Knightsbridge Asset Management, LLC

October 14, 2013

Fall Quarterly Commentary

Robert J. Shiller
Author, Irrational Exuberance
Professor, Yale University
Recent Nobel Laureate

"...in 2000 I gave a long list [of risks that I thought of not as imminent, but still as potential problems]. The list was as follows: a sudden decline in consumer demand, a dearth of new development opportunities, failures of major technological initiatives, heightened foreign competition, a resurgent labor movement, an oil crisis, a corporate tax increase, newly discovered problems with the longer-run consequences of downsizing and incentive-based compensation for employees, a decline in employee morale and productivity, a war (even one among foreign countries, which disrupts our own trade or destroys a stable environment for economic operations), a terrorist attack or even a new terrorist threat that hampers business activities, an industrial accident that suggests that certain technical processes are more dangerous than previously thought, heightened regulatory or antitrust activity, increased foreign tariffs or import quotas, a depression abroad, stricter environmental standards, class-action lawsuits against corporations, a suddenly erratic monetary policy, systemic problems due to a failure of major banks or financial institutions, a widespread computer system problem in the same vein as the once-predicted Y2K-related malfunctions or an unstoppable computer virus or communications satellite problems, large-scale weather problems, natural disasters, and epidemics."

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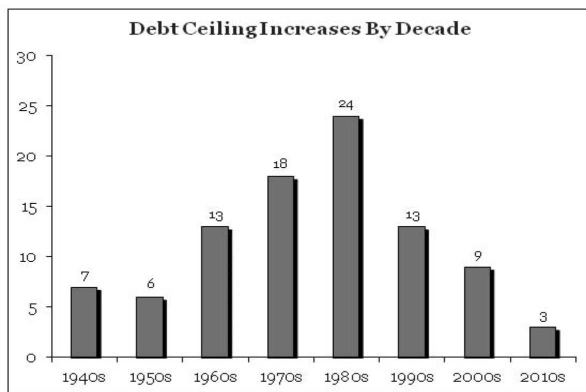
Yale Economics Professor Robert Shiller is not only a great theorist but an astute observer of market conditions as well. His most famous book, Irrational Exuberance, aside from thoroughly documenting and explaining market irrationality, warned that the stock market had become dangerously overvalued. It was published in March 2000, the same month the tech bubble burst. Lucky? Perhaps. But in the second edition published in 2005, he expressly warned that house prices were the most dangerously inflated asset of that time. Prices peaked in 2006 and the bubble burst in 2007 and 2008. With the stock market again hitting new all-time highs, we thought it appropriate to review the list of potential problems he outlined in 2000. Despite the fact that five of these events have already occurred since Dr. Shiller's initial prediction (we underlined them), the risk of all the items on the list is ever-present.

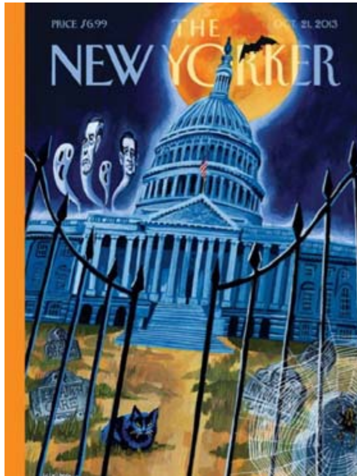


Source: Strategas Research Partners

One risk that Shiller didn't specifically enumerate is that the government might shut down due to political disagreement or that Congress might decide not to cut spending AND not to raise the cap on debt the Treasury is allowed to incur, thereby forcing a voluntary default. This current situation has shattered confidence regarding the economy, with 67% of polled Americans saying the economy is getting worse. Gallup's weekly economic confidence index just fell by the most since the week after Lehman Brothers filed for bankruptcy during September of the 2008 financial crisis. Politics has recently roiled markets but in a manner we expect to only be temporary. As the above chart indicates, the debt ceiling has been raised many times before, and in previous government shutdowns all stock market losses were recovered once the government was re-opened. We believe it best for investors to ride through this period and focus on the longer-term market cycle and company fundamentals, as they are what really matter, at least to longer-term investors like Knightsbridge.

