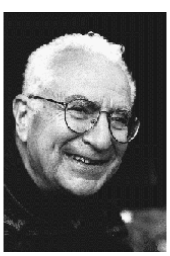
Knightsbridge Asset Management, LLC

February 3, 2003

FOURTH QUARTER COMMENTARY

"People are scared by the unpredictability and especially the uncontrollability of much that we see around us, much of which comes from the restricted range and capacity of our senses and instruments: we can pick up only a miniscule amount of the information about the universe that is available in principle. Finally, we are handicapped by our inadequate understanding and by our limited ability to calculate."



- Murray Gell-Mann, Ph.D., 1929-
Nobel Laureate, Physics, 1969
Professor, California Institute of Technology
Co-founder, Santa Fe Institute

This astoundingly humble admission of human limitation comes from the greatest living American theoretical physicist. It offers a degree of forgiveness normally conferred only by God Almighty or possibly the Governor of Illinois who recently commuted the sentences of 169 convicts on "death row".

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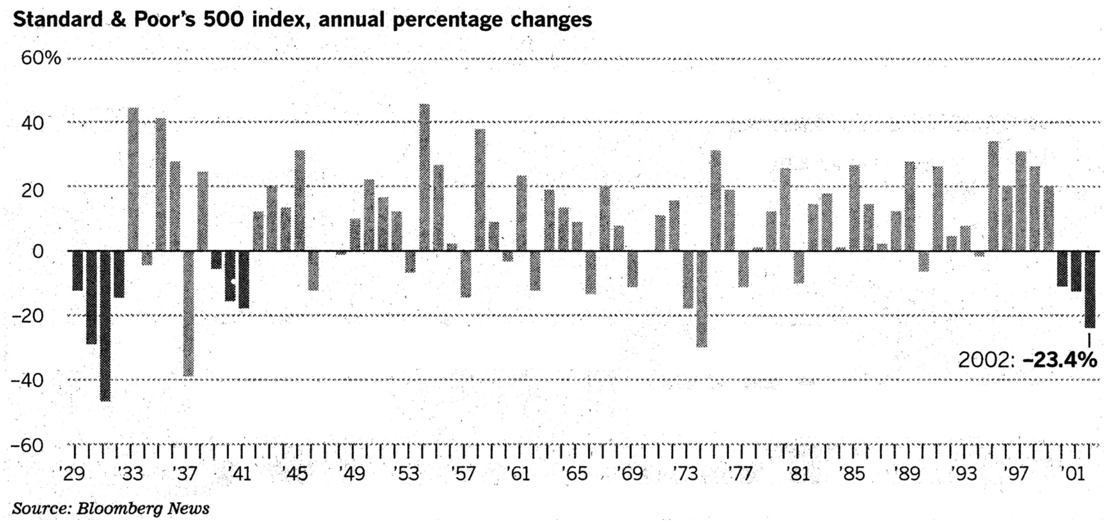
And so it was in 2002, investors' analytical frailties confirmed. Some must have felt like they were on "death-row". Good riddance to '02 we say. The S&P 500 generated a negative index return of 23.4% and including dividends a negative total return of 22.1%. Completing a third consecutive year of negative returns (-9.1%, -11.9%, -22.1%), one cannot help but wonder if 2003 could be the fourth for the veteran index. Precedents? Yes, 1929, 1930, 1931 and 1932 were four consecutive years of negative returns with markets discounting "The Great Depression", the last great deflationary event witnessed in America. As for our performance here at Knightsbridge, our average



equity account was down 11.9%, better than the S&P's -22.1%, but nevertheless, unsatisfactory. We maintained what we thought was a defensive posture turning more bullish in August. Although the market seems to have found a broad base, the lack of a sustained upward move to date, combined with unsettling geo-political events, has left the market groping for another, somewhat higher bottom.

