Knightsbridge Asset Management, LLC

January 30, 2004

<u>Fourth Quarter Commentary</u>

"Look! You fools! You're in danger! Can't you see? They're after you! They're after all of us! Our wives…our children…they're here already! You're next!"

"Invasion of the Body Snatchers" words of Dr. Miles Bennell in 1956 science fiction film based on Collier's Magazine piece by Jack Finney

This film classic is seen by critics as a disturbing and cautionary tale depicting the excision of individuality and emotional psyche through conformity and group-think. The people of fictional Santa Mira, California are being infected by alien seed-pod creatures from outer space inhabiting them parasitically to survive, rendering the people identical in appearance to their former selves, but devoid of ability to think independently or experience emotion. This film was credited as the first ever to depict the "enemy" as "us" rather than a visible Godzilla-like monster.

What do investors and investing have to do with this film statement? On one level, were investors able to function devoid of emotional psyche, results might be far different from those actually experienced. On another level, it is

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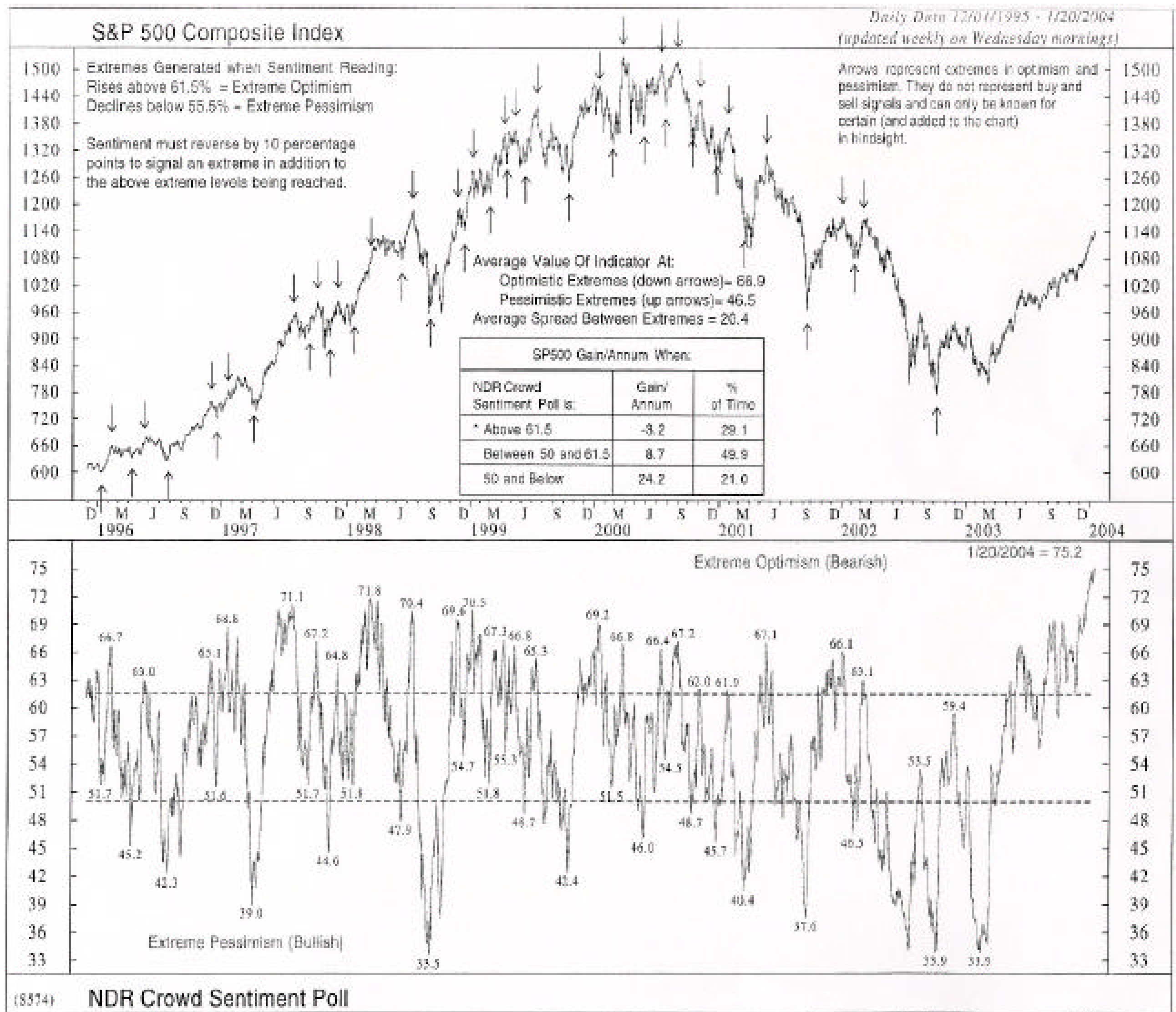
completely appropriate that investors view the "enemy" as "us". And on yet a third level, suspended rationality or irrational exuberance is clearly accentuated by media-induced group-think, i.e., crowd psychology in all its modern-day manifestations.

