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THE WALL STREET TRANSCRIPT
Questioning Market Leaders For Long Term Investors

Exploiting Investment Anomalies

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TWST: Would you start with an overview of Knightsbridge Asset Management and your investment philosophy?

Mr. Beimfohr: Knightsbridge is a privately owned firm, owned by myself and John Prichard, 50% each. We manage money for high net worth individuals as well as a smattering of institutions. We finished 2007 with $722 million under management and I think as of the moment that is largely unchanged.

Year to date, 2008, we are proud that we've been able to protect our clients a bit. We are down 3.8% after fees versus down 11.4% for the S&P 500 and 11.2% for the Russell 3000 Value.

As to Knightsbridge and its historical roots, we've been in business since 1998, so we're in our 11th year. Prior to that we were a division of another firm whose primary focus was consulting, and we managed portfolios there as well, going back to 1992, before we spun off.

What Knightsbridge does that's a bit different from other people managing money is that we look for one of seven or eight investment anomalies to be present before looking at the stock itself. This gives us a statistical edge, as we have studied forward outcomes exhaustively to convince ourselves that superior returns are available solely from the presence of the anomaly. These anomalies may be occurring in the market at any given point in time among a fairly small number of stocks. Some of these anomalies would be things like dividend eliminations, spinoffs, merger blowups, currency devaluations, insider-buying clusters, bankruptcy emergence, etc. In our portfolio construction, historically 40% of the portfolio has come from spinoffs.

These investment opportunities are mostly event-driven and are characterized by a redistribution of the shareholder base from a less risk-tolerant group to a more risk-tolerant group, or in the case of spinoffs and bankruptcy emergence, from shareholders who received shares involuntarily to shareholders who will purchase shares voluntarily. Our primary competition in this arena, rather than other money management firms, has been private equity. With the collapse of financing to the private equity world, we took some lumps last year in a couple of names, but we were happy on balance to see that occur because it meant that we perhaps would not have private equity as intense a competitor as we had in a number of cases for the ideas that we wanted to buy.

Our investment process is four steps with anomaly research the first. Next is to identify companies experiencing the anomaly. Third is to look at a company's industry relative to the S&P 500 over a 25-year period in terms of standard deviations of either undervaluation or overvaluation. In an ideal world, we would like to have the industry trading below the S&P 500 on a relative basis compared to where it has traded relative to the S&P 500 for the last 25 years. Ideally, we'd love to see an industry be a couple of standard deviations below the S&P 500, which would identify an industry out of favor. But in practice, we use industry valuation as a screen-out tool more than a screen-in tool to assure we are not fishing in the popular waters. If we saw an industry trading above the S&P 500 in valuation by any serious amount, that would be a reason not to go any further with the analysis.

The last leg of the process is to look at the company relative to its peers in its industry; we look at perhaps three or four metrics to convince ourselves that the company is cheap relative to its peer group. If we hold a stock three years, we assume the price at which it will be trading at that time will be related to earnings and cash flows in the fourth year. We typically assess cash flows four years out and drop down to an earnings number also four years out to see if the stock has the requisite return potential we seek. Those are the four phases of the investment process.

I'll give you some examples. One that we rejected because the industry was too generously valued when we looked at it was **Wyndham Worldwide** (WYN), which was spun out of Cendant. **Wyndham Worldwide** was in the hotel industry, and last summer the hotel industry was trading in healthy fashion, one or two standard deviations above where it normally trades on a 25-year look-back. Occupancy rates in the hotel industry were running quite high, profitability was good, and lots of major hotels were undergoing renovations and expansions. This is an example where we didn't take the analysis any further when we saw that the industry was overvalued relative to the S&P. **Wyndham** was $33 then and this month is trading at $20.

I'll make one comment about some of these anomalies. Some are dependent upon the economic cycle to a great degree. A dividend elimination anomaly is the sort of thing where, when economic times are good, you will get relatively few dividend eliminations, and if you do get them, they'll be very concentrated in one distressed industry. We saw that with the auto parts industry over the past few years. Normally, dividend eliminations come toward the latter half of a recessionary economic cycle and then you have lots of opportunities, such as financial companies today. We are beginning to identify those opportunities, particularly in financial and related stocks, though it may be too early for purchase right now.

TWST: Which brings me to the current situation in the market and the economy. How are you faring in this climate and are you finding enough investment anomalies?

