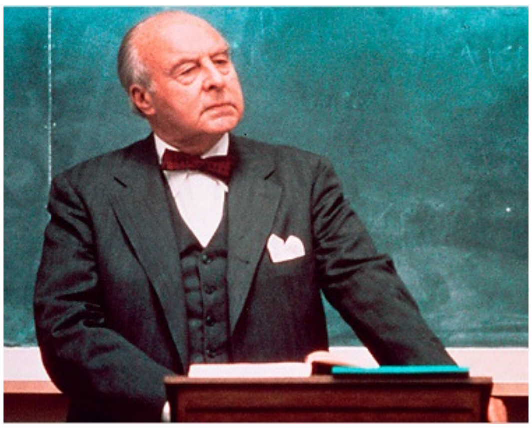
Knightsbridge Asset Management, LLC

November 5, 2010

Fall Quarterly Commentary



"They make money the old fashioned way: they EARN it."

John Houseman, 1902 – 1988
Actor, Dramatist, & Screenwriter
Academy Award Recipient
Best Supporting Actor,
"The Paper Chase", 1973

Professor Kingsfield reminded us that all would be right with the world in his 1979 Smith, Barney, Harris & Upham commercial...if we just clung to those old-fashioned values, tried and true. With patrician authority he reassured us of the value of hard work, as well as reminding us that an occasional foray into financial shortcuts might have an ending other than happy. We would choose to ignore this man's advice at our own peril.

But ignore we did. 'Hard work?'...better to apply some leverage. Once we learned the difference between recourse lending and non-recourse lending, could there ever be such a thing as too much non-recourse borrowing?

All of this was before zero down, liar loans and inflated appraisals. It became a game to be played...an x-box game where hundreds are killed but no blood is shed.

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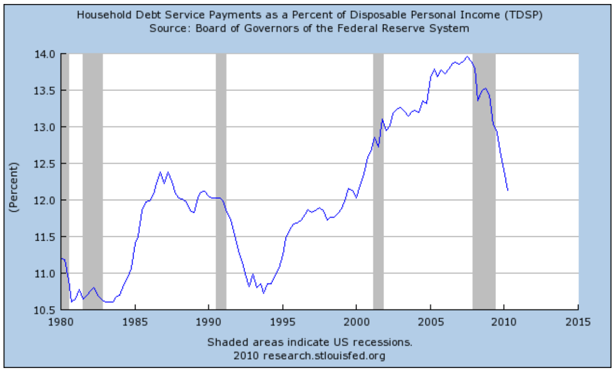
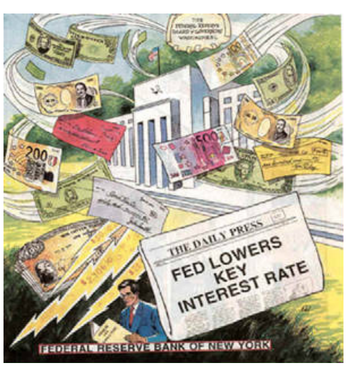
Have we learned the lesson? Apparently not. One of our clients close to the scene says the latest game is in 'short sales'. It goes like this. Homeowner tells bank he wants to sell via 'short sale' and can no longer make the payment (a lie). Bank agrees to a price for the short sale to occur. Homeowner is careful to continue making property tax payments and HOA dues payments while not making monthly mortgage payments. Homeowner saves what would have been monthly mortgage payments for 18 months, say $30,000, and bank has allowed him to stay in the house free. No foreclosure is made. Bank has been ripped off for thirty grand. Homeowner sells house and moves on to purchase new property with his $30,000 as down payment. FICO score drops 120 points but new lender is forgiving.