We ask if the current market euphoria is not unlike "Body Snatchers" as seen in the bottom panel of the following chart with crowd sentiment at a positive 75%, the highest in at least eight (8) years, even higher than at any time during the supposedly irrationally exuberant tech bubble!



With an S&P 500 Index total return of plus 28.7% in 2003 and real estate prices not far behind, up 23% in Los Angeles County and up 21% in Orange County, it is probably

fair to say that those Americans on the upper rungs of the economic ladder experienced the greatest single year increase in net worth ever.

We confess having to steady ourselves upon reading in the Newport Beach/Costa Mesa Daily Pilot, our hometown journalistic effort, that from November 2002 to November 2003 the median home price in Newport Beach had risen from $1.2 million to $1.9 million, a 58% increase. We can only hope that Warren Buffet's advice to the Governator, Mr. Schwarzenegger, that "property taxes are too low" is substantially ignored: real estate deflation fueled by rapidly rising property taxes would be a questionable prescription for prosperity.

We are thankful for a terrific stock market performance in 2003. The conspiracy of bullishness created by falling interest rates and rising earnings was a potent combo. In fact, only 8.5% of all issues in the S&P 500 showed a negative return. Market worry-warts are wondering if anemic employment, ballooning trade and budget deficits, a swooning dollar and/or rising interest rates will soon derail this bullish freight train.

PERCENTAGE OF S&P 500 STOCKS WITH NEGATIVE RETURN EACH YEAR

Year	Percentage	Year	Percentage
1973	83.272	1989	23.783
1974	89.219	1990	71.645
1975	9.833	1991	19.275
1976	11.512	1992	32.580
1977	68.121	1993	33.333
1978	53.107	1994	57.774
1979	23.985	1995	13.244
1980	28.932	1996	25.665
1981	53.308	1997	18.690
1982	28.269	1998	42.085
1983	19.653	1999	52.207
1984	52.174	2000	44.465
1985	16.154	2001	57.361
1986	33.012	2002	73.535
1987	52.571	2003	8.511 (NEW RECORD LOW)
1988	27.672		

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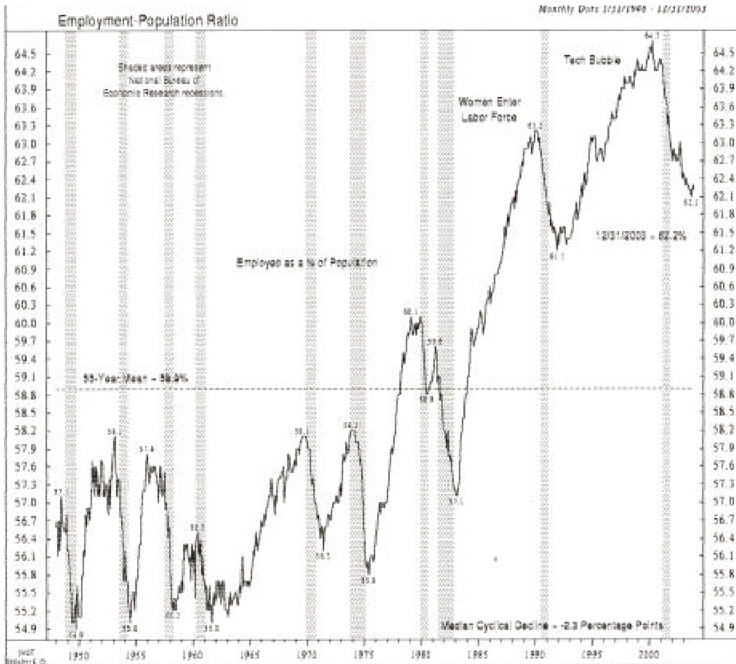
Regarding concerns that the U.S. economy is creating too few jobs, I would encourage the reading of M.I.T. Professor Lester Thurow's recent book Fortune Favors the Bold.

