Knightsbridge Asset Management, LLC

February 14, 2007

FOURTH QUARTER COMMENTARY

"Notwithstanding that some say, 'there can be no truth entirely determined for certain which concerns the future', I will confess, Sire, that I believed myself capable of presage……………………"

Michel de Nostradame, 1503-1566
(AKA Nostradamus)

Medical doctor and prognosticator

Letter to Henry II, King of France
Salon-de-Crau, Provence, 1558

Each year we are asked by clients what we envision for the upcoming year………mostly in January……almost never in April or August. We are tempted to say "Quod de futuris non est determinata omnino veritas" which would fall in the camp of deliberate obfuscation because one would have to have had at least two years of high school Latin to decipher this statement. Since high schools stopped teaching Latin some thirty years ago, only old people who took Latin and who had not yet succumbed to hardening of the cranial arteries

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would stand a fighting chance of translation. But rest easy……the internet tells us it means "there can be no truth entirely determined for certain which concerns the future".

From the Oracle at Delphi to the Roman fixation on the entrails of slaughtered bulls, to the quatrains of Nostradamus, superstition, soothsaying and prognostication have entertained if not enlightened. We make no claims to predictive prescience and our crystal ball is perpetually clouded. We did not predict with any precision the above-average performance the world markets exhibited in 2006. Divining aggregate annual market returns in January we leave to others.

Nevertheless, at this juncture we see few reasons why the U.S. equity market cannot turn in a respectable performance this year. The biggest threat to this conclusion, and an important caveat would be yet higher short term interest rates in response to unexpectedly higher inflation data. Were this to occur, it would most assuredly send the real estate market into reassessment mode as the ridiculously low cash-on-cash capitalization rates upon which recent lofty transactions have been based would be called into question, not to mention the carrying costs for mortgaged property. As for the affect upon equity markets, such action would tip the balance toward recession and the domestic stock market would then be forced to abandon the soft-landing hypothesis in favor of harsher realities.

In our last quarterly letter we guessed that the futures markets had it wrong regarding the Fed lowering rates early in 2007, and we continue to believe the best case scenario may be that the Fed is "on hold" for most of this year. This conclusion tends to be fortified by 4th quarter real GDP being up a strong 3.5%, U.S. unemployment down to a seven year low of 4.5% (ticked up to 4.6% recently) and world unemployment at a twenty-six year low.

Although it would seem that a 5.25% Fed Funds Target Rate has done little or nothing to slow the U.S. economy, it may be premature to arrive at this conclusion. Typically it requires twelve to eighteen months for these policy moves to show up in statistics of aggregate demand. All in all, we believe the soft-landing scenario to still be intact and although we worry about a less friendly outcome, we believe it has a low probability of materializing. But low is not zero.

Offsetting the potentially negative influences of the aforementioned are four positive factors that may argue for the stock market moving higher:

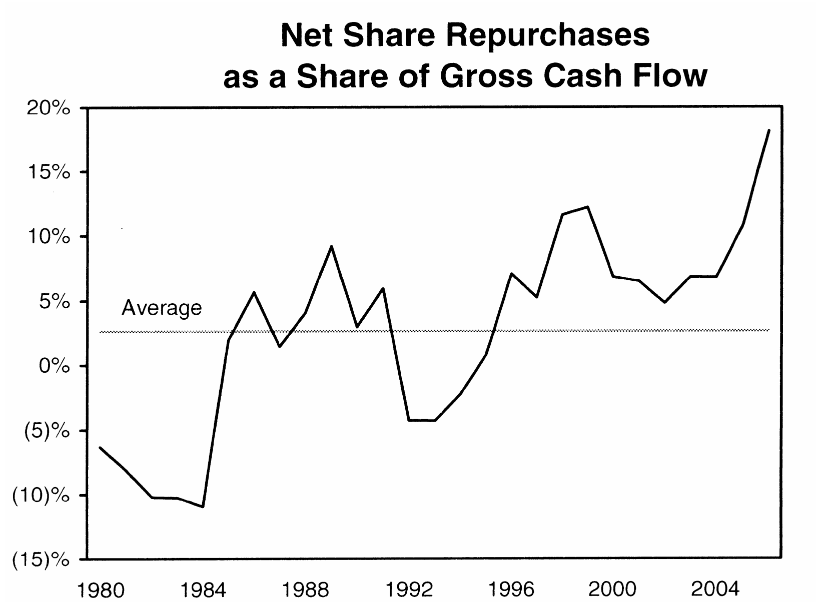
1) Supply and demand for publicly traded equities,

2) Stock P/E's compared to real estate cap rates,

3) Equity risk premia, and

4) Investor net liquidation of domestic equity mutual funds

Recent years of accelerating corporate privatizations and stock buybacks coupled with relatively low issuance have conspired to create a positive supply and demand balance for publicly traded equities. Ironically, it may be that Sarbanes-Oxley legislation, designed to make difficult and punitive to managements the shenanigans of the Enron-WorldCom-Adelphia sort, is having the unintended consequence of driving IPO's from U.S. shores. All factors equal, this reduces the supply of stock trading in U.S. markets.