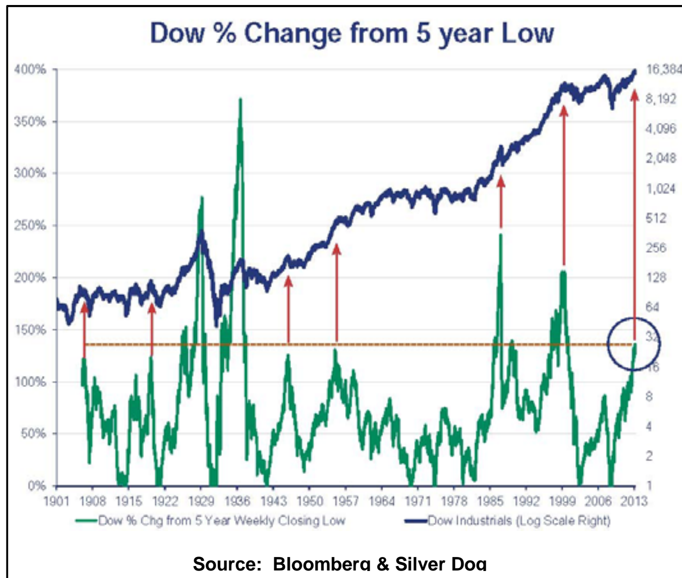
Though we see the government shutdown / debt limit showdown as more of a distraction than a real issue, it has garnered such attention recently that it warrants a few words. At the time of this writing it is in the news that Fidelity and JP Morgan are selling their Treasury holdings. To be more exact, their money market funds are selling their Treasuries that are coming due in the next 30 days or so. Despite how worrisome this sounds, the main motivation for this move is publicity.

The danger (if indeed there is any danger worth worrying about) for these funds is that the *fear* of a default could cause a run on the fund...not an actual default. There is an almost-zero chance that the U.S. would miss a debt payment, and if it did, the panic it caused would almost certainly leave even the most prudent money market fund totally shattered.



What should the prudent investor do? We must consider what would happen were the government to "default". We put this in quotes because it wouldn't really be a "default" in the common understanding of the word (you don't get paid), but rather, since the U.S. can decide to print its own money with which to pay, sooner or later it would decide to pay and hence the default would just be a delay. If you can wait to get paid, then there really is no problem. Nevertheless, it is difficult to understate the amount of financial turmoil even a quoted "default" would cause. The fear of a crisis would undoubtedly cause a real crisis and shatter that which all financial markets are built upon: confidence. People would start demanding their money back instead of lending it out, starting a spiral of defaults for those who couldn't pay immediately (even if they could pay eventually). This brings us back to money market funds...what are they buying if they are selling near-dated Treasuries? It doesn't matter. All the alternatives (commercial paper, certificates of deposit, repos) would immediately lose value due to the rush for liquidity and might default themselves. No financial institution, and few commercial ones, could be counted on to make good on their obligations. Because of the precariousness of banks, even bank deposits wouldn't necessarily be safer, so the only other option would be to literally hold physical cash (which carries theft/storage risks all its own). Paradoxically, only the U.S. government could be counted on, because all it has to do is decide to pay. This leads us to the very strange conclusion that...if you had 100% certainty that the government was going to "default" you might very well actually want to *buy* treasuries because everything else would go to hell. The upside to all this is that policy-makers are well aware of the damage a default would cause and more can-kicking (or dare we hope for...compromise?) will be the inevitable result of the current showdown.

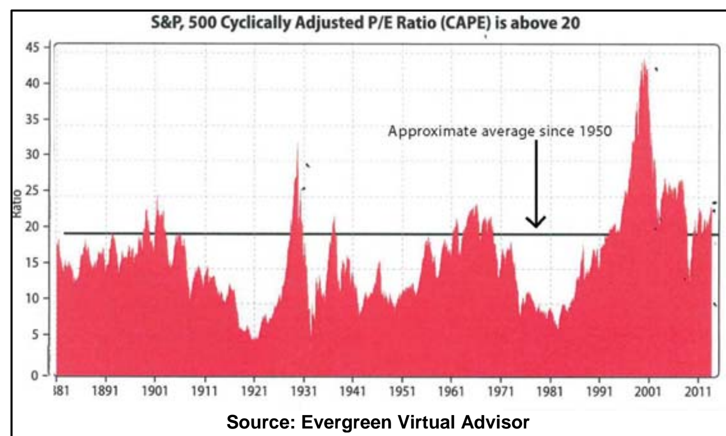
Back to what matters, the Dow has made a very large move off its five-year March 2009 low (see green line and left axis on chart: a 130% increase). Looking back to 1900, the more extreme the five-year



Source: Bloomberg & Silver Dog

percentage rise, the more likely the Dow was reaching a peak and the sharper the subsequent decline. We view further equity market appreciation as cause for increasing caution, as the market is potentially creeping into overvalued territory. However, one should not head for the hills simply because of a rich valuation, indeed 1) markets can and do become and remain overvalued for long periods of time, and 2) the underlying intrinsic value of the stock market increases even when the market is overvalued (and hence can kind of catch up). One only wants to be out of the market when one believes a snapback is impending or in motion (as a truly gross overvaluation can sometimes imply). In more mildly overvalued markets, the chief thing one can do is to adjust expectations. As Professor Shiller put it last month, "I'm not really saying don't invest in stocks, but don't expect miracles."

