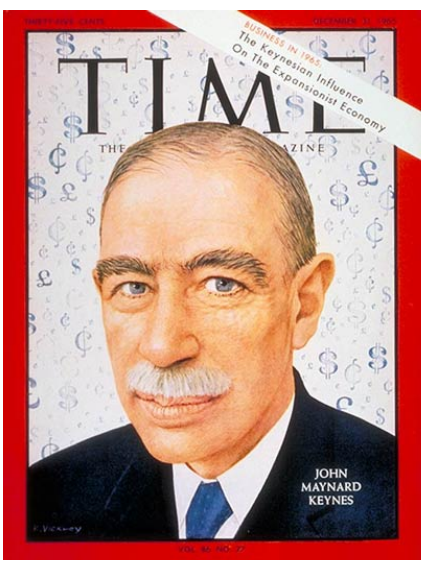
Knightsbridge Asset Management, LLC

October 13, 2009

Fall Quarterly Commentary

"I feel no shame in being found still owning a share when the bottom of the market comes. I do not think it is the business of serious investors to cut and run on a falling market. I would go much further than that. I should say that it is from time to time the duty of a serious investor to accept the depreciation of his holdings with equanimity and without reproaching himself...an investor is aiming, or should be aiming, primarily at long period results and should be judged solely by these."



John Maynard Keynes, 1883-1946

British economist, investor, mathematician, journalist

1938 letter to Francis Curzon, National Mutual Ins. Co.

John Maynard Keynes: The Economist as Savior, 1920-1937 by Robert Skidelsky

Source credits: Murray Stahl, Horizon Research Group

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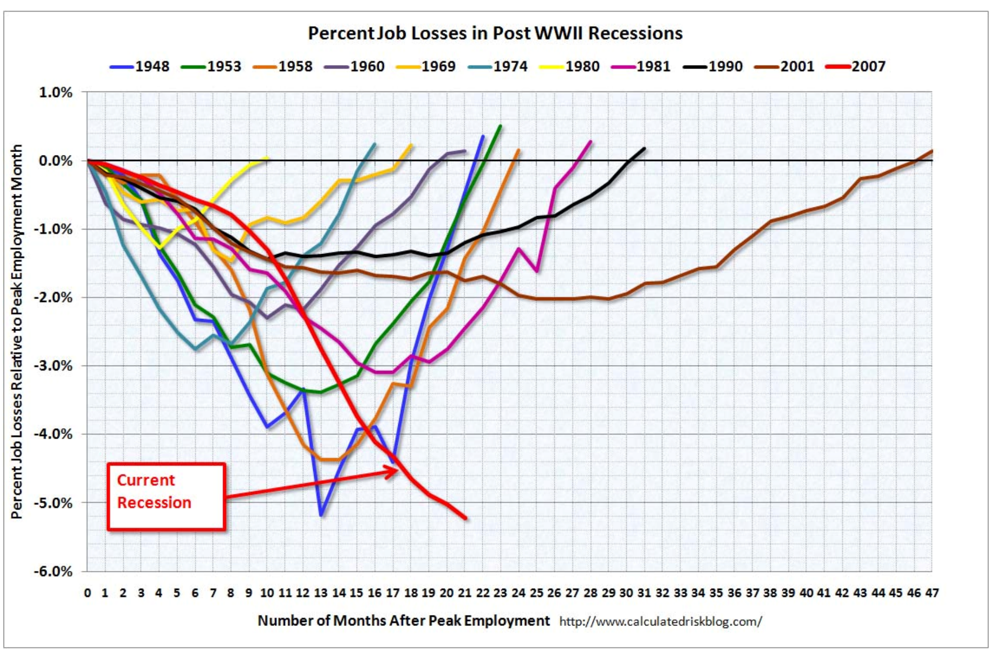
John Maynard Keynes managed the endowment of Kings College, Cambridge University from 1927 to 1945, and outperformed the U.K. Index by better than 9% per annum. This incredible investment feat caused the "Chest Fund" as it was known, to increase five-fold while the averages dropped by 15% over the same period. Even more remarkable, the "Chest Fund" lost 50% of its value from 1927 to 1932, implying that in the following period, 1933 to 1945 the returns were on the order of 22% per annum, not only completely overwhelming the earlier 50% loss, but going on to achieve a truly stellar performance. We are certain Morningstar would have awarded him five stars.