The prospects for a major deflationary outcome are a significant worry in today's markets. Gone are the days when Fed-lowered interest rates would automatically cause an upward blip in the stock market. Now it is a confirmation of continued economic weakness and a reason for the stock market to head south! The PPI (producer price index) is already exhibiting negative numbers. What we most must avoid are negative CPI (consumer price index) numbers as negative numbers portend an increase in the "real" cost of borrowing. That is, if it costs 3% to borrow money and the price index is dropping at, say, 4%

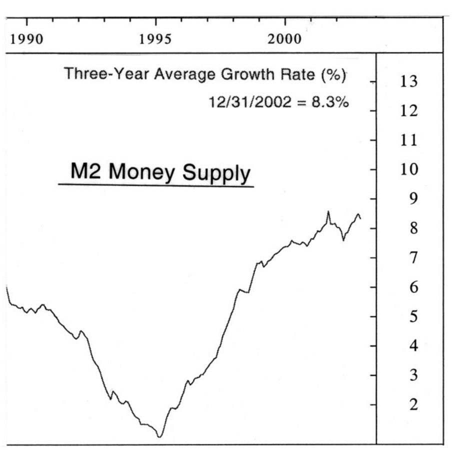
per annum, then the pretax "real" cost of borrowing is 7%. This is the same "real" cost as borrowing at, say, 10% with inflation at 3%, again, the difference being 7%. If allowed to develop, such high "real" borrowing costs will slow economic activity and encourage balance sheet shrinkage, and in "catch-22" fashion, reinforce further deflation.

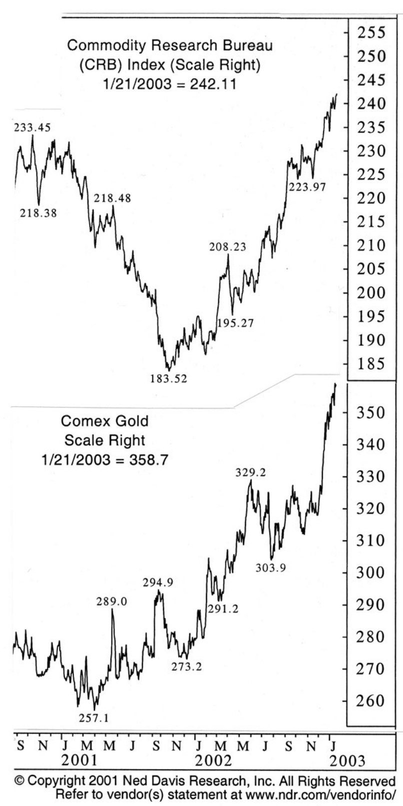
We believe there can be no question that globalization exports jobs to lower labor cost nations, e.g., China… particularly if that low labor cost nation has an educated or educable population with a reasonable work ethic. The fact that China's foreign trade increased an astonishing 21% in 2002 in an environment where no other single country increased foreign trade even 10% tells the story. In a November trip to Beijing and Shanghai we were told that *half* of the world's construction cranes were in China. We were told they borrow money at 0.8% to buy homes and condos. Even with a "one child" policy their net population is increasing by the equivalent of greater Los Angeles each year (15,000,000 per year). In short, China is exporting deflation to the rest of the world.

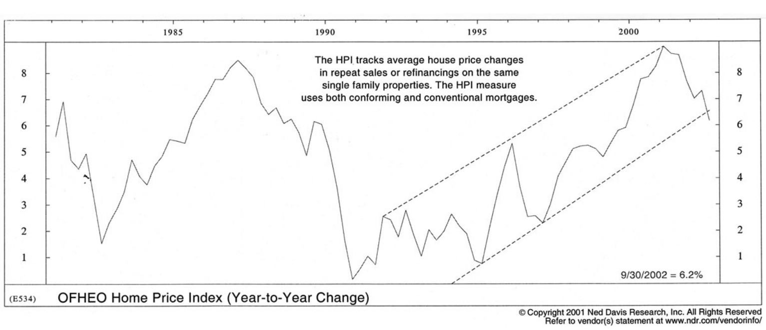
The battle against inflation was initiated in 1979 by then Fed Chairman Paul Volcker. Investors paid little attention at the time… many were still trying to contain their laughter at Gerald Ford's "Whip Inflation Now" buttons (they have since become collectors' items purchasable on eBay for about $4 or so). But the Fed has powerful tools. Even in an environment of "fiat" currency following Richard Nixon's closing of the "gold window" in 1969 and the earlier inflation encouraged by Lyndon B. Johnson's "guns and butter" Viet Nam policy, policy changes were announced but largely ignored. But gradually, ever so gradually at first, the astronomical interest rates of 1980/81 began to come down.

