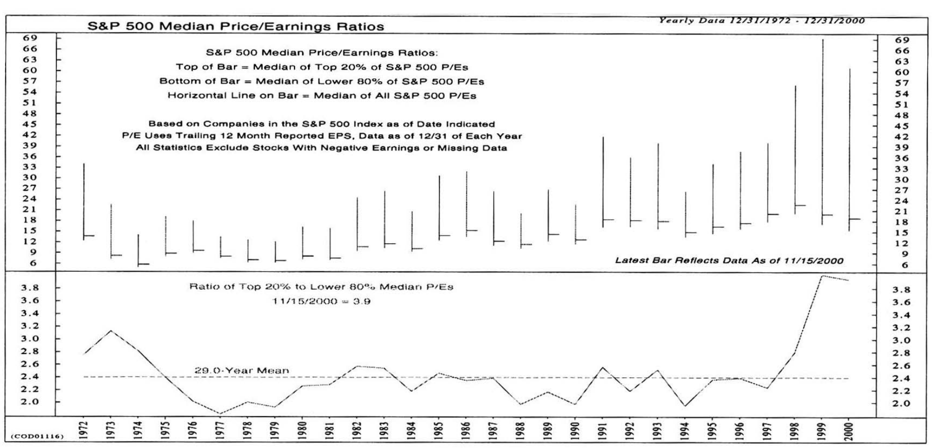
As for debt financing, it used to be that telecom investment grade debt financing was 10 percent of the corporate total. The past two years saw this rise to 20%. As for junk bond financings, telecoms went from 26% to 38% in the past two years. In fact, one-third of all junk bonds are distressed, defined as "in default" or yielding in excess of 20%. Information technology spending declined precipitously as year 2000 unfolded. Clearly Y2K pent-up demand was a stimulating factor, and now we are experiencing the hangover from this spending binge. The wonderfully enabling technology of the Internet is now shown to be an extremely competitive arena where few survive and prosper.

What a difference a year makes. Last year *Time Magazine* named Jeff Bezos, CEO of Amazon.com, "Person of The Year". Talk about groupthink. Amazon.com was $76 on December 31st, 1999. One year later it is $16 and still losing money.

We are reminded that between 1904 and 1908 some 240 companies entered the automobile manufacturing business. In 1908, Henry Ford introduced the Model T, and two years later, many if not most of these competitor companies had been put out of business. In the 1880's, more miles of railroad track had been laid than in any previous decade. The 1890's that followed saw more railroad track mileage in bankruptcy than ever before. The railroad boom and bust cycle materialized because there were enormous fixed costs accompanying a commodity product. This is strikingly similar to the cable and long haul fiber optic markets today, and a recipe for plummeting long distance rates.

In all probability, sufficient market damage has been done to create a lull in downward momentum. Certainly Federal Reserve discount rate lowerings are helpful. Nevertheless, we believe there are still a number of mega-cap stocks dominating the cap-weighted NASDAQ and S&P 500 averages that trade at unjustifiably high P/E's and with S&P 500 EPS growth rates now being lowered into the single digits for 2001, these lofty P/E's are feeling a gravitational pull southward.