Mr. Beimfohr: We're finding enough anomalies. We're in a 25% cash position, and we will use cash as a defensive tool when we think it's desirable to do so. As a manager of individual accounts, we would probably normally run with just transitional cash in accounts, which might be 5% or something like that, but we have felt that this most recent period called for greater defensiveness. To give you the history in the last year, we had done quite well up through June 30, and then we took some lumps in the third quarter and early in the fourth quarter, particularly in November, when we had remained fairly fully invested and we probably shouldn't have been. Initially, at summer's end we were hopeful the contagion had been contained. When we looked back at some of the ABX mortgage paper pricings in September and October, we saw that they had rallied off their lows, a good sign. But then November came, and it was very obvious that there was more damage to be done, more write-offs to be taken. We felt the market had yet to fully process this.

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We made a decision in the first week of December to raise cash, and we sold off 15% to 20% of our holdings at that point, and tried to do the lightening-up in the most consumer-sensitive names. We came into 2008 with our fingers crossed. So far this year it's been a market disaster but we've fared reasonably well, all things considered. We are not heavily into commodity plays, we are not heavily into any of the really high momentum stocks that you see in the market today, which might be coal-related or fertilizer-related. Obviously the commodity cycle is running very strongly. We have stuck to our guns and held the names that we came into the beginning of the year with.

TWST: You've got a large cash position. Are you more defensive in your equity exposure?

Mr. Beimfohr: I would say that the cash by definition makes us more defensive in our equity exposure. In terms of whether or not we have rotated toward owning utilities, tobacco and drugs, the classical defensive industries, I think the answer is not really. We do have a fair representation, for us, of healthcare names, but I don't think our energy exposure is really very much higher than it is in the S&P 500 where it's 12%. Our financial stock exposure is actually not terribly different from the S&P 500. We don't really look at sector weights, per se, but it just turns out that our sector exposure is fairly neutral. What I'm trying to say is, we haven't done any serious tilting either toward financial names because we think they are unusually cheap or away from financial names because we think they are excessively risky, given likely rewards, and likewise for the healthcare group.

"We started buying Discover in the low $20s, and it's currently trading around $15. We think that they can work their way out of current financial conditions, where the market anticipates higher charge-offs. Certainly, Visa and MasterCard are alive, healthy and well and trading at p/e ratios that are twice Discover's. We are willing to hang in there with it."

TWST: You are by nature, I suppose, what you would call a contrarian. Where do you think you make a contrarian bet compared with most other money managers?

Mr. Beimfohr: I think most managers make bets on what they think the current year or the following year's earnings are going to be, and we do not make bets based on that. We make bets based on what we think cash flows are going to be typically four years out because when we buy a stock we plan on owning it probably for three to four years. That's a long enough period of time that if we are going to start using earnings as the basis for trying to extrapolate stock values that far out, we have to be looking out much further than the next quarter's guesstimate.

In fact, in many cases we have to be going farther out than many Wall Street analysts' models. Typically what we do is extrapolate cash flows four years out and then work back down to an earnings number that we think is some reasonable bullet number. We understand that aside from that bullet number there is going to be some probability distribution associated with the actual earnings number being higher or lower. Without any particular magic happening, we would like to buy a stock for which, if we were to hold it three years on the assumption that it will trade in the third year at what people are expecting for earnings in the fourth year, 80% to 100% total returns are achievable.

That means that we are going to be looking at names that are oftentimes controversial, names that are disliked more than they are loved, names that, as analysts like to phrase it, contain "headline risk," names that may be trading "on the balance sheet" rather than "on the income statement." We will look at these stocks, provided there is an anomaly that has drawn us toward that stock. We look at insiders buying clusters and we run a table every week of what the insider buying and selling activity is in every stock we own. If we see selling, that raises some cautionary flags, depending on the size of the selling and who is doing the selling. We definitely pay attention to large insider purchases by individuals that are in excess of, let's say, $1 million; we are interested to know that those people think that their stock is worthy of an open market purchase — not an option exercise, but an open market purchase.

