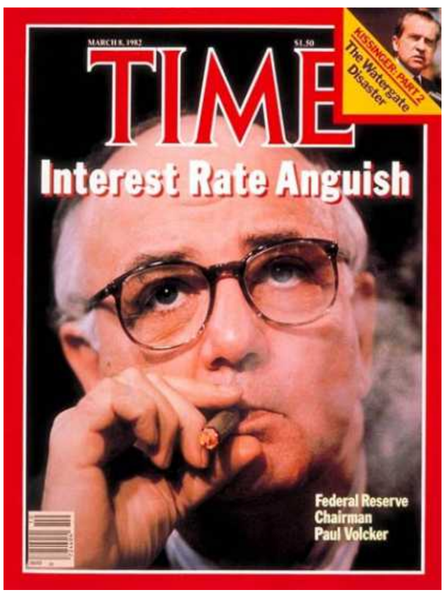
October 15, 2012

Fall Quarterly Commentary

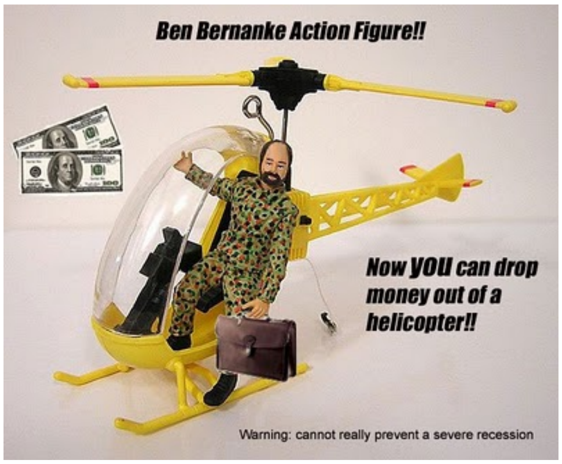


"My point is not that we are on the edge today of serious inflation, which is unlikely if the Fed remains vigilant. Rather, the danger is that if, in desperation, we turn to deliberately seeking inflation to solve real problems — our economic imbalances, sluggish productivity, and excessive leverage — we would soon find that a little inflation doesn't work. Then the instinct will be to do a little more — a seemingly temporary and 'reasonable' 4 percent becomes 5, and then 6 and so on."

September 21st, 2011 Op-Ed, New York Times
Paul A. Volcker
Chairman, Federal Reserve 1979-1987
Chairman, Economic Recovery Advisory Board 2009-2011

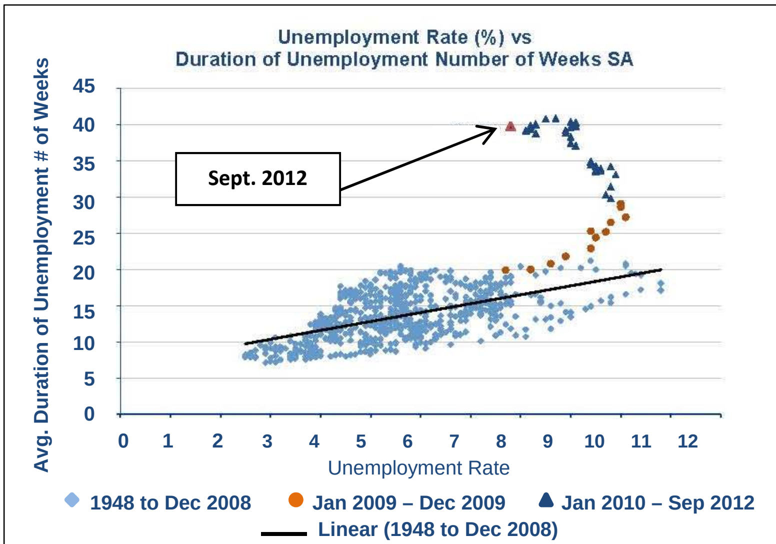
It was a busy quarter for central bankers. A surprise statement during July by European Central Bank (ECB) President, Mario Draghi, moved markets: "Within our mandate, the ECB is ready to do whatever it takes to preserve the Euro... and believe me, it will be enough." Hand-written last-minute on the margin of his otherwise pedestrian speech, these words sparked an immediate and sharp turnaround in European bond yields *(down)* and world equities *(up)*. Not to be outdone, Fed Chairman Bernanke announced QE3 on September 13th, promising to continue purchasing bonds, thereby increasing the money supply, until employment conditions improve. The Dow (DJIA) raced 200 points to a new high for the year the following day as a result of QE3, or "QE infinity", so