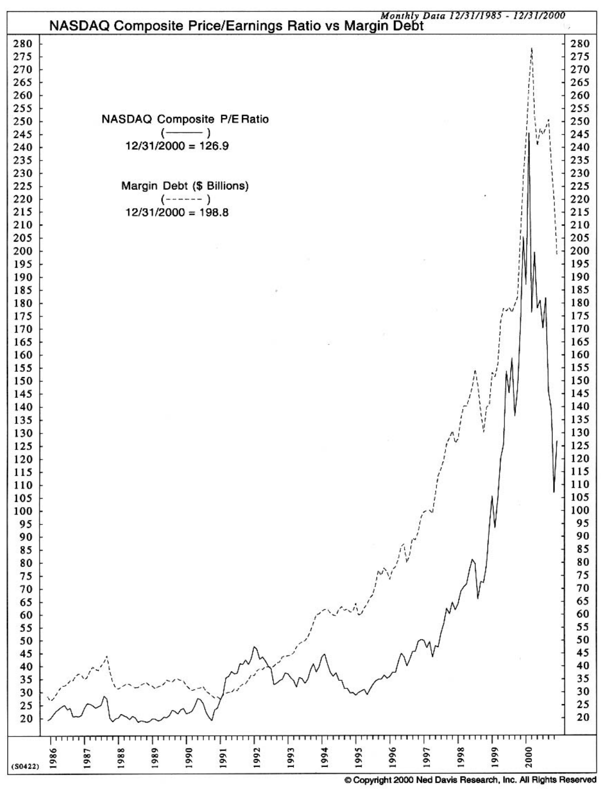
We should remember that the high P/E's are very concentrated among the 100 largest capitalization stocks, and that the bottom 400 for the S&P 500 are trading at normal and reasonable P/E's. We encourage investors to reflect upon this dichotomy in deciding where to take their risks, and ask what forms of groupthink might still be present in today's market. We believe the 3.9:1 ratio of P/E of the largest 100 to less-large 400 in the S&P 500 is



simply not sustainable long-term. Accordingly, we maintain our caution. Freud said that a group was susceptible to belief on uncertain evidence… we believe the uncertain evidence is that acceptable investment returns are obtainable from such high P/E stocks, even if the earnings are growing and uninterrupted. There is no historical evidence to suggest, that paying 40 times trailing earnings for a great company growing earnings at 11% to 13% per year, will generate a satisfactory investment outcome, long-term. Yet that describes General Electric today.

Holding contrary opinion views is necessary for investment success… perhaps insufficient in and of itself, but nevertheless necessary. To ignore the riptide of groupthink and crowd behavior is dangerous, and the stronger the consensus the more dangerous it is. Year 2000 will go down in the annals of market history as one of the more egregious examples of this behavior.

Although the tone of our quarterly letters has been cautionary of late, we suspect that things may calm down a bit in the next few months. For one, there has been enough market damage to introduce a much-needed counterbalancing element of caution. Secondly, margin debt has dropped by an amount that would indicate the worst may be over for now. However, though the Fed has switched from unfriendly to friendly, we question whether their interest rate tools have the same potency as in past years. Perhaps not, for several reasons. First, the Fed only raised rates to 100 basis points above where they were prior to the bailout of Long Term Capital Management in 1998, remembering that the first three bumps up merely replaced the lowerings that transpired during that crisis. Secondly, because the U.S. has evolved to a largely



service economy, interest rate movements have less effect. And thirdly, because interest rates on 30 year fixed rate mortgages were falling throughout 2000, housing construction activity was not muted by rising short-term rates. Therefore, a subsequent lowering of short-term rates is unlikely to meaningfully act as a stimulus to the housing market. We suspect that the current slowdown has been exacerbated by unusually cold weather… (who wants to go shopping when its 20° outside?)… and the attendant increase in expenditures for heating oil, natural gas and gasoline, acting as a consumer tax. We lean toward the notion that the market is most likely trying to build a base. In fact, in some cases stocks are now going up on bad news, and as perverse as this may seem, this is a necessary precursor to a bull market.

In December we took a portfolio position in Avaya, Inc., a spin-off from Lucent Technologies, at prices around $12 per share. Avaya should earn $1.25 per share in 2001 and has plans to take this to $1.80 in 2003. A global enterprise communications company, Avaya serves 78% of the Fortune 500. With $7 ½ billion in revenue, they plan to trim overhead costs, a problem left unattended by Lucent. With 4300 engineers from the former Bell Labs and an R&D budget running 9% of sales, Avaya's intellectual property position is strong, and key to their future in internet protocol telephony.

Although January 3rd may have been an important low, we remain somewhat cautious. "Reasonable agency" compels us to maintain our relatively defensive posture in light of improved but still stretched valuation evidence. We thank you for your patience, support and understanding."

Very truly yours,

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