Broad U.S. equity valuation is in our view no longer set to produce miracles. One measure demonstrating this is the "Shiller P/E" also known as the Cyclically Adjusted P/E ratio (CAPE), which considers today's S&P 500 Index level relative to the last ten years' inflation-adjusted earnings. While a blunt measure, we consider it one of the best gauges of the overall market.

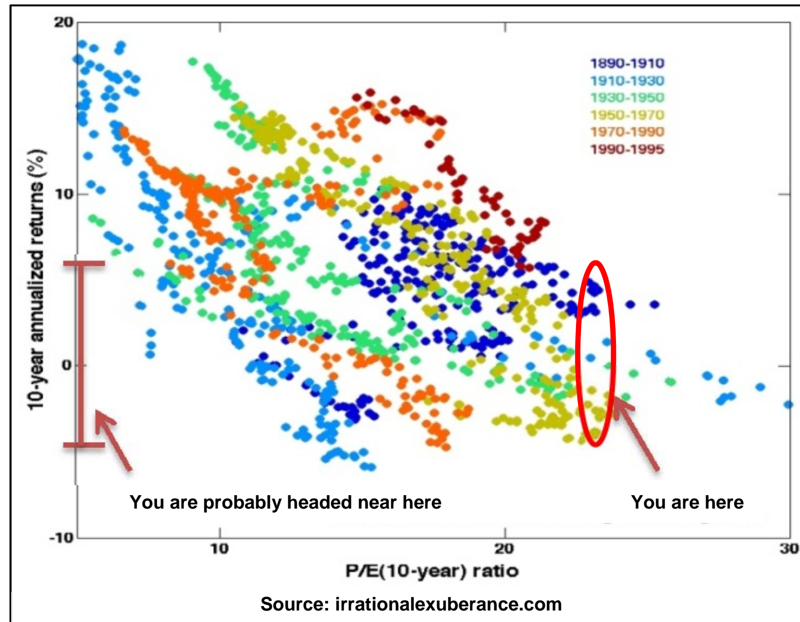


Source: Evergreen Virtual Advisor

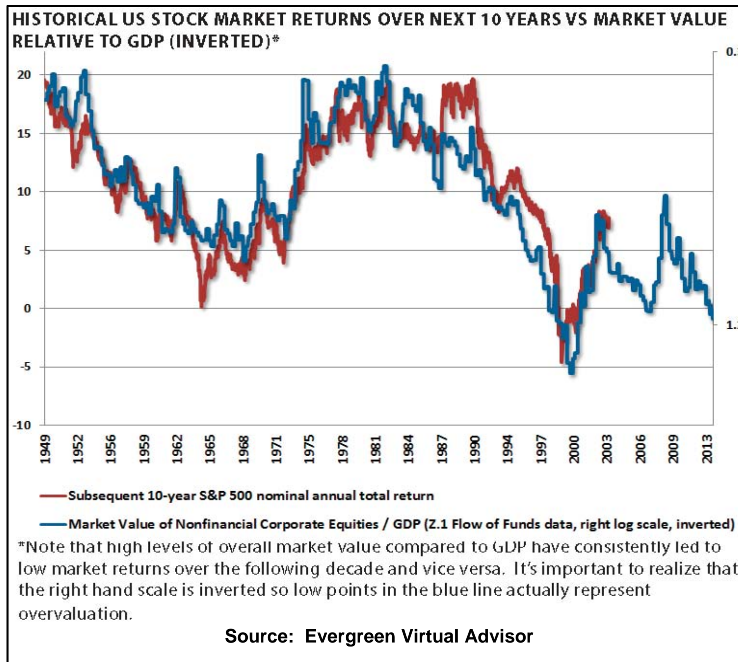
High prices are the enemy of future returns[1]. Somewhat paradoxically, in the same way that drivers would not root for higher gas prices just because they already have some in the tank, those who intend to keep saving and putting money into the markets should be rooting for *lower*

[1] This of course applies not only to stocks, but to all assets: bonds, real estate, fine art, etc.

prices (all else being equal[2]). Observe the below chart. While the range of forward returns is wide (and varies considerably by era) it is clear that both within every era and overall, a higher CAPE means lower forward returns.