nicknamed because the Fed has placed no time or dollar limit on the number of bonds it will purchase. These events confirm one of our rules: in a crisis, policy makers will throw out the rule book and charge ahead to forestall disaster scenarios. *But charge ahead into what?*



Unlike President Obama with Iran, Chairman Bernanke has drawn a "clear red line" on unemployment, deciding to bombard unemployment into submission with cash instead of missiles. After all, he got the nickname "Helicopter Ben" after musing as a professor that money could be dropped on the economy out of proverbial helicopters.

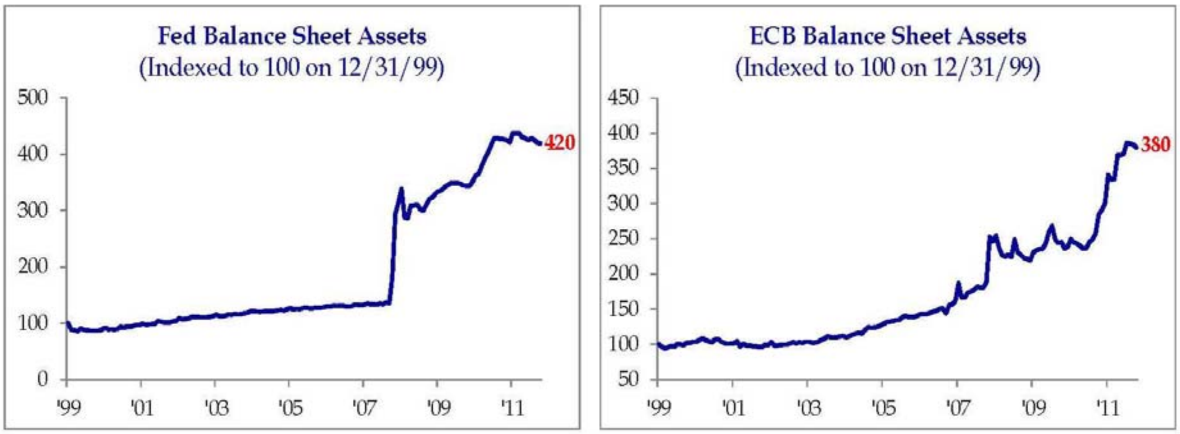
Such singular Fed focus isn't new, but it has never been applied toward this aim since full employment and price stability were established by Congress in 1977 as the Fed's dual mandates. Despite the emphasis on twin goals, Chairman Paul Volcker shortly thereafter sacrificed the former to crush the latter. By boosting interest rates to 20%, he beat back inflation from 12% to 5% percent by 1984. However, unemployment reached 11% as the country suffered through double dip recessions. Though the current US Fed fights a different enemy with the same break-the-back mentality, it may be similarly unlikely to achieve victory in both price stability and full employment at once. The chart below showing both the level and duration of unemployment goes a long way towards explaining why the Chairman feels the need to break out the big guns.