And so in October and November of 2002, sequential speeches given by Fed Board Governors Ben Bernanke and Alan Greenspan have signaled an important shift…*a shift to which every investor should pay attention*. The war on inflation is OVER! The war on deflation has commenced. We believe it is important to observe that it was Ben Bernanke, a relative newcomer to the Fed Board in August 2002, who detailed the policy shift and not Alan Greenspan. Why? Probably because Ben Bernanke's credentials qualify him to be a *deflation* fighter whereas Alan Greenspan is closely associated with being an *inflation* fighter. Prof. Bernanke, former Chairman of the Economics Department at Princeton, is the author of both The Great Depression and Inflation Targeting: Lessons from the International Experience. Although it will take time to unfold, this watershed policy shift in the fourth quarter of 2002 will likely be referenced as the turning point for years to come. But like the Volcker speeches in 1979/1980, no trumpets blared. Only economists and policy wonks took notice.

In reality this shift seems to have arrived earlier. It can already be seen that the CRB (Commodity Research Bureau) Index, M2 Money Supply, gold prices and real estate have made serious moves to the upside: that this could occur in an environment of deflation-worry speaks to the strength of the offsetting deflationary forces. A falling dollar, mushrooming defense spending and increased foreign oil dependencies would normally be predictive of higher inflation. Perhaps the only missing ingredient is the passage of time. Our expectation is that there will be little deflation, and that the 2.4% inflation of 2002 will be headed higher during the upcoming economic recovery.



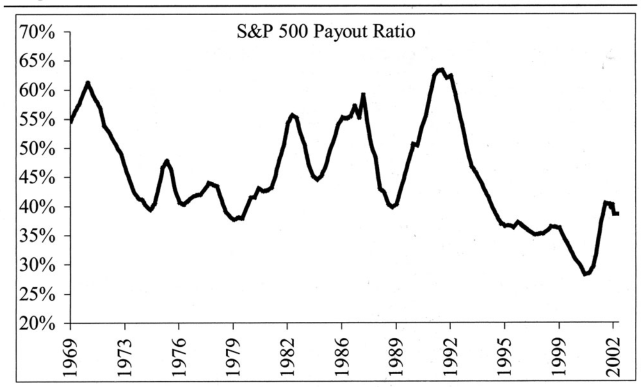




President Bush's tax relief package, including a provision to allow investors to receive dividends tax-free, caught the imagination of Wall Street at first blush. The market responded with a smart rally. But the announcement by Microsoft of a dividend initiation, was met with a resounding "thud" as MSFT dropped 2 points, three years worth of the proposed dividend, in one day. It seems dividends are terrific but may be interpreted as "slower growth ahead", shaving a point or so off the P/E ratio. We acknowledge that corporate dividend payouts (dividends as of a percentage of earnings), are on the low side (see chart below)

Exhibit 1

Payout Ratio Should Rise



Source: Morgan Stanley Research

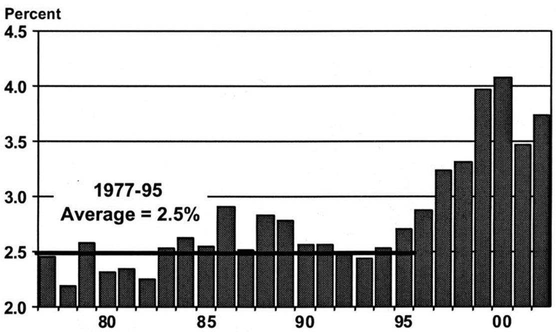
and could be bumped up substantially, particularly if the stock repurchase habit were to be broken. Since corporate stock repurchases have been running about 1.5% per annum, if this were to be added to a 2.5% dividend yield, then 4% tax-free dividend yields would truly look appetizing.