Source: irrationalexuberance.com



*Note that high levels of overall market value compared to GDP have consistently led to low market returns over the following decade and vice versa. It's important to realize that the right hand scale is inverted so low points in the blue line actually represent overvaluation.

Source: Evergreen Virtual Advisor

Another way to view valuation is to look at the value of stocks in comparison to the nation's annual output, GDP. The blue line on the chart at left shows the inverse of this measure (meaning the line goes lower when stock valuation is higher) and compares it to the subsequent ten-year return in U.S. stocks. It turns out there has been a pretty close inverse relationship; today's above average market value vs. GDP looks likely to deliver minimal appreciation in the *overall* U.S. equity market.

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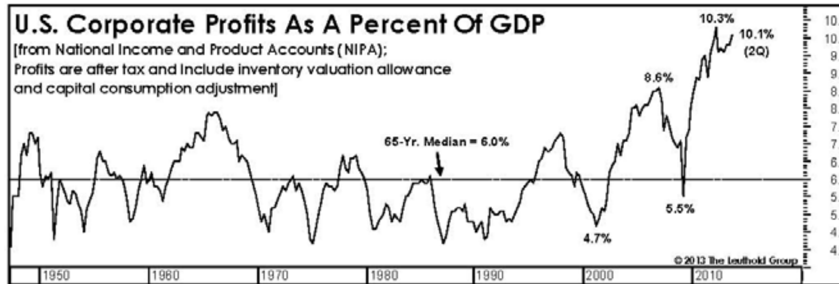
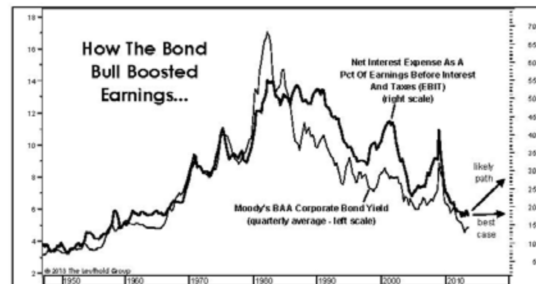
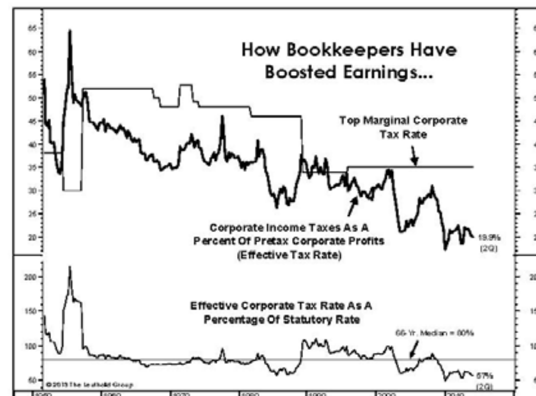
[2] Don't feel too guilty if you find yourself celebrating when the market is up, most of the time, all else is *not* equal. If the price of stocks goes up because the intrinsic value of the companies backing them increases, then wealth has truly been created and everybody wins. It is only when stock prices increase faster than intrinsic value that future returns are impaired.



Source: The Leuthold Group

One (justified) reason stock prices are up is that earnings have increased. In this way profit margins have been the friend of investors, moving significantly higher over recent history. Let's look at how margins got here and whether they can be sustained going forward?





Margin Expansion:
From The Late 1990s Profitability Peak To Today

NIPA Income Statement	1997:Q3	2013:Q2
Earnings Before Interest & Taxes As Pct. Of "Sales" (i.e., GDP)	15.1%	15.3%
Net Interest Payments Pct Sales	4.8%	2.7%
Corporate Income Taxes Pct Sales	2.9%	2.5%
Net Corporate Profit Margin	7.3%	10.1%