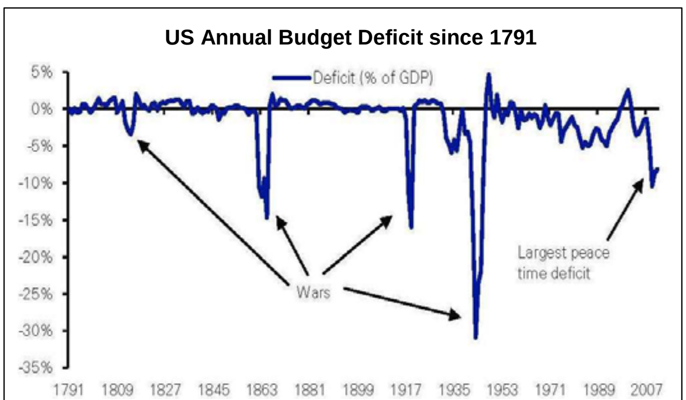
Source: Bureau of Labor Statistics, Sixth Man Research

After 43 consecutive months of unemployment above eight percent (a streak broken by this month's much discussed reported 7.8% unemployment rate), Chairman Bernanke indicated he too, like the ECB's Draghi, will do "whatever it takes". *But at what cost?* Pile-driving much of the yield curve below the rate of inflation means savers pay the price in an era of financial repression. *And at what risk?* Eventually the Fed's massive balance sheet will need to be unwound and, someday, über-easy monetary policy will need to be reversed. There is substantial risk that our great monetary experiment will not end with a Goldilocks-type perfect landing. ***Material inflation, in the high single digits or higher, is a distinct possibility if not the most likely outcome within the next decade.***

Growth of Central Bank Balance Sheets – A Rough Proxy for Money Creation

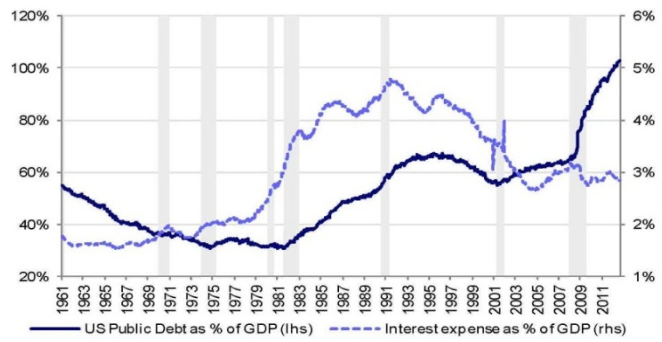


Source: Strategas Research Partners



Source: Deutsche Bank

It is well known that we have a fiscal deficit problem. Having spent much of the last 30 years in deficit, it is easy to lose sight of the fact that this represents sharp contrast with the generally balanced budgets seen over most of our nation's peace-time history, as the chart to the left illustrates. Unprecedented government debt will make Chairman Bernanke's job that much more difficult. An interesting side effect of today's low rates is that despite unprecedented government debt, interest expense as a percentage of federal spending is a relatively tame figure, only 3% of GDP as seen in the chart on the next page. If, in an effort to fight inflation, Bernanke raised rates to Volcker-era heights (i.e. 15% on the Ten-Year Treasury from the current 1.7% rate, US Debt/GDP & Interest Expense/GDP (1961 – June 2012)

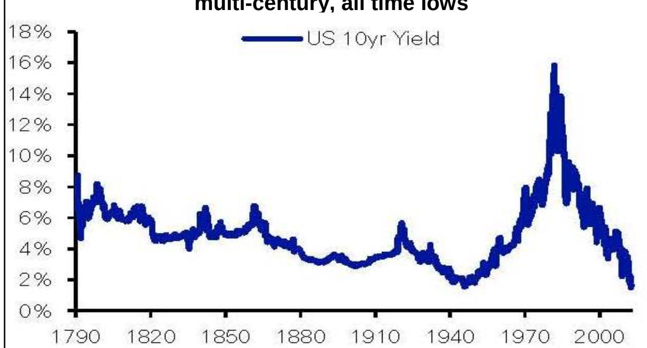


Source: US Treasury, Deutsche Bank

an increase of 8.8 times), one might speculate that US interest payments could be north of 80% of GDP! These numbers are of course not a forecast, but they do illustrate the difficulty of raising rates whilst carrying a large debt load. Should he need to raise interest rates to fight inflation the way that Chairman Volcker did, Bernanke well knows that the increased interest expense would likely decimate the US budget. Now, according to the rules, the "independent" Chairman is *supposed* to ignore these concerns... but, knowing what he does, we suspect he might misplace his rule book and decide a little inflation isn't so bad after all.