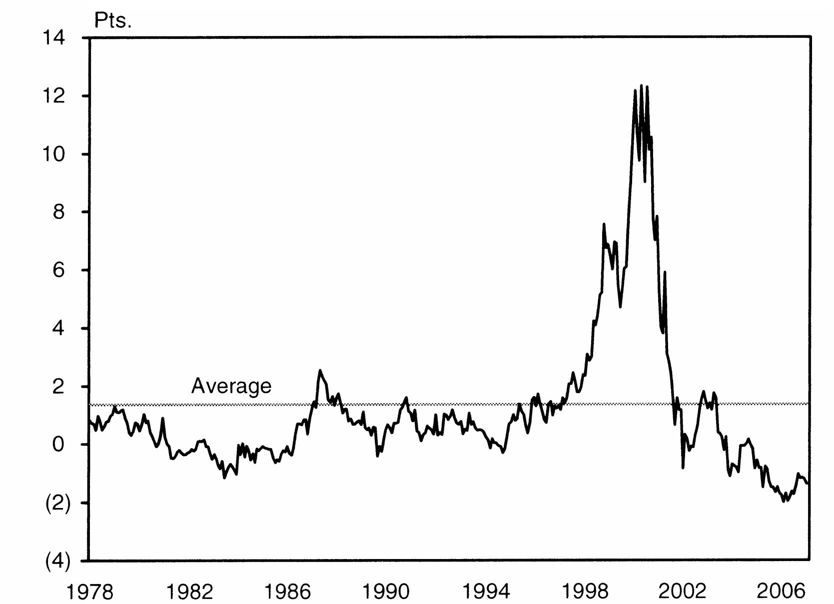


Source: Sanford Bernstein

Certainly the current craze for "private equity" deals, almost $400 billion last year, is holding back stock issuance from the publicly traded equity markets. Goldman Sachs is currently raising $19 billion in its sixth

partnership of such deals. Moreover, it is likely the institutional appetite for private equity is at least in part being funded by a liquidation of mega-cap names prominent in the indexation boom of the 90's. Could this be a reason why the biggest stocks are looking cheaper and cheaper?

Forward P/E Spread: Largest 50 Stocks – Next 450 Stocks
(Through the End of December 2006)

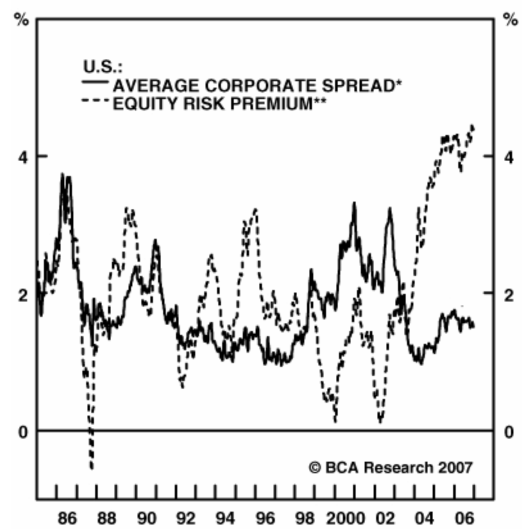


1 Data are capitalization-weighted.

Source: Sanford Bernstein

Among all asset classes the past couple of years, consensus thinking has been that commodities and real estate were the ones "gone wild". The white-hot commercial real estate market has not been cooled off by Fed action as evidenced by the recent feeding-frenzy over Equity Office Properties (EOP) owned by Sam "the grave dancer" Zell and others. Blackrock and Vornado participated in a bidding war that took the cap rate down to somewhere in the 4.5% to 5% area (and the price up to 33.8 times cash flow). Office building portfolios were recently changing hands at cap rates of 6%. I can honestly say that most of my adult life such cap rates have run 8% to 9%. Rumor has it that based on this transaction, rents for Class-A high-rise buildings all over the U.S. will be moving much higher, the upward spike incubated by this spectacular transaction. But one must wonder, as Sam Zell, not known for being a fool, is the seller. What does he know that others are ignoring?

If a real estate cap rate, inverted, is analogous to a P/E ratio for real estate, then a 4.5% to 5% cap rate is a P/E of 20 to 22.2. General Electric trades at a forward P/E of 16.5 and 11 times cash flow (after-tax earnings plus depreciation). General Electric pays 3.1% and has had a dividend growth rate of 13% per annum over the last 12 years. Can the future owners of EOP match that? These appear to be excesses in the real estate market, but perhaps we are unqualified to judge. Nevertheless, we see no equivalent goings-on in the stock market. But looked at another way, if these cap rates in real estate are in fact justified, then an equivalent upward adjustment in stock market P/E might be likewise justified.