However, the municipal bond market has already reacted negatively, and last week's $3.0 billion issue of Golden State tobacco securitization bonds were required to pay as much as 7% tax-free (rated Moody's A1, S&P A-) on the heels of a general downgrade of the state's credit. Which brings us to another subject which is the massive amount of state budget deficits occurring and the likelihood that 2003 will go down as the year of the downgrade for state credits just as 2002 was the year of the downgrade for corporate credits. The triple-whammy faced by California consists of: 1) potential new competition from dividends for tax-free dollars that would increase borrowing costs,

2) an unanticipated decline in state revenues from a shrinking capital gains tax component (see chart below) and 3) a bloated bureaucracy in need of adjustment (see table below).

Equity Bubble Tax Windfall

CA State Income Tax Revenue as % of CA Income



State Gov't Employment Surge

Employment & Population Comparisons

	State Gov't Employment 2001 / 1997	State Population 2001 / 1997
CA	+13.6%	+6.2%
FL	5.4	8.0
TX	2.9	8.0
AZ	8.1	12.0
NV	9.6	19.4
US	5.8	4.5

Courtesy, Straszheim Global Advisors

Solutions to these problems will mean further employment retrenchment in the public sector in California, exacerbating recovery locally.

Eliminating the double taxation of dividends is not designed solely to correct injustice in taxation. It is also designed to encourage corporations to use more equity and less debt in their capitalization. It could easily be argued that the deductibility of corporate interest expense, along with double taxation of dividends, tilted running the corporate enterprise towards 1) excessive use of debt, and 2) executive stock option compensation geared to taking advantage of the system. By this we mean that given equal probabilities of large positive and large negative outcomes through excessive leverage, executive stock option compensation rewards do not possess the same symmetry of outcome as shareholder rewards. If their stock goes up, they win big. If it goes down, they lose little, and then get their options "reset" to a lower exercise price. In such a world, incentive compensation may drive corporate behavior in directions detrimental to shareholder interests. Elimination of double taxation of dividends should greatly assist in alleviating this problem.

Furthermore, another positive virtue of the Bush dividend proposal is that it would reduce capital gains taxes by allowing for the cost basis of a purchased stock to rise by the amount of a "deemed dividend". We will not elaborate on this somewhat complex aspect here but suffice it to say that this is a big plus for taxable investors, and would advantage equity ownership over corporate/government bonds, real estate, etc., all factors equal.

There are those who believe the anemic recovery experienced so far will fade into a "double-dip recession". Although we acknowledge this remains a possibility, we do not believe it is the most likely scenario to unfold. For one, the recent contraction of yields in the high-yield sector portends an improving economy, not a worsening one. The Merrill Lynch Hi-Yield Index is close to the lowest yield of the last 52 weeks. After a recession-induced yield spike in 2002 accompanying record bankruptcies, this is good news.

The current perseveration over Iraq will pass, and the "fear factor" most likely subside, as discussions of ricin, anthrax, botulin and sarin give way to other less scary concerns. In that process we believe history shows investors are well served to stay the course, and not react to the "unpredictability and especially the uncontrollability of much that we see around us" as reminded by this week's tragedy of the space shuttle Columbia. And as so eloquently stated by Murray Gel-Mann, we reluctantly accept "our limited ability to calculate." And we thank you for bearing with us through trying times.

Very truly yours,

Alan T. Beimfohr　　　　　　John G. Prichard, CFA