Knightsbridge Asset Management, LLC

October 30, 2008

Fall Commentary

"Present fears are less than horrible imaginings"

-William Shakespeare, 1564-1616
-English Playwright and Dramatist
-MacBeth, Act 1, scene iii
-MacBeth ruminating to himself

The S&P 500 lost a fifth of its value in the first ten days of October, and 28% through Friday the 24th. That's not year-to-date, that's since most investors got their last monthly statement! At this rate of drop, the stock market should reach zero by January 15th, about the time our new President will be preparing his 'State of the Union' speech. And some state it is in. For anyone invested in the stock or bond markets, it seems Shakespeare must have been a cockeyed optimist as "present fears" appear to be much more than just "horrible imaginings"; rather, they have become "horrible realities".

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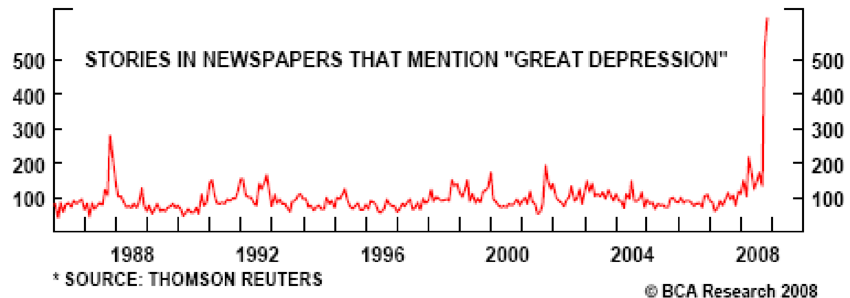
What investors have been subjected to in the past few weeks reads like a Kafka novel; disorienting, surreal and unlike anything previously experienced. Like dominoes falling one upon another within the financial system, Fed and Treasury have rushed to shore things up with equity infusions into banks, buying up of commercial paper, expansion of FDIC insurance, and money market fund asset purchases to prevent their "breaking the buck". All this, in addition to purchases of troubled mortgage paper from failing institutions, accelerated by the bankruptcy of Lehman Bros., the first time since the Great Depression that an institution with access to the Fed window defaulted on their bonds. Allowing the bankruptcy of Lehman is now widely seen as a policy mistake in light of subsequent chaos and blowing-out of credit spreads. It was said this could not happen, but it did.



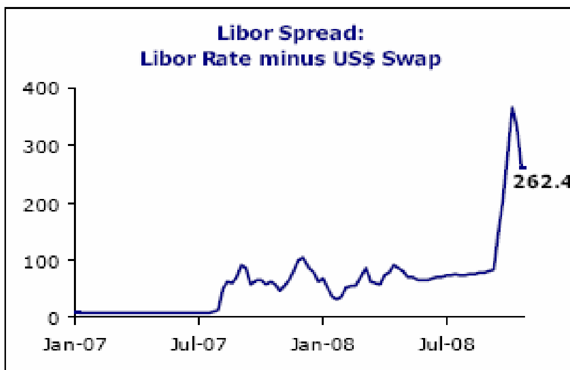
Treasury Secretary Hank Paulson, earning the sobriquet "King Henry", went to Congress the last week in September to sell a three page plan, now known as TARP (Troubled Asset Recovery Plan). By the end of the week, a 730-page document had passed, replete with pork of every flavor. The nationalization of Fannie Mae and Freddie Mac, the forced acquisitions of Merrill Lynch by Bank of America, of Washington Mutual (and Bear Stearns) by J.P. Morgan and Wachovia by Wells Fargo as well as the failure of A.I.G. and the issuance of commercial bank charters to the two last remaining independent investment banking firms, Morgan Stanley and Goldman Sachs, set the stage for the market rout that followed. The CDS (credit default swap) market is in total disarray (think of credit default swaps as wagers that a particular company bond will or will not be able to pay its interest). Treasury's decision to try to put up a fence around the nine largest banks in the U.S. marked a turning point. Although not made public at the time, it now appears that the money being injected into these favored banks in the form of preferred stock purchases is intended to facilitate a series of shotgun weddings with lesser institutions. Possibly this is because FDIC funds are now down to $45 billion which, for example, might have been inadequate in the case of Washington Mutual to take over an institution with a $320 billion mortgage portfolio of dubious quality.