In our last letter we referred to quantitative easing, specifically, QE2. Quantitative easing is like TARP except one does not have to use the politically unpopular 'TARP' word. Moreover, QE, as it has been named, can occur by simply having the Federal Reserve buy up mortgage paper or other obligations out of sight of the public eye and those who object to further assumption of debt on the part of the U.S. Government. These people have become fearful of the fact that borrowing is at or on the cusp of the point where aggregate obligations will never be repaid. Once enough people can see the 'emperor has no clothes', the 'volk' become unsettled and begin to think that bankruptcy might not be far behind, or at least a lower standard of living accompanied by wealth-diminishing and punishing inflation, either an unwelcome outcome.



Source: http://www.batr.org

All investors have been taught that the Fed had as one of its two missions, the containment of inflation. New York Fed President, William Dudley (and former Chief Economist for Goldman Sachs), began making statements early in October concluding: "The current levels of unemployment and inflation and the timeframe over which they are likely to return to levels consistent with our mandate are unacceptable."

Charles Evans, Chicago Fed President, shocked the investment world on October 16th by announcing that Fed policy needed to create some inflation, lest the lack thereof create even greater problems.

These proclamations energized the stock market, as did the QE2 announcements earlier. The deflation threat is in the 'here and now', and the inflation threat is out on the horizon somewhere.

The past quarter was dramatic to the upside following investor ennui in late summer. Could it be that we are going to somehow muddle through and resume climbing the proverbial wall-of-worry? Equity markets have started to suggest so, with an upward climb ushered in following Chairman Bernanke's August 27th speech at the Jackson Hole, WY Fed annual meeting in which he made clear the Federal Reserve "remains committed to playing its part to help the U.S. economy return to sustained, non-inflationary growth". We question the ability of the Fed to engineer this outcome in a non-inflationary manner. The declining U.S. dollar, rising longer term treasury rates that are outside the cross-hairs of QE2, and advancing precious metal and other commodity prices are signaling inflation.

Nonetheless U.S. equities are showing signs of life. Is it that markets are responding to euphoric Republican capitalists who see the possibilities in strong congressional gains without worrying about potential Tea Party disunity in their ranks?

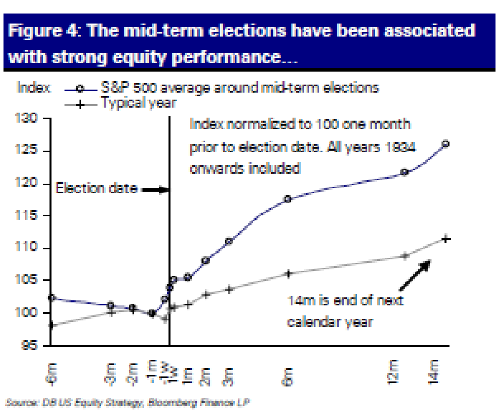
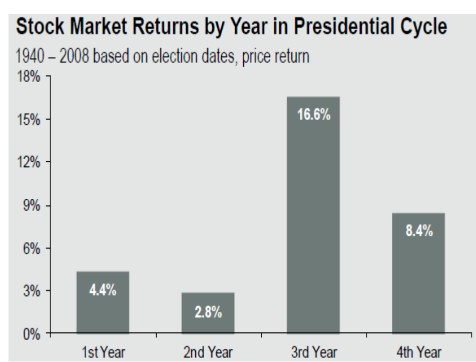


Figure 4: The mid-term elections have been associated with strong equity performance...

