Knightsbridge Asset Management, LLC

**January 25, 2011**

**WINTER QUARTER COMMENTARY**

***"It is really foolish to be unhappy now because you may be unhappy at some future time."***

**Lucius Annaeus Seneca, 1 BC – 65 AD**
**Roman Stoic Philosopher and Statesman**
**Teacher to Nero; later forced by Nero to commit suicide when implicated in an assassination plot on Nero's life.**

**Investors seized upon Seneca's dictum in the quarter just passed heartened by election results and the administration's move to the more business-friendly political center. As a result, market euphoria has quickly returned and is being shown in some market statistics to be the most euphoric in five (5) years. For example:**

- **AAII (American Association of Individual Investors) survey is at five-year highs of bullishness**

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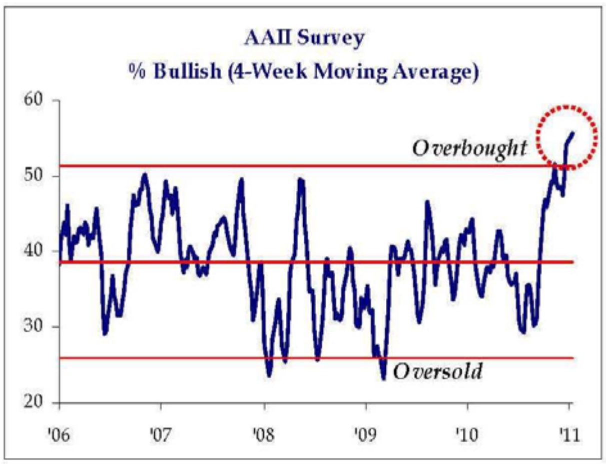
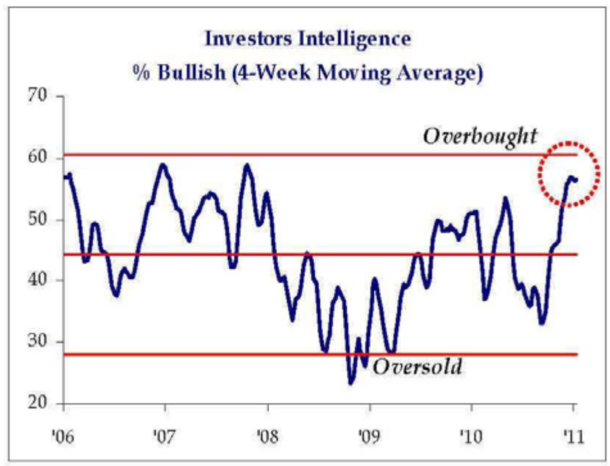
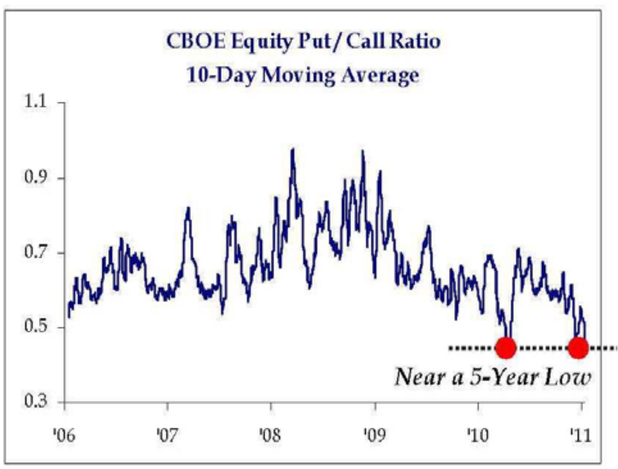
- Investor’s Intelligence survey has moved strongly to “overbought”
- Put/Call ratio is at a five-year low reflecting investors' lack of fear
- NYSE short interest is at a three-year low reflecting a lack of bearishness