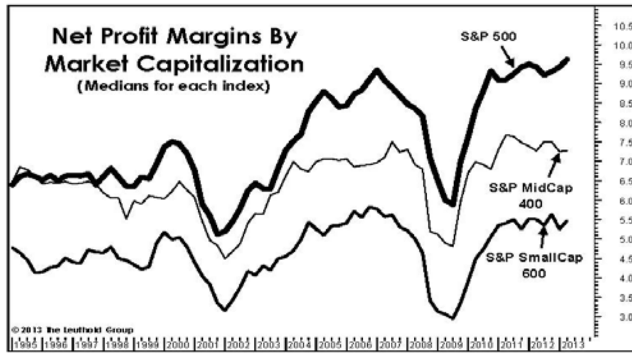
Source: The Leuthold Group

1) Cheap labor. We continue to have significant unemployment, but what is bad news for employees actually ends up being good news for employers, because laborers are willing to accept lower wages in order to just keep their jobs. If the economy and unemployment improves, we might see labor costs creeping up, thus hurting margins and profits.

2) Cheap debt. Historically low interest rates have meant it is easier for companies to pay the interest on their debt. If the economy improves and interest rates rise, corporations will have to pay more.

3) Cheap (ok...low) taxes. Despite having a nominally-high corporate tax rate, corporations have been getting better and better at avoiding these taxes, and hence the real, effective rate that they pay has been going down and down; see the above chart. How long will society accept a situation where workers make less money and corporations make more? We see building potential for a populist backlash which could mean higher taxes (that are actually paid).

It is worth noting that these factors have not affected all companies equally. Smaller companies are more dependent upon constrained bank lending and cannot get the rock-bottom rates available to large

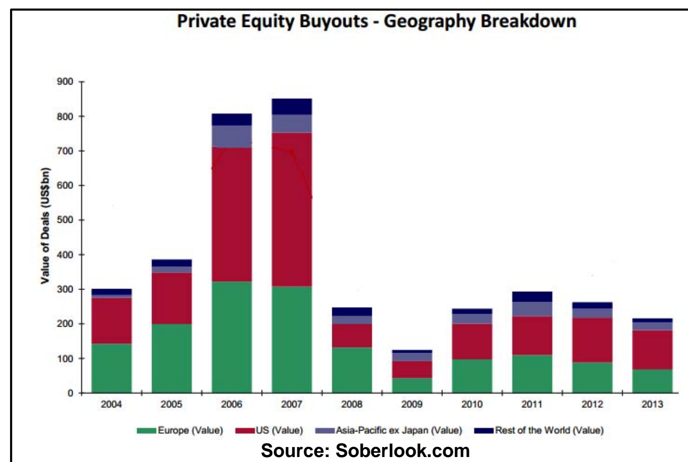


Source: The Leuthold Group

companies in the bond markets. Additionally, lacking the financial resources to lobby Congress for loopholes or pay high-priced strategists, they are less able to take advantage of international tax arbitrage and end up **gasp** actually paying something closer to the statutory rates. As a result, profit margins are less high and therefore less at risk among smaller companies. Fortunately, unlike many other funds, Knightsbridge has the flexibility to invest in companies of all sizes, and to protect against the potential for a general margin squeeze, we seek out companies with currently depressed margins that offer potential for expansion.

As you can see, we worry about profit margins and, increasingly, equity valuation. Thus, with discretion being the better part of valor, Knightsbridge expects to begin building ballast against wayward market winds we may see next year. We do so by potentially raising cash and also by buying stocks positioned to be driven predominantly by company specific developments (we think favorable ones) and much less so by general market movements. A Knightsbridge strategy hallmark is the uncovering of *company-specific* turnarounds and stocks suffering from structurally induced turnovers in shareholder base. Sometimes these stocks aren't "sure things", but rather "good bets" where outcomes are variable, and in this sense the stocks could be individually called "risky". The key is that these risks are stock specific, and if they do materialize, it will have little do with whether or not the market is experiencing a general decline.

Given the eyebrow-raisingly high market valuation and potential for margin mean reversion, are we calling a market top? Not just yet. So far we haven't seen the kind of speculative zeal that often accompanies a market top...and that would have us taking aggressive evasive action.