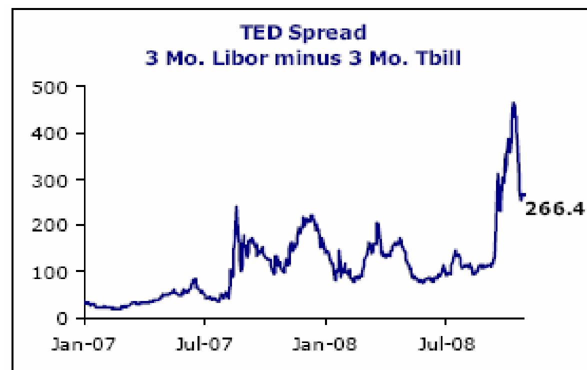
Although perhaps too soon to declare victory, three widely watched indicators of system health have been showing improvement:

1) U.S. T-bill rates (we want to see their yields go higher which would indicate a lessening of a flight to quality),

2) LIBOR, an acronym for the London Inter-Bank Offered Rate, the rate at which banks lend to each other (we want to see these yields come down indicating banks are more willing to lend to one another), and,

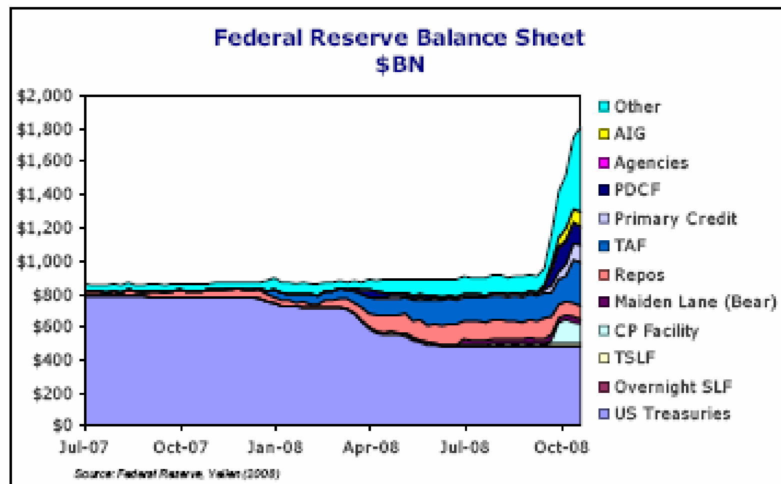
3) the TED Spread, acronym for the Treasury Euro Dollar spread (we want to see this differential shrink).