Source: DB US Equity Strategy, Bloomberg Finance LP



Source: JP Morgan Market Insights

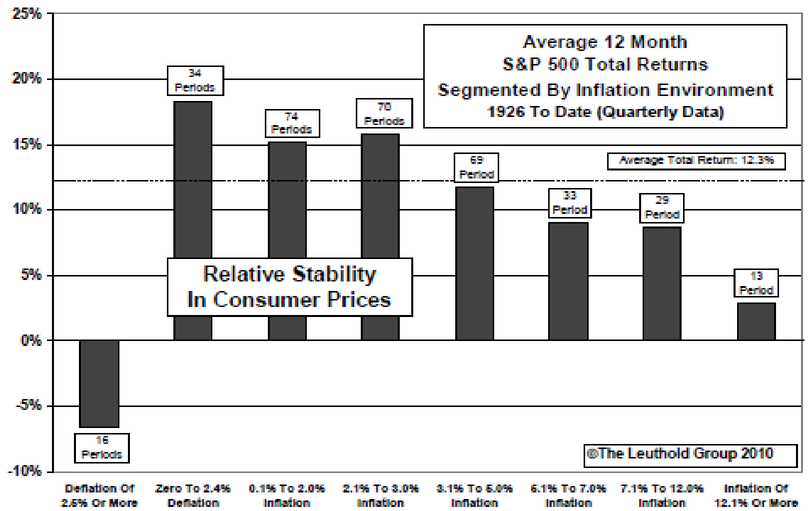
Perhaps investors are responding to the tendency toward better equity returns following mid-term elections and during the upcoming 3rd year of presidencies, as seen above.

In any event, political paralysis is preferred by investors, and that is what appears was delivered via an election that even President Obama called a “shellacking”. Amazing what a combined $4 billion spent by campaigning candidates can do.

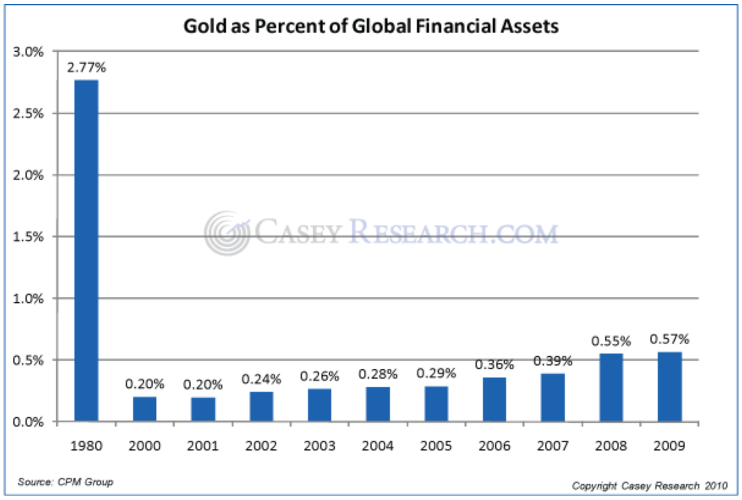
While a change in political scenery and the stimulative seeds of QE2 have already returned U.S. equities to ‘pre-Lehman’ levels, we do see potential for further gains as we move into 2011.

Before the vote count was even complete, the U.S. stock market surged forward on word the President may be ready to extend the Bush tax cuts for all. Such relief would help both economic growth and confidence at a time sorely needed. It would seem any view of a move toward ‘normalcy’ in business conditions would justify higher valuation given that U.S. equities have historically tended to trade at higher multiples of what are expected 2010 and 2011 earnings and relative to current inflation levels.

The S&P 500 Index has gained at a double digit annual rate at slight deflation (above -2.4%) or moderate inflation (below +5%). Clearly we are in such an inflation range for the time being.

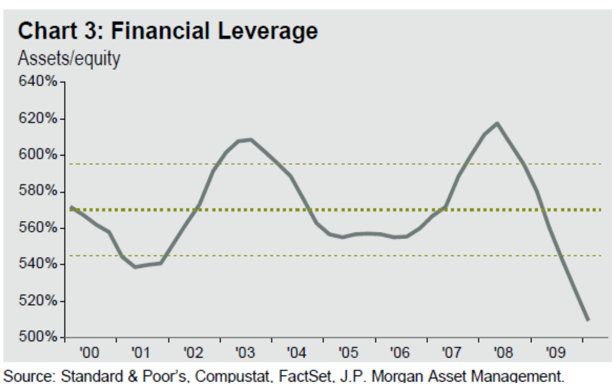


We worry about inflation longer-term; perhaps today’s depressed equity valuation reflects broader recognition of this potential path. It is easy to see inflation as the potentially preferred path of least resistance with respect to a work-out of government debt levels.