So with the past quarter showing the greatest quarterly increase in the S&P 500 in the past eleven years at 15.6%, as well as the most rapid recovery from a market bottom since 1938, investors, like Keynes, have been rewarded for ignoring the impulse to "cut and run on a falling market".

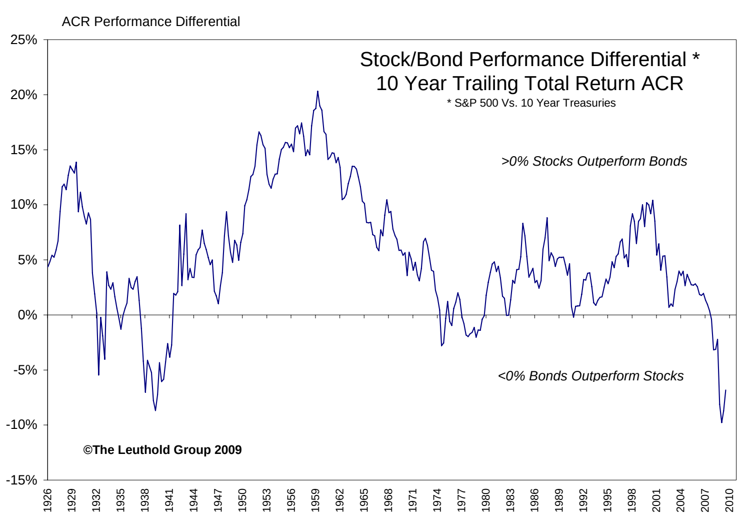
Armchair investors are having trouble reconciling high and increasing unemployment with high and increasing stock prices. As can be seen here, the current recession has brought with it the steepest job losses in at least 60 years. In fact, private sector job creation has been almost nonexistent in the past decade which leads some to conclude that future job creation prospects must rely heavily upon the public sector.



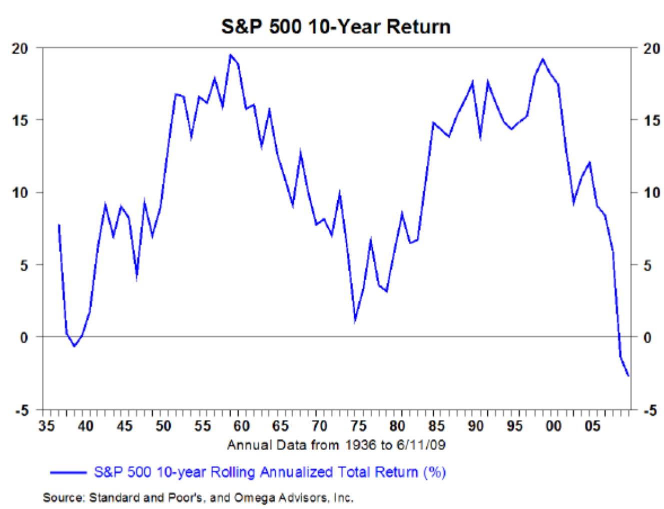
Our take on it is that "computerization" and its aftermath are significant contributors; after the initial surge in private sector employment when the information age was dawning, roughly 1990 or so, new jobs were being created, especially for young people with the latest skills. Now, the ubiquity of the computer is reflective of market saturation and slow unit growth. Where are the secretaries? Everyone is at their own keyboard. Dell Computer, a good proxy, traded for $60 per share in March 2000 on its way to $8 per share in March 2009. Earnings grew at only 6.1% per year over the past decade and the stock's return an insulting -9.3% per year.

There continues to be general disbelief in the merits of equity ownership. For the 40 year period ending March 31st, 2009, the annual total return from owning the S&P 500 bettered owning 10-year treasuries by just 30 basis points (3/10ths of 1%) per annum! Again, 40 years! According to The Leuthold Group, that is