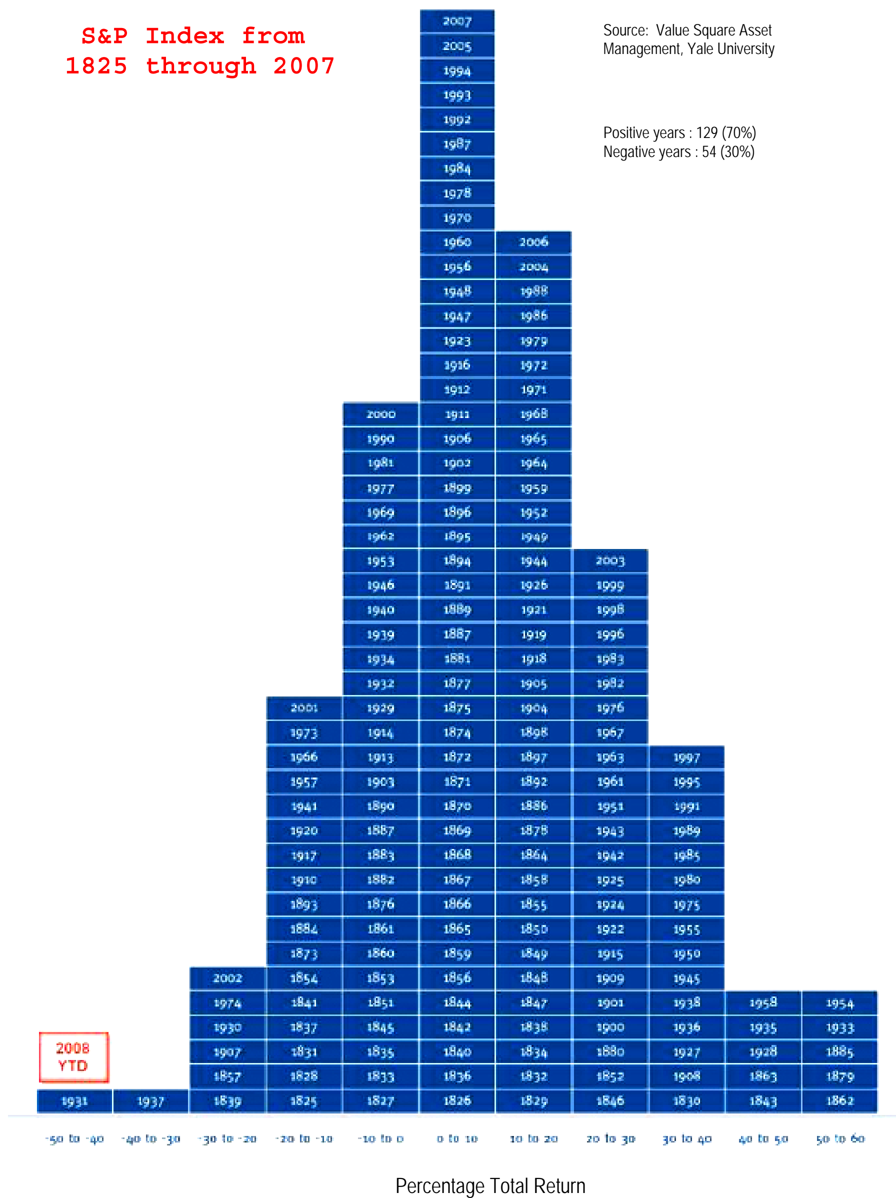
Each seems to be going in the desired direction. Certainly, when the Fed brings out the howitzers and bazookas, one should not stand in the way. As seen above in charts by Strategas Research Partners, LIBOR rates are beginning to come down, and the TED spread is narrowing.

The Federal Reserve 'balance sheet', which is to say the assets owned by the Fed, has changed dramatically, almost doubling in the past several weeks. Moreover, the agglomeration of assets owned by the Fed, which now includes mortgages, etc., is only 30% U.S. Treasury paper now whereas several weeks ago it was 90% U.S. Treasury paper. What the outcome of this bloating will be



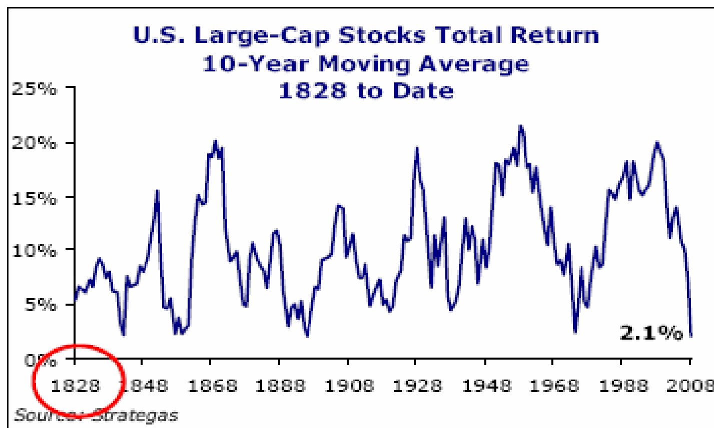
down the road remains to be seen. The list of governmental actions taken so far in the month of October alone and the size of each commitment is illustrated by the Federal Reserve Balance Sheet on the previous page.

The central question for equity investors bludgeoned and shell-shocked by events of the past month is whether the stock market has hit bottom… "*a*" bottom or "*the*" bottom. Since there seem to be few or no historical precedents within memory to the current fiasco, we think investors need to look at some very long market history in order to capture as many data points as possible to draw appropriate conclusions.