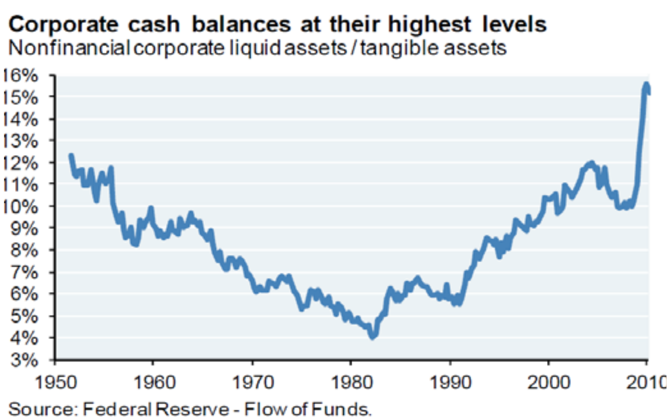


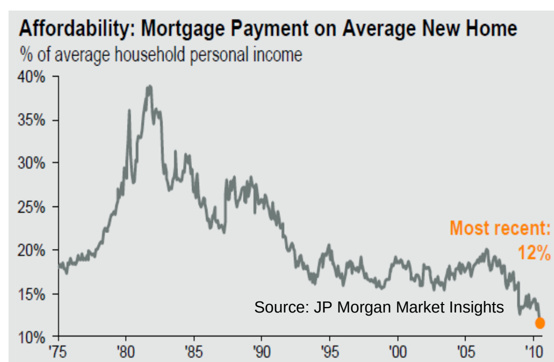
To this point, it appears there is more talk than actual adoption of gold ownership by the broader investment community. The president of the World Bank, Robert Zoellick, in advance of this week's Group of 20 summit in Seoul, has entered the discussion, arguing a co-operative world monetary system should be built, with gold employed as an "international reference point".

S&P 500 Companies

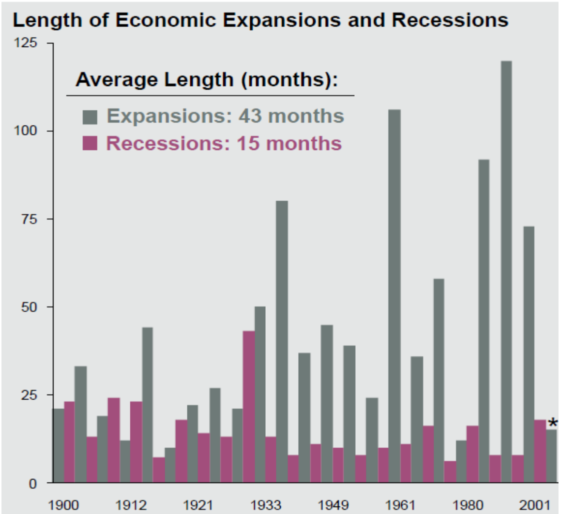


Economic and employment conditions remain soft amidst continued deleveraging. Developed market debt and currency issues remain. There are however offsetting positives. Corporations are in good shape with lots of cash and moderate leverage. Household finances are improving as well.





Further, it is important to remain cognizant of the fact that conditions can change and equities are forward looking. Housing and autos, common drivers of economic expansion, should kick in at some future point.



Source: NBER, J.P. Morgan Asset Management.

History would suggest additional duration of economic expansion as seen in the chart to the left. The remains from the days of imploding housing and credit conditions may render economic expansion 'sub-par'; we would view this as consensus expectation reflected in today's equity prices. U.S. GDP and earnings have recovered further, to pre-2008 levels in fact, whereas U.S. equities have lagged behind.

Professor Kingsfield pointed out the merits of hard work. Equity investors must endeavor to look forward, remembering that the bearish case is often based upon what has happened and is therefore more visible, while the bullish case requires consideration of what the future may hold in the way of a changed environment more conducive to investment gains.

Very Truly Yours,

Alan T. Beimfohr

John G. Prichard, CFA

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