1-Year Daily Chart of Discover Financial Services

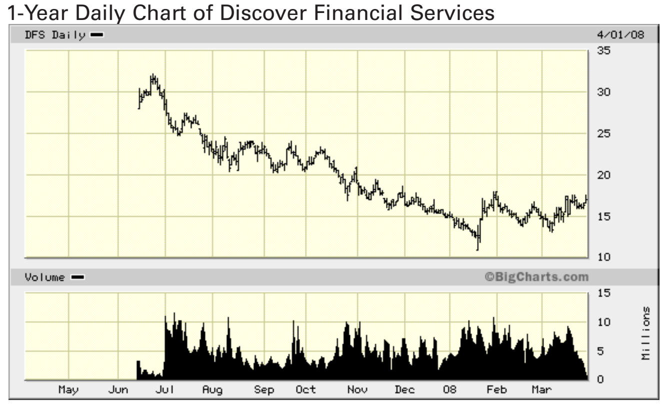

Chart provided by www.BigCharts.com

TWST: What are some examples of your investment approach that shows that you are exploiting investment in anomalies?

Mr. Beimfohr: I will give you an example of one that has not worked out especially well, and I'll give you an example of one that has worked out reasonably well. One that we own that hasn't worked out well so far is **Discover Financial Services** (DFS). This is the Discover Card, one of the original cards with 50 million cardholders. You have to remember that the ownership of Discover Card started out with Sears Roebuck, and then it was owned by Dean Witter, and then **Morgan Stanley** (MS), which spun it off. It was always the stepchild in every corporation by which it was owned. It didn't fit in with **Morgan Stanley**'s other businesses, but when **Morgan Stanley** acquired Dean Witter, they inherited it. At that point, Discover was thought by some to be too much a local domestic player, so **Morgan Stanley** bought a European operation in the UK and folded it into Discover, which now **Discover** has sold (for substantially less money) to concentrate on the domestic and Asian businesses. We started buying **Discover** in the low $20s, and it's currently trading around $15. We think that they can work their way out of current financial conditions, where the market anticipates higher charge-offs. Certainly, **Visa** (V) and **MasterCard** (MA) are alive, healthy and well and trading at p/e ratios that are twice **Discover**'s. We are willing to hang in there with it. We've owned it for possibly eight or nine months on what we think will probably be a three-year hold.

One that has worked reasonably well is **Hospira** (HSP). **Hospira** was spun out almost four years ago from **Abbott Labs** (ABT). **Hospira** was a slower growing part of the parent, an operation selling mostly injectable drugs. Typically the investment bankers

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go into the parent company and they say, "The p/e on your stock is too low, and the reason it's too low is that your overall earnings growth is too low, and the way we can make your earnings growth higher is for you to dump the parts of your business that are the slowest growing." For **Abbott** at that time, the slow growing orphan was **Hospira**. For many other companies this is the rationale for a spinoff or possibly a sale. After the spinoff, the parent company theoretically is justifying a higher p/e because now their earnings growth is going to be higher. **Hospira** is something that we bought in the mid- to high $20s; it's currently trading around $43, and it's been higher and is doing reasonably well in this market environment. It has underperformed slightly if you were to take our initial purchase point and take the point where it is today. It's returned less than we would ideally like to see, but that's true for most stocks that we own because of the market environment that we are in at the moment.

Incidentally, given what's been going on lately, I believe the market is giving a very good accounting of itself, particularly today in light of the **Bear Stearns** (BSC) announcement. I think we're getting closer and closer to the end of this downturn, and I think it will be proven to be a bear market. But the market has made a pretty good showing of itself. given recent events. I think if you had told anyone a year ago, "Well, here's what's going to unfold in the next year. We are going to have this subprime mortgage crisis, and this crisis is going to infect all these other areas. We are going to have **MBIA** (MBI) and **Ambac** (ABK) on the ropes, **Citigroup** (C) and **Merrill Lynch** (MER) will require infusions of foreign capital, and **Countrywide Financial** (CFC) and **Bear Stearns** will go under." I know they're being taken over by **Bank of America** (BAC), and **JPMorgan Chase** (JPM), but take **Thornburg Mortgage** (TMA) — they are essentially going out of business having held almost nothing but AAA mortgages! If you had said that this was going to be the scenario and asked people to predict how much the market would be down, I think they would all have picked a number that is way, way more than the amount by which the market has actually gone down.