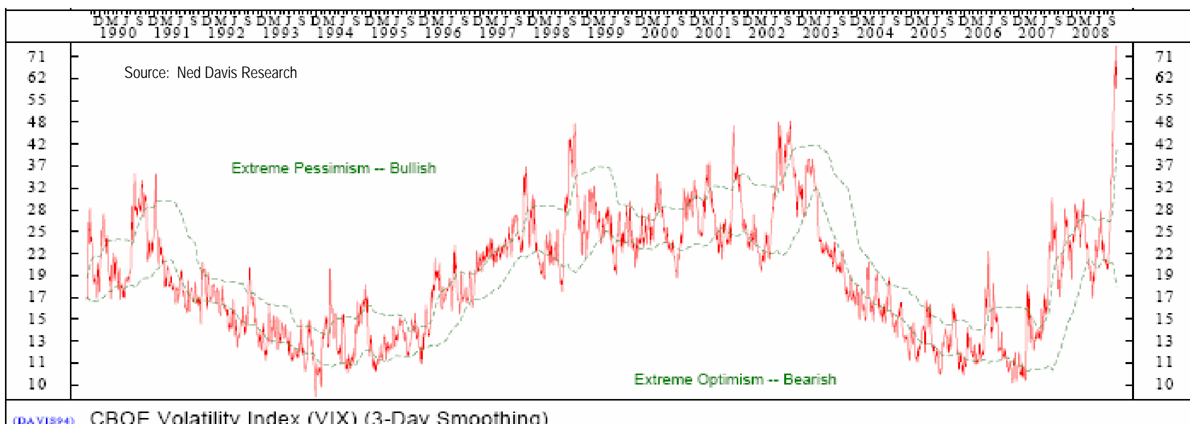
As can be seen here, so far in 2008, the decline is only matched by 1931, the worst year on record since 1825, a period of 183 years! This history takes in the collapse of the currency in 1842, the civil war 1860-1864 and subsequent inflation, then deflation, the banking panic of 1907, WWI, the crash of 1929, and more recent and memorable history. Clearly the history books will be talking about this one for many years to come.

Nor has the decline been confined to stocks. High- yield corporate bonds dropped 18% in the 40-day period from September 1st to October 9th. According to Martin Fridson of Fridson Investment Advisors, a drop of half this amount should happen only once every 27,000 years. Lucky us! Such a price drop is predictive of a quadrupling in default rates in the next year, from about 3% to some 12% according to Mr. Fridson. This is despite the non-financial sector cash/debt ratio being at a 48-year high and non-financial debt/net worth ratio at a 38-year low.



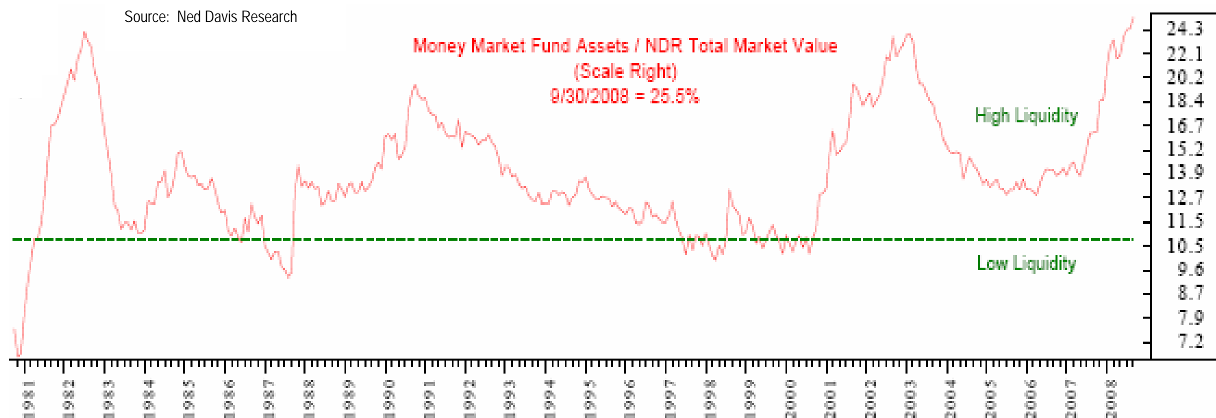
The chart at left shows that whenever the ten-year return on the Dow Jones Industrial Average drops to only 2% per annum, the future returns move higher. The DJIA is presently about 8500, and was about 8500 in October of 1998, and dividend returns have been approximately 2% through this period. Since no sane person would invest money in the stock market over a period of ten years to achieve a return of only 2% per annum, such an extended period must culminate in profound investor disappointment. Conclusion: a buying opportunity seen only once every 40 years, or five times in 180 years going back to 1828!