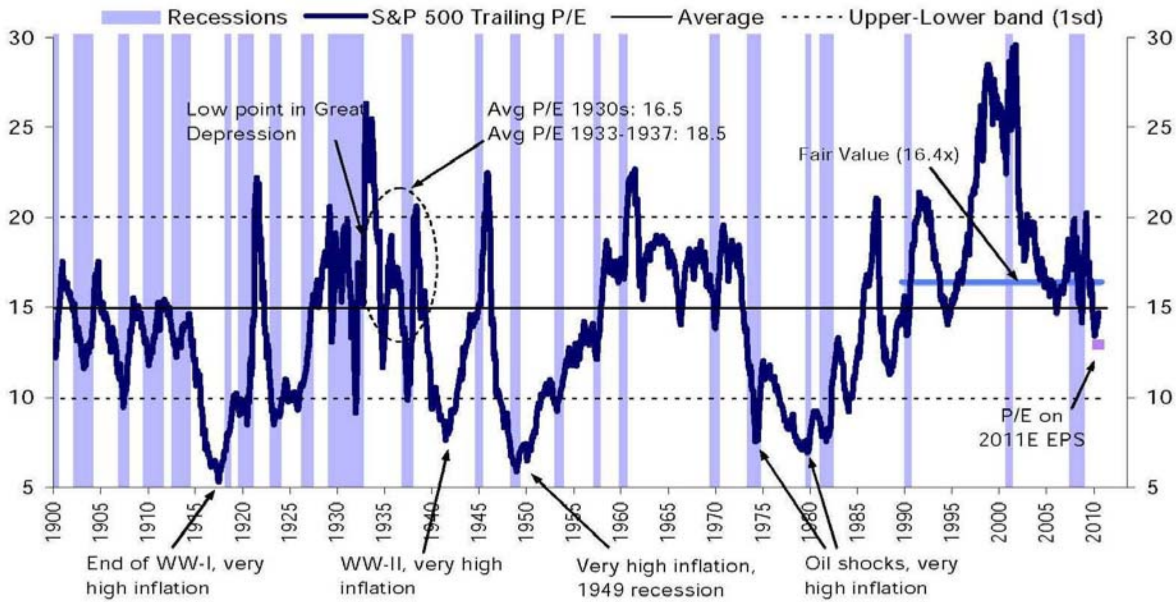





Source: Strategas Research

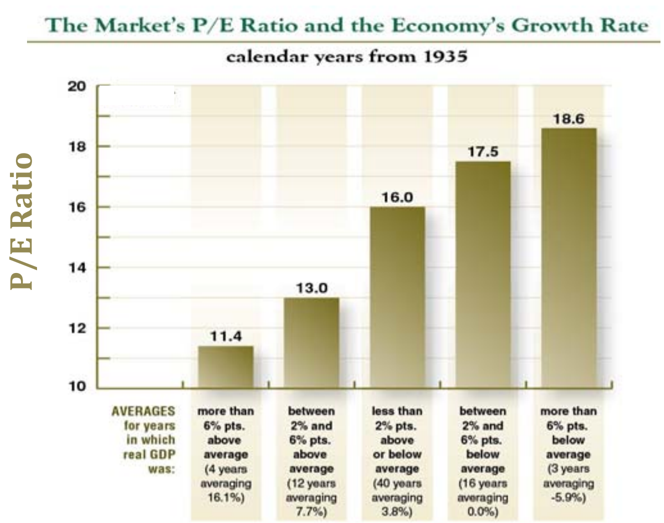
Because these indicators have become so bullish, we look for some type of correction or choppiness to bring these indicators into less extreme position and better balance. In plain English, we look for the market to work its way a bit lower before any further meaningful upside move can be experienced. Nevertheless, our outlook is a positive one overall for the calendar year. We expect not only higher earnings but also an improved investor environment to be the catalyst that will allow for a slightly higher multiple (now 14.5x 2010's earnings) on those higher earnings as seen below:




Source: Bloomberg Finance LP, Deutsche Bank

All in all, it should be a year of recovery, both economically and for the equities markets. The market undoubtedly will once again climb the proverbial wall-of-worry with negatives and risks including:

- Unresolved euro currency issues
- Government debt growth, federal and municipal
- Municipal solvency issues
- Unresolved "flash crash" issues
- Segue from governmental stimulus to private sector growth




Source: H.C. Wainwright Economics

We also believe that consensus 2011 real GDP growth, currently expected to be about 3.5%, a number that has moved up in the past few months, is supportive of a 16-multiple for the market as seen to the left. Therefore we must believe P/E's are going higher rather than lower.