One astonishing statement in this book is (pg. 248):

"If all of the world's factories were generating at capacity, subtract what the world is going to buy, and you will find that the world's production potential exceeds the world's expected consumption by at least one-third in almost every industry." Further "part of this excess capacity comes from new technologies that have dramatically raised productivity. Part of it comes from competitive pressures that force firms to invest in new low cost offshore production capacity even though they were not short of capacity at home."

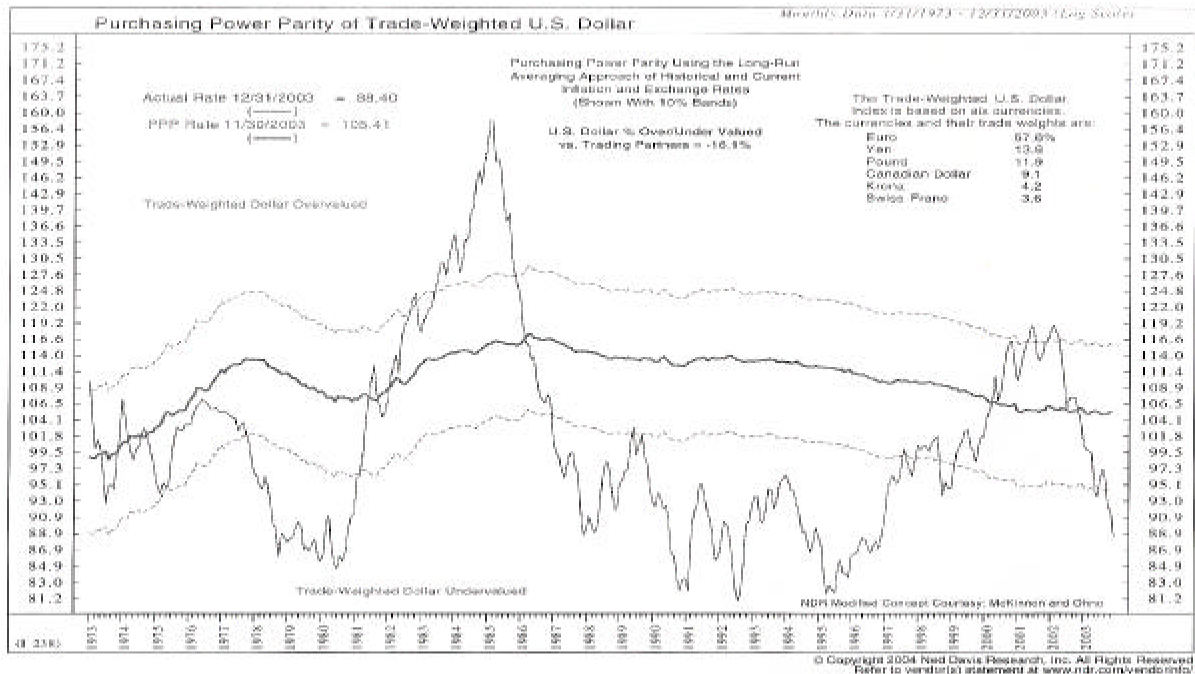
Therein lies the problem. Enormous productivity increases in the last half of 2003 are actually preventing employment increases. As can be seen on the chart below, employment peaked at 64.7% of population in 1999 and is currently 62.2%.



This drop is in line with past drops, but disguises the fact real incomes per worker have been dropping approximately 1% per year for 25 years, and that the substitution of manufacturing jobs with lower paying service sector jobs puts the squeeze on the middle class. This is why corporate earnings can be booming off trough lows, yet Wal-Mart's same store revenue gains are pathetic. Wal-Mart is a hyper-market to the lower and middle classes and their customers are the ones not yet benefiting from productivity increases and economic recovery.