Stock market volatility has hit extremes never before seen. The popular VIX index is an index of volatility. Heretofore, the highest volatility ever recorded, which is always occurring at market bottoms, was a VIX (3-day moving average) reading of 47…only to be eclipsed by the current read of 67.



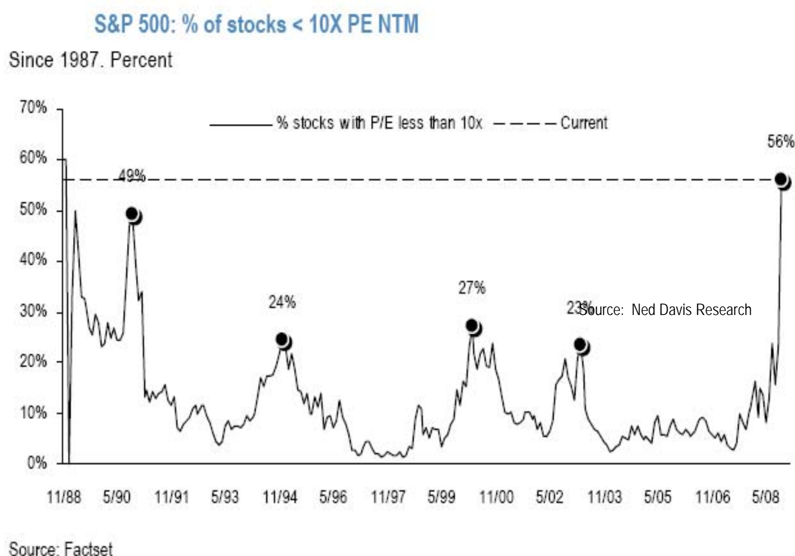
CBOE Volatility Index (VIX) (3-Day Smoothing)

Another bullish indicator is the amount of sidelined cash in money market funds as a percentage of equity market value. The chart below shows this cash at all-time highs.

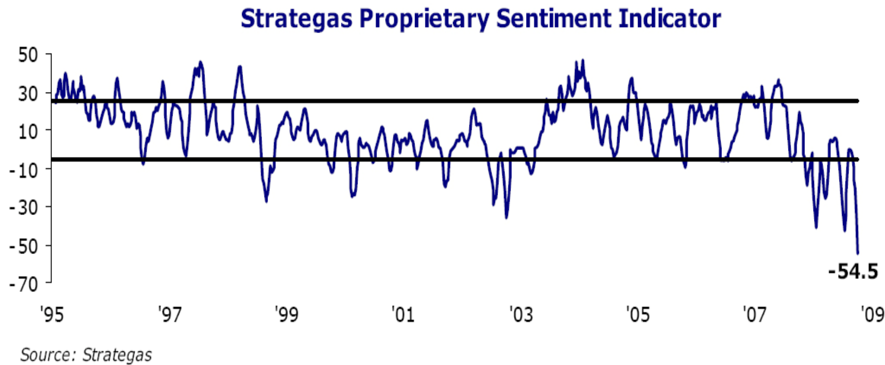


However, the story is even more extreme than shown here as this data is as of September 30th, and the overall market has dropped at least 25% since then reducing the denominator of the fraction accordingly. Also, no adjustment has been made for the flight to direct purchases of T-bills which has even driven their yields negative on several occasions in the past two months. Therefore, with these two adjustments, the already highest reading ever, is even dramatically higher, possibly by as much as 35-40%. Previously the highest readings were in 1982 when T-bonds yielded 15% and T-bills double digit. The way this data should be viewed is "fuel for the next bull market". But then again, who is thinking in terms of the next bull market? No one.