We think it worthy of note, and a big positive for bank stocks, that the FASB (Financial Accounting Standards Board) reversed course this week announcing that they were abandoning their crusade to reinstitute mark-to-market accounting.

Some observers credit the rule change proposed by Bernanke and others in March 2009 with turning the entire stock market. FASB caved in on April 2nd, 2009 and changed the rule. Basically this rule requires banks to reserve for losses after their financial assets have been marked-to-market (which means reduced-in-value, presuming the market price *is* the value). This rule, although sound in principle, has the unfortunate side-effect of producing losses whenever a credit-crunch occurs, placing stress on bank equity requirements. However, in May of last year, FASB proposed bringing mark-to-market accounting back again. So this week's news is good news indeed as banks will no longer be threatened with the need to book "losses" as a function of wildly fluctuating prices in the market place.


**Source: Bloomberg Finance LP**

We suspect bond market outflows have just begun, reversing the trend of the past several years. As the economy recovers further we expect upward pressure on interest rates and lower bond prices in general. BCA Research (formerly Bank Credit Analyst) predicts the ten-year treasury will trade at a 6.0% yield in three to five years. That yield is currently about 3.4%. Bond investors, batten down the hatches!

Many have asked our thoughts on gold. We speculate the gold price goes generally higher longer term. Now *there* is a safe

**bet! We'll give our readers a couple of ways of looking at how high the price of gold might go.**

**Throughout recent history, currencies that were backed by gold were never 100% backed. Most were backed by something like a mid-teens percentage of gold value at prevailing market prices. So just for laughs, let us assume the US dollar was to be backed 15% by gold, and we expressed that as a percentage of M2 money supply. The US owns 261.5 million troy ounces of gold. M2 is about $8.8 trillion. Divide the two...that's $33,700 per ounce at 100% coverage. At 15% coverage that's about $5,100 per ounce. Maybe given the time it might take to get such a new hypothetical gold-backed currency in place, the current price of $1,350 per ounce is somewhat but not quite fully reflective of where it should be, given that a move from $1,350 to $5,100 is slightly less than a quadruple. Over a hypothetical twenty years that would be 7.0%/annum. Since M2 has historically grown at 6.9%/annum over the past 50 years, we might therefore expect a 14%/annum rate of price increase.**

**Another way of viewing gold's potential or lack thereof is to look at the value of the world's gold versus the value of world total financial assets (stocks, bonds and cash). All of the world's gold is currently valued at 0.6% of total global financial assets. It was 0.3% in 2001 when gold bottomed at $254/oz. It was 3.6% when gold spiked up to $800/oz. in 1980. And it was 4.6% in 1968 a few years before Nixon closed the gold window in response to French President Charles de Gaulle demanding gold in payment. So we have a very wide range of 0.3% to 4.6% at different points in history. At the current 0.6%, it would seem to have plenty of upside but we do not know how long it will be, and it could be a very long wait, like maybe twenty years, in which case the return compounded from here at $1,350/oz. might be 9% per year to get a price equivalent of 4.6% of global financial assets. Of course the 9.0% number is low because global financial assets themselves are growing. Global financial assets grew a sub-par 4.0%/annum over the past decade. Adding this to 9.0% would result in a 13.0%/annum rate of price increase, a number remarkably similar to the 14.0%/annum calculation above.**

We remind our readership that the ten-year rolling price returns on the S&P 500 still favor a regression to higher equity returns over time. Equities look inexpensive if one compares operating cash flow yield on the S&P 500 ex-financials (which themselves are cheap!) against the ten-year treasury. That spread has been historically stable at 4.6% but now runs 8.0%. For these reasons and others alluded to above, we feel the equity market will be seeking higher ground.


Source: Bloomberg Finance LP, Deutsche Bank

The modern version of Seneca's dictum would be something like: "Don't worry, be happy!"

The S&P 500 has advanced 93% from the March '09 lows. The painful 17% correction in 2010 has now been relegated to the dustbin of history, and the guns are out of their holsters looking for targets. We encourage caution in the near term but believe market strength will be the norm for most of the year.

We thank our investors for their patience and understanding and wish all an abundant new year.

Very Truly Yours,

Alan T. Beimfohr

John G. Prichard, CFA

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