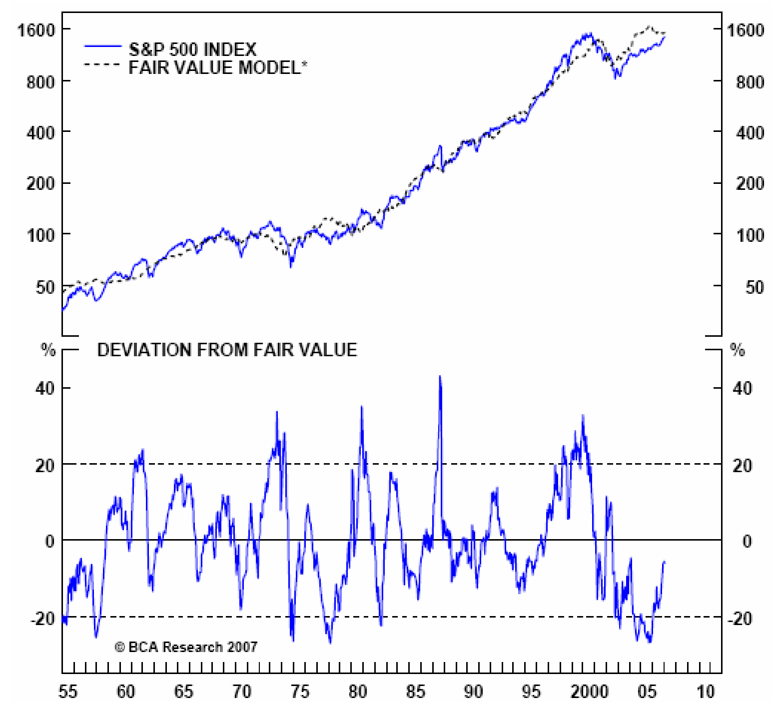


*WEIGHTED AVERAGE INVESTMENT-GRADE AND HIGH-YIELD SPREAD OVER TREASURY; SOURCE: MERRILL LYNCH
**BASED ON CURRENT S&P500 INDEX VALUATION, AND LONG-RUN EXPECTATIONS FOR EARNINGS GROWTH, DIVIDEND PAYOUT RATES AND INFLATION

Another reason equities might do better than some believe is that the “equity risk premium” for stocks appears high by historical standards. The “equity risk premium” is that percentage of total return demanded by equity investors for the risks of owning stocks instead of bonds. Historically this has been 2.5% to 3% extra return demanded over and above intermediate maturity treasuries. Since such treasuries are yielding about 4.75% today, an average equity risk premium of, say, 2.75% would mean stock market investors were expecting a return of 7.5% (4.75% + 2.75% = 7.5%). But this is not the case. Rather, the ”equity risk premium” appears to be running closer to 4%. When added to the same treasury yields of 4.75%, the new number is 8.75%.
So here is the bottom line……………if equity investors went from demanding 8.75% to demanding 7.5%, the resulting price rise in market values with a year’s earnings growth thrown in would be somewhere in the 20% to 25% range! True, this may be looking at the glass as being half full, but it is not entirely out of the realm of reason.

Finally, the last reason for a positive outlook has to do with investor behavior. Mutual fund investors have been net liquidators of domestic equities since last summer when the current rally got underway. Why would this be? Is it not true that 401K purchases each month make it very difficult to run net liquidations for very long? Yes. Some of the explanations we have seen are 1) selling domestic mutual funds to buy ETFs (exchange traded funds), 2) selling domestic mutual funds to buy emerging markets funds which own non-U.S. stocks, 3) suffering from acrophobia due to long-lasting nature of current bull market and, 4) belief Fed action will result in recession and concomitant market decline. We accept all of these as being contributory. But wrong. Or at least resulting in an investment posture that will in retrospect be proven suboptimal.

So for these four reasons, we believe the market has the potential to make 2007 a decent year, and surprise those who have found reasons to think otherwise, barring further increases in short term interest rates. Moreover, as seen in the chart below, in an era where a surplus of liquidity seems to render price levels of many assets barely beneath the troposphere, common stocks appear to be the most undervalued (or least overvalued) of available investment alternatives.



* BASED ON 10-YEAR TREASURY RETURNS, GOLD PRICES, COMMODITY PRICES, REAL ESTATE AND PROFITS. INTERVAL OF ESTIMATION: 1955 - 2004.

We covertly admit to a certain fascination with Nostradamus……after all, who among us wouldn't want to have

such powers of presage? And Nostradamus believed that he did have such powers. Delusionally, perhaps, but he passed the first test of belief………forget trying to persuade someone else you can do something extraordinary; convince yourself first.

Though we lack the Nostradamus-like qualities that would allow us to be market prognosticators with any precision, we do see a list of reasons why the market may yet be capable of again surprising to the upside. One year ago we recall no one who was predicting 15% returns for the market, yet such was the eventual outcome after a rocky start. We thank you for your patience, tolerance and understanding.

Very truly yours,

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