Another indication extraordinary values may be upon us is the observation that 56% of the S&P 500 Index now has a P/E ratio below 10. Since this statistic is calculated using consensus earnings for each stock, naysayers might

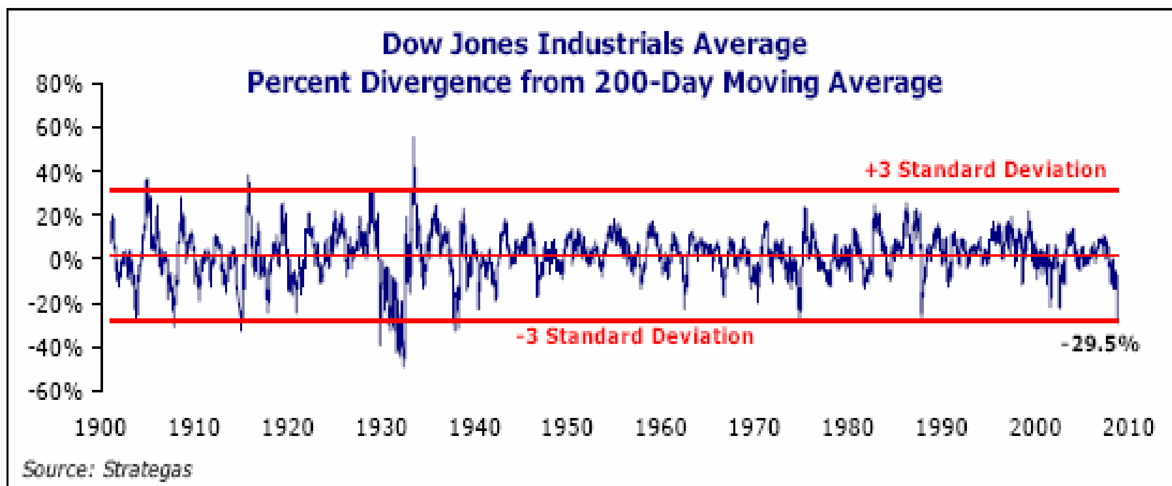


claim the earnings being used are too high. This is surely the case, but the conclusion is still valid since prior data points were created using the same flawed estimates being made at the time.



We all know intuitively that equity market sentiment must be at all-time lows. Nevertheless, it is always instructive to visually see just how extreme it is. The chart above only goes back to 1995, but sentiment is the most negative it has ever been as seen here. Moreover, just today it was reported that the Conference Board Survey of consumer sentiment reached a reading of 38 for October, the lowest reading ever, and down from 61 in September, placing equity market and consumer sentiment in synch.

Yet another indication the fall in equity prices may have reached a proximate bottom is a measurement of how far the Dow Jones Industrial Average has gone below its 200-day moving average. This measure shows that as of October 10th, the DJIA was three standard deviations (3 sigma) below its 200-day moving average, a rare enough occurrence that it has happened only three times since 1937 (1974, 1987 and 2008).



Investors have been subjected to an emotional roller-coaster the likes of which are seen perhaps once or twice in a lifetime. No one would voluntarily submit to the type of financial torture all investors have experienced in the current malaise. Once again, unintended consequences have come into play, and one can only hope not to compound the present damage by taking wrong action at the wrong time. But temptations are great. We apologize to all our investors and constituency for having taken part in this drama, and are looking forward to days when volatility returns to more normal levels and investment returns are once again in the positive column.

Our experiences in October 2008 will not be soon forgotten. We are reminded of the poem written by William Ernest Henley in 1875 entitled "*Invictus*" (Latin for "Unconquered").

Out of the night that covers me,
Black as the Pit from pole to pole,
I thank whatever gods may be
For my unconquerable soul.

In the fell clutch of circumstance
I have not winced nor cried aloud
Under the bludgeonings of chance
My head is bloody, but unbowed

Beyond this place of wrath and tears
Looms but the horror of the shade
And yet the menace of the years
Finds, and shall find me, unafraid

It matters not how strait the gate,
How charged with punishments the scroll
I am the master of my fate;
I am the captain of my soul.

Very truly yours,

Alan T. Beimfohr John G. Prichard, CFA

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