Some caveats are in order. While we believe the situation is precarious and inflation is the most likely outcome, it is easy to use Armageddon-like terms which overstate the nature of the inflationary threat. We believe hyper-inflation is extremely unlikely. When people say the Fed is "printing money", it is a reasonable approximation, but it is not quite exactly the truth. What the Fed does is it buys bonds with electronic money that previously didn't exist, thereby lending money into existence. Since money is being lent into existence, it can be repaid into oblivion when the bonds mature or are sold by the Fed. Even the inflation fighter himself, Paul Volcker, has said, "There is no reason why they cannot reverse QE when the economy is stronger. The question is whether they can do it soon enough, strong enough." And another point on the matter is that people act as if our debt obligations to the Chinese will leave us somehow enslaved. The much more likely outcome is that China (and <u>you</u> if you binge on government bonds) will not be paid back in full with dollars worth anything near today's value. Having lent great sums to a profligate government with the power to produce its own currency on demand, the Chinese are actually in a much more precarious position from a potential loss of wealth perspective than the US.

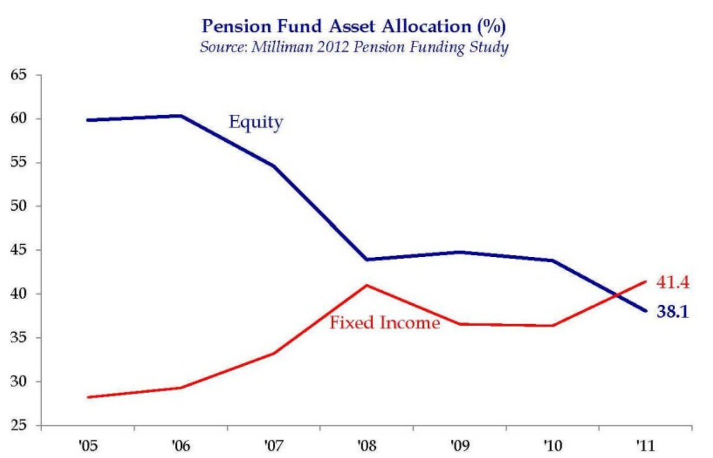
US 10 Yr. Bond Yields recently at multi-century, all time lows



Source: Deutsche Bank

Despite the aforementioned case for inflation, the yield on Ten-Year US Treasuries dropped during

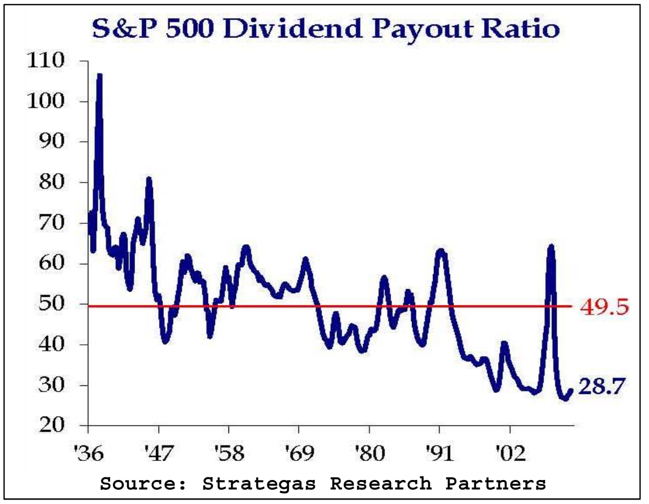
July to 1.39%. One might be interested to know that this represents the lowest yield since the first publicly traded US Government bond was issued during 1790 in order to refinance Revolutionary War debt. This means, of course, that despite the unparalleled deficit, despite the dangerously high debt, despite trenchant European examples of perilous overspending, and despite the most dysfunctional Congress since the Civil War, the US government has never been able to borrow more cheaply.