1-Year Daily Chart of Hospira

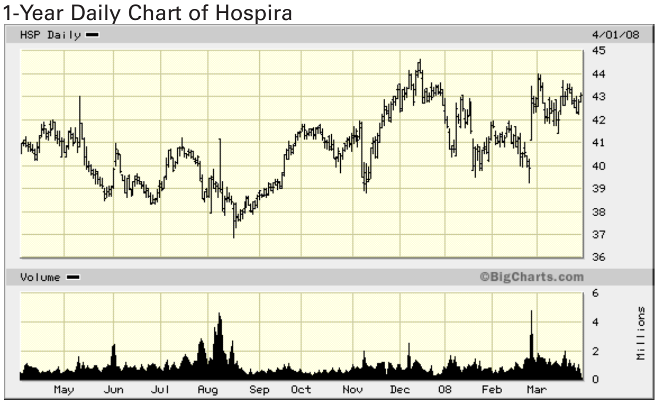

Chart provided by www.BigCharts.com

Now I will grant you that **Citigroup** and **General Motors** (GM) are at new all-time lows as we speak. I am going to say that we are not at the market bottom precisely at this moment. But the bottom is likely not far away and the market has not gone down that much. If investors have a choice between buying real estate at this point, buying Treasuries yielding 2% or 3%, or buying **General Electric** stock, **GE** stock comes up looking pretty good. In the institutional world, I believe that the same could be said. That tells me that we have to be looking for the element of surprise, which is that all of this will be discounted long before the last write-off is taken. Really all that needs to happen for the market to rebound is to have enough confidence that the system is going to survive. There will be discussions about whether or not we ought to have mark-to-market or mark-to-model accounting or be going back to Glass-Steagall, and brave investors will be able to look out on the horizon and say yes, we only have $100 billion worth of this left to write off or maybe it's some other number, but they'll at least be able to quantify where this is going to end, because write-offs of this stuff are one-off events. It is not going on forever since you can only write off 100% once.

I think that probably by the time this is all said and done, you will basically have the Federal Reserve or a federally constituted entity buying mortgages, not just lending money to member banks using mortgages as collateral. You have to go back and acknowledge that the collateral for the banking system in America is real estate, and therefore, you have to stem the decline in real estate prices to save the banking system. Whether or not the Fed has the muscle to do that is the open question.

I think that before it's all said and done, you will see some kind of government program that is way beyond what has so far been proposed or announced or attempted to have been implemented or has been implemented to support the price structure of certainly AAA mortgage paper. You can't have a system where AAA mortgage paper is trading at $0.50, $0.60, $0.70, $0.80 on the dollar. Just because the sellers are overwhelming the buyers at the moment forcing all these write-downs, you can't have that going on for very long because ultimately what it will do is shut down all lending. If any institution has the opportunity to buy 5% coupon mortgage paper at $0.50 on the dollar (current yield of 10%, yield to maturity of maybe 20%) instead of originating a new mortgage at rates no one can afford, it's going to buy the old mortgage. And if the mortgage trades at half par value for very long on a property than might have 50% equity, then that is a de facto recognition that the property is worth 25% less. It's a problem that there is a mismatch of buyers and sellers for an entire asset class; that has the unfortunate side effect of undermining all bank lending in America. That's the way I look at it.

TWST: Is it a case of too much debt or too little credit?

Mr. Beimfohr: For one thing, I think we have subsidized housing too much in this country. I think politicians have to accept the responsibility that in the cookie-jar of wonderful things, we wanted to encourage home ownership because we thought it promoted democracy and social stability. And a certain segment of the political spectrum believes that some inflation is a good thing because they think it provides for wealth-building in real estate and suppresses class entrenchment. But as well as discouraging savings, it also destroys savings and encourages the investment casino. We made lending really cheaper than it should have been, given the risks associated with the borrowers. The way we made it cheap was by taking some guy out there who has a normal job and packaging his loan with the government waving the magic wand over it to make it almost as good as a Treasury bond. Now what's wrong with that you say? Well, taken over long periods, it causes capital to disproportionately flow to unproductive uses (think bigger houses) at the expense of productive uses (think jobs at **General Motors**).

The assumption was if the government waves the magic wand, then it will trade like a Treasury bond. Maybe it would trade 50 basis points higher in yield or something. In reality, the average corporation in America is a BAA credit and the average individual borrowing money for his house is getting terms that are way better than a BAA credit and you know what, he is not even a BAA credit. I think if you really want to wind back to where this all started, you get into the preferential treatment ideas with deductibility of interest, capital gain exclusions, and tax postponement through 1031 exchanges. You end up with this huge one-way valve, filling the balloon where you have only air going into the balloon, but you don't have any waste-gating of air coming out in any other part of the balloon. We all know what the end is. In the end the balloon explodes, we just don't know when. I know this is controversial, but we created too many rules that funnel capital into real estate and part and parcel of all that was to create rules that made credits that didn't deserve high ratings get high ratings. That's what it took to produce low interest rates for lots of people to borrow money.