But for investors, counter-intuitive as it may seem, higher unemployment is apparently a good thing. Statistics show that the S&P 500 has advanced 15.9% per annum when unemployment was above 6.0%, but only 0.1% per annum when below 4.3%. We conclude therefore, that anemic employment, while a concern for other reasons, is not a concern for portfolios.

The dollar/euro exchange rate is currently about 1.27 dollars per euro; the dollar is undervalued by 16% to a trade-weighted basket of currencies based on "purchasing power parity".

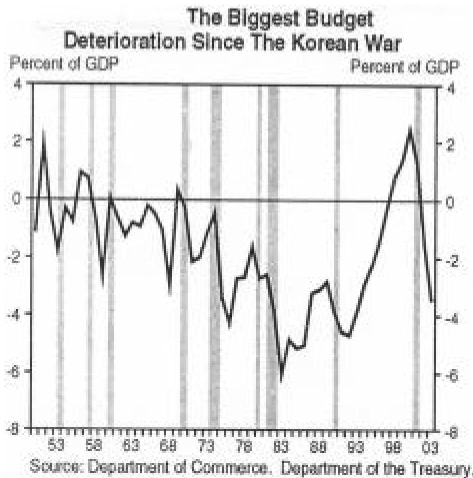


However, one must acknowledge that substantial fluctuation above and below "purchasing power parity" has been the historic norm. Over the past thirty (30) years, the greatest drop in the dollar occurred from the 1985 peak to the 1992 trough, a drop of 47%. Were we to experience a 47% drop this time around, having peaked so far this cycle at 0.82, the dollar/euro exchange rate would go to 1.55 from its current 1.27. We do not sense that Washington policymakers yet have sufficient concern for the negative aspects of a severely falling dollar to initiate a policy change. Nevertheless, our gut instincts tell us a counter-trend rally is due.

Should the dollar's fall be broken with a policy change akin to the 1985-1987 experience (the majority of the 1985-1992 fall had occurred by late 1987), i.e., the rapid

raising of interest rates as seen in 1987, then we would expect a negative response from the equity market, but perhaps not as extreme since a rise in interest rates would be starting from lower absolute levels, and the expectation of an historical repeat would result in a more anticipated and therefore subdued response.

We are rapidly approaching the point where budget deficits, about $500 billion now in absolute terms, will be approaching the prior extremes seen in 1983 and 1992 in relation to federal tax revenue. It is difficult to escape the conclusion that spending has run amok, partially due to the "war on terror". With the current administration having just advocated a 7% increase in the defense budget, it seems this message has yet to be heard. However, the relationship between budget deficits and stock market moves is not a clear one.



Lastly, rising interest rates, a common current prediction, have yet to materialize. All economic observations would point in this direction...a strengthening economy, a falling dollar, a rising gold price, etc. However, little is ever quite as simple as it would appear, and this is no exception. Evidence shows that since 1917, the average stock market performance one year following the first move up in the Federal Reserve Discount Rate is a positive 8%. Therefore, we conclude that the unemployment and anticipated rising interest rate scenarios are actually positive for the equity markets, partially offset by the negative features of budget deficit. The fact that the IPO market and the venture capital markets have only recently revived also leads us to believe the market has further to run. Additionally, with a positive stock market return in January assured, the probability of positive return for all of 2004 is 91% judged by the past 53 years.

That 4th quarter operating earnings could be up by an expected 27% year-over-year is remarkable. Even more remarkable is the fact that this powerful market advance could occur with never so much as a single 5% correction and in the face of so many supposedly negative macro-economic factors as a backdrop. We believe the $700 billion in hedge fund dollars partially explains this phenomenon, but even so, we are ourselves amazed by this behavior, and would not have predicted it. Which proves that in the portfolio management business, assumptions regarding attribution should be posited but not too strongly held, and are mostly identified only with the help of the rear view mirror. After all, there is a reason economics is called the "dismal science". Was anybody predicting the 6% GDP growth that transpired in the last half of 2003? No.

We wish to thank all our constituencies for a successful 2003; employees, clients, friends of Knightsbridge and last but not least, the faithful readers of these turgid tomes!

Very truly yours,

Alan T. Beimfohr John G. Prichard, CFA

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