Source: Strategas Research Partners

Not to be left out in the race toward no yield (alternatively stated as high prices), current US Corporate AAA bonds yield 3.5%, a level last seen in 1958. One sign that the corporate bond market is out of whack is the fact that first-lien leveraged loans yield more than high-yield bonds. This is puzzling because these loans would be paid back before corporate bonds in the event of default. What might explain this? Retail investors continue to plow into funds that hold corporate bonds as opposed to first-lien leveraged loans. Retail investors aren't alone in the rush to bonds. Corporate pension funds now allocate more to bonds than stocks, as the above left chart illustrates. Deprived of interest income due to currently low rates, savers around the world are chasing after yield. We are concerned. Remember Raymond DeVoe Jr.'s eloquent warning, "More money has been lost reaching for yield than at the point of a gun."

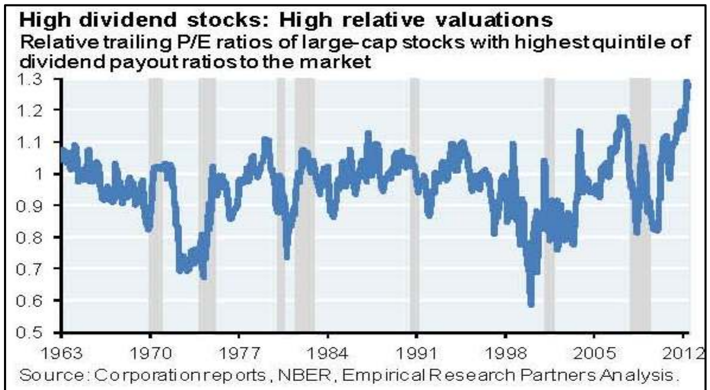
Consider the current "P/E" ratio of the Ten-Year Treasury, which is 59 (price of 100 divided by yield of 1.7%). Compare to the trailing P/E of the S&P 500 Index, currently at 16. Alternatively, consider that 57% of the stocks in the S&P 500 (and the index itself) pay their owners more cash than do Ten-Year Treasuries. Keep in mind that this analysis doesn't even count the 71% of profits that are not paid out as dividends, but



Source: Strategas Research Partners

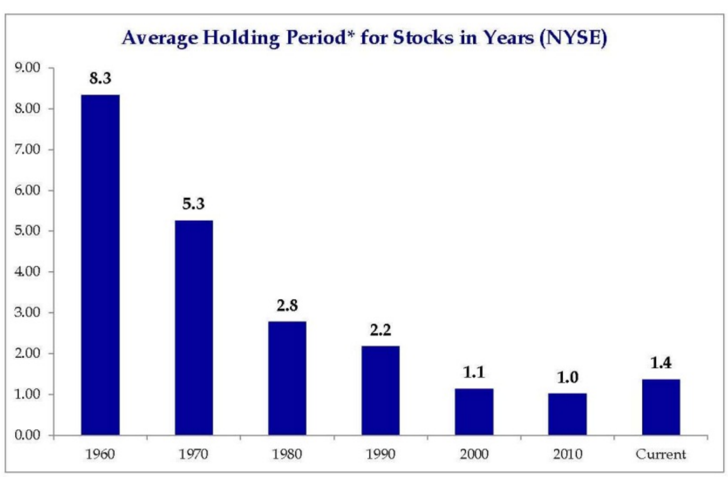
rather are available to reinvest in the business on the stockholder's behalf (100% - 28.7% payout = 71.3% reinvested earnings). See chart on the previous page to the right.

Investors are clearly reaching for yield within the stock market. But are they overreaching? The chart to the right might suggest this is the case, as companies that pay out the highest proportion of earnings as dividends trade at a P/E premium. However, given the lack of income available elsewhere, a dividend premium may well be justified and persist. As such, we seek to own companies that have long-term dividend paying potential. However, we endeavor to acquire them without paying full price. We search for situations where the dividend stability or potential aren't overtly obvious.