To circle back to your question, you asked the question of whether or not this was too much debt or too much credit, and I would say that it is too much of both, but the culprit is the way the system was patched together throughout history. It became too easy for anybody who could fog a mirror to walk up and get a loan. And insufficient recognition has been given to the instability of employment and income in an age where all the middle-class production jobs have evaporated; what is affordable today may not be affordable five or 10 years down the pike, but a mortgage is for 30 years of a 40-year working lifetime. Incidentally, I only see a furtherance of past behaviors. Congress is now contemplating a $15,000 tax credit for first-time home buyers.

TWST: You invest on a long-term basis hoping to get outperformance from your holdings, but what triggers an exit? What is the sell process?

Mr. Beimfohr: Our sell process is a combination of price-based considerations and time-based considerations. We have, at the time that we buy a stock, a target price in mind, and there are things that will cause us to change the target price. Whereas we might mechanically say that we would sell something in three years, we don't really do that because if the stock seems to be depressed when the three years comes up, we may hold it a little bit longer to try to get a better exit opportunity. There are a host of other factors in buying, and identifying market bottoms seems to be a little bit easier than identifying market tops. I think you can say that not only for the market as a whole but for individual stocks as well. We are trying to buy at as close to bottoms as we can determine. We are trying to not get our profits from trading, per se. We are trying to get profits from the holding period and quite frankly, there are acquisitions and divestitures and changes that alter the landscape along the way. There are many things that go on in the life of a holding that are going to cause you to revisit and revise what you think a reasonable sell target is.

Our selling tends to be conditions-based. We would like to see a whole host of analysts in love with the company when we sell. We would like to see nothing but rosy estimates for future earnings. Unfortunately, all those wonderful conditions don't show up all the time. Ideally, we're going to sell stocks when we think the anomaly has statistically run its course, and when the potency of the anomaly is no longer with us.

We have a fellow with a PhD in mathematics at Knightsbridge who spearheads our effort to statistically study whether a particular anomaly is likely to produce excess returns and for how long. For example, we know that with dividend eliminations, in most cases you need to wait somewhere between six months and a year after the elimination to purchase the stock in order to have all the negativity be behind you. I think we're more successful on the entry points than we are on the exit points. One of the problems with the exit points is, of course, that theoretically you have a stock going up as a function of time in many cases, so that in the normal progression of things, stocks may go up at a certain rate that perhaps is the same rate as the S&P 500. The S&P 500 historically has gone up over really long stretches of time somewhere between 6% and 7% a year, without dividends. By adding dividends, that gets you to the historical 10% total return. So if we would like every stock we buy to go up, let's say, 80% in three years, then that requires an expectation of a 21% annual return. Our experience tells us that failure to attain that return in the first year is predictive of subpar returns in the next two years. So to attain the overall goal requires that some outperform the goal, or arrive at the goal early and be allowed to run further. Just as it is possible to overestimate a company's potential, so too it is possible to underestimate a company's potential. Either requires an adjustment to the sell target. Rebalancing is inherently a process of selling winners to add to losers, which will retard performance, so we are careful in this regard as well.

Although we would like to have excess returns relative to the S&P 500 at all points in time, there will be times when keeping up with the S&P 500 will be a wholly satisfactory outcome. We've beaten the S&P 500 seven years out of the past eight, and knowing what not to do is every bit as important as knowing what to do.

TWST: What do you think gives Knightsbridge its edge? What are the defining features that distinguish you from other peer firms?

Mr. Beimfohr: I think there are only a handful of money management companies in this country that are attempting to manage money the way we are. We are bottom-up stock pickers using anomalies as the driver of the process. I could name three or four others that do it this way, but there aren't many. The way we can most practically deliver our results is to have basically a portfolio of 15 to 25 names, which means that we are more concentrated than most. At least the institutional world calls that concentrated. For some institutions that's too much concentration; they want to see portfolios that are 100 names or more. But the mathematical reality is that you capture 90% of all diversification benefit once you have 12 to 14 names, provided they aren't in overlapping industries. We believe the loss of focus that invariably accompanies greater numbers of holdings is a strong reason not to try to capture that last 10% of diversification benefit. In reality, the reason the behemoth money managers hold so many issues in their portfolios has more to do with trading liquidity and business risk (their business) than it does diversification benefits for the investor. So we believe size, in addition to process, gives us an edge as well.