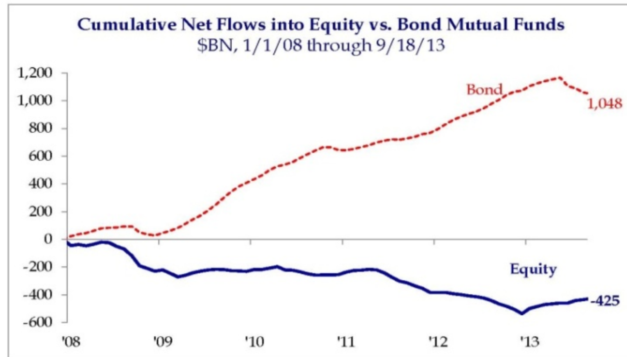
Source: Soberlook.com

1) One sign of market frenzy, private equity buy-out activity, has remained

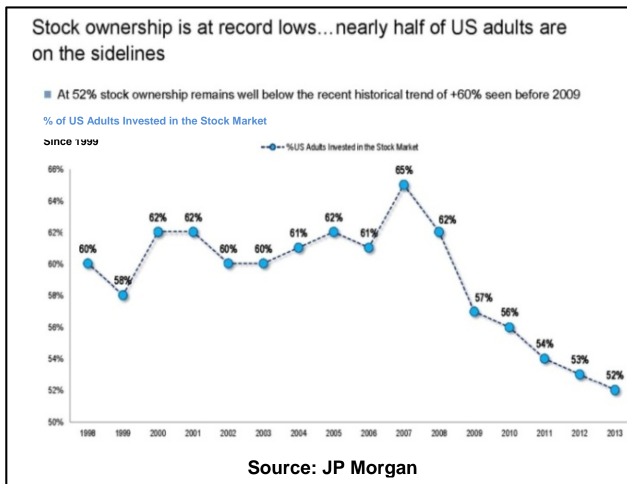
fairly modest. (That being said, we do see frenzied activity in the high-tech IPO corner of the market).

2) While some investors have begun to rotate out of bonds and into stocks this year, there is still a long way to go to reverse the trend of money flowing out of equity funds and into bond funds.

3) Stock ownership among the general public is depressed. It is tough for the average Joe to get caught up in the stock market when he doesn't own any stocks.



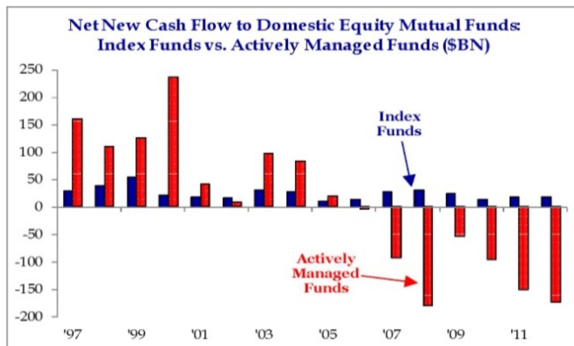
Source: Strategas Research Partners

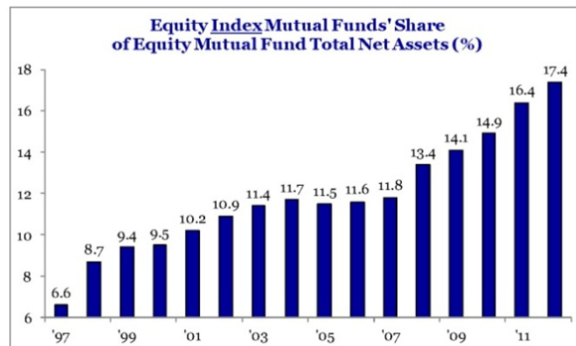


Source: JP Morgan

There is one final trend on which we'd like to touch. Many investors have given up on "active management", and have been steadily putting money into index funds.

This means there are increasingly fewer managers out there looking for stock market bargains, and more people who just want to buy everything without looking at it. This is great news! When these (now perhaps unemployed) "active managers" find stock bargains, they tend to buy them, which increases the price, and makes the stock no longer a bargain. Hence, fewer active managers means more bargain stocks, which makes our job easier (and our work more rewarding for you) as we

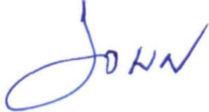




Source: Strategas Research Partners

forage in a more inefficiently priced market. Hence while U.S. equity indexes may provide a disappointingly small return going forward, Knightsbridge, in exploiting specific "investment anomalies", seeks to provide you a much more rewarding investment experience.

Very Truly Yours,



John G. Prichard, CFA

P.S. Last minute addition: we congratulate Professor Robert J. Shiller for today winning the 2013 Nobel Prize in Economic Sciences.

Portfolio Note: On September 27th, SAIC Inc. (SAI) spun off Leidos Holdings, Inc. (LDOS) and was renamed Science Applications International Corp (SAIC). Please note that many custodians are NOT correctly reflecting the corporate action on your September monthly statement. Knightsbridge portfolio accounting and our quarterly report values correctly reflect the spin off and renaming.

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