Source: JP Morgan

Before closing, we'd like to briefly digress to a topic that has long been on our minds but that has only recently gained steady media attention: high frequency trading (often abbreviated HFT). This practice of trading in and out of securities in miniscule fractions of a second now makes up a staggering 50% to 70% of all trading volume. However, the actual percentage of orders submitted by the HF traders is much higher than 50% to 70% because for every order submitted that is actually executed, many more are cancelled right after submission. In today's market, an astonishing 95% to 98% of all orders are cancelled before execution.



*holding period proxy = 1/turnover

Source: Strategas Research Partners

The HFT industry justifies itself by claiming it adds liquidity to the markets, liquidity being the "ability to sell without causing a significant movement in the price". But we ask, how can they add liquidity if they never actually hold onto the shares they buy, but rather just turn them over to someone else? Ahh yes, without the HFT firms stepping in-between, one might have to wait a couple hundred milliseconds before selling that second million dollars worth of stock without moving the price a tenth of a cent. It is out of such benefits delivered to society from whence HFT makes their untold millions (billions?)... ostensibly.

HFT is a booming industry, and competition among traders resembles an arms race. HF firms place their "traders" (i.e. computers) closer and closer to exchanges to get a jump on everyone else; they buy special data feeds from the exchanges to outmaneuver others; they transmit their orders via microwaves, abandoning painfully slow fiber optic cable. Observers have begun to catch on that HFT may not be in the public's interest.

The media has mainly focused on suggesting that the main problem of HFT is its contribution to severe market dislocations, such as the 2010 "flash crash" when markets suddenly plunged for no apparent reason and then recovered almost immediately. While this is certainly true, as the HF traders who purportedly add "liquidity" immediately turned off their trading computers once liquidity was actually needed. However, to us this is but a mild side effect: the true investor is never forced to sell because of falling prices, and therefore can either watch such plunges with amusement or take advantage of the silly prices (though the true investor likely isn't glued to his screen watching such ephemeral fluctuations anyway). The true damage, immensely harder to prove and thus under-reported, is that high frequency traders try and succeed in ripping off anyone else who buys and sells stocks. In the classically blunt words of legendary investor Charlie Munger, high frequency trading is "legalized front-running."

Front-running, a practice that has long been illegal for broker dealers, is basically taking the knowledge that an unsuspecting buyer is about to purchase a stock, then making a quick pre-emptory purchase for themselves... then, after the unsuspecting buyer has pushed the price higher with their purchase, the shyster can sell his shares back to the market for a quick profit. Similarly, high frequency trading basically works like this: the HF firms submit a plethora of orders to the marketplace, sense what the reaction is (i.e. what real orders are out there waiting to be filled), cancel their original orders and submit new orders specifically designed to take advantage of the real waiting orders.

Though the Securities and Exchange Commission is woefully outgunned in this area, whistleblowing industry insiders have started to come forward explaining to newspapers and Congress how high frequency trading takes advantage of other orders. Also coming to light is how the exchanges have been complicit bystanders, even accessories, because they get to share in the spoils by collecting increased fees by selling privileged data and from the higher trading volume... recall that most exchanges recently converted to for-profit corporations from member-owned enterprises. We suspect a regulatory response is on the horizon, and we applaud it.

Happily for Knightsbridge clients, we have likely reduced any leakage to the high frequency bandits due to a longstanding policy of limiting trading in general, with the goal of reducing taxable gains and any brokerage commissions assessed at each trade. Content to wait more than 20 milliseconds for our investment ideas to bear fruit, we tend to hold positions for three to four years.

While investors face much uncertainty and certain dark clouds loom on the horizon, it is heartening to remember that 2012 has produced double digit equity returns. While problems are real, they are well-publicized and fretted over. Often times the appropriate moment to worry is when others do not.

On behalf of all of us at Knightsbridge, I would like to express our appreciation for the trust you place in us. We continue to invest our own accounts alongside yours and are dedicated to delivering compelling investment results.

Very Truly Yours,

John

John G. Prichard, CFA

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