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TWST: Looking ahead, what potential problem areas or challenges (that we are not already facing) do you think investors should be wary of?

Mr. Beimfohr: I have been in this business 36 years and there have been two or three times in that period when the external environment totally overwhelmed anything to do with individual stock considerations. You can own a company where the earnings outlook is bright and mutual funds can be selling that stock down and down and down because they are getting liquidation notices from

401(k) account holders to sell their fund and their fund owns that stock, and they end up having to sell that stock.

I think this is one of the imperfections that we are going to have to live with where 401(k) legislation basically created accounts for individuals to manage. The practical part of it is that individuals pick mutual funds from a preselected menu in their 401(k) plan, and they have the ability to switch holdings. All academic evidence suggests that they underperform the market by 4%, 5%, 6% per year. I even saw one study say 10% a year underperformance by individuals buying at the wrong points in time and selling at the wrong points in time. They don't even have a stockbroker to talk to! They are just thrust into this position of being an employee and having a 401(k) account, and now they have to pick mutual funds. They don't have any basis for knowing how to do this. 401(k) account holders are going to be the new crowd and they're going to create the upcoming market bottom when the heat in the kitchen will be way too intense for them. They will all become convinced that they won't have any money left for retirement if they don't take evasive action, and of course, that will be the wrong thing to do.

Most of the sentiment indicators right now will tell you that the market is "oversold," and in a position where historically the forward 12-month returns are on the order of 20% for the S&P 500. Yet tragically enough, these 401(k) investors will all be selling when that market bottom is being created, and it will cause good companies to go down to ridiculous levels because the funds that owned these stocks have to throw the baby out with the bath water. Mutual funds will not sell themselves down to a place where they only have five or 10 stocks. At the bottom they will still have a 100 stock portfolio like they did at the top. What that means is, they're selling the great ones with the good ones, and they are all good because otherwise they wouldn't own them, right? As a fund manager, you can have your nose in the minutiae of trying to figure out should I own Stock A or Stock B, and it's all for naught because they are all going to get sold off together. Some of this is going on now because there have been 11 consecutive months of domestic equity funds liquidation so far. Whenever you string together that many consecutive months of liquidation, it's going to lead to selling across the board in almost all names, and there will be very few places to hide. You can just picture these poor hapless and helpless 401(k) investors trying to grapple with the current environment. It's not a pretty picture.

As I said, I have only seen maybe two or three times when this has occurred; certainly 1974 and even the 1980 to 1982 time frame — those were such times. We went through it again in 1987. I don't think we really went through it in 1994 and 1998 and I'm not sure we really went through that much in 2000, 2001, 2002 up to March 2003 actually, but we are going through it now and there will be tremendous bargains out there. Insider buying is confirming this. Forward p/e's are low, even if one makes further downward adjustments for recession. If you think of stock prices in terms of sinusoidal waves in mathematical terms, the point at which you first think something is cheap is not going to be the bottom. You have to resist the temptation of buying something when you first think it is cheap because when you first think it is cheap, it's because you've been stimulated by looking at past prices relative to today's price, and that simply means that tomorrow's price will be lower yet, because it is statistically highly improbable that you will come to that cognition right at the market bottom. You'll come to that cognition before the market bottoms.

The point is this: if you have to walk through the valley, better to buy them on the far side of the valley than the near side of the valley. That's better mathematically and it's certainly better emotionally.

TWST: Is there anything that you would like to add?

Mr. Beimfohr: I think these are very difficult times. I doubt that the bottom of the market has been reached yet, but I don't believe it is very far away. I would encourage people not to shoot themselves in the foot in this environment by taking what seems to be obvious evasive action. Obvious action is almost always wrong action. The compulsion to sell is strong, and investors are wondering if Chicken Little might not have been right. There are investors out there who are sophisticated, highly educated people who are wondering if liquidating their portfolio isn't the thing they should be doing. The fact that Treasury bills are yielding their lowest rates in 50 years tells you that there has been an enormous flight to safety and the fear factor is running high. But this too shall pass.

TWST: Thank you.

Note: Opinions and recommendations are as of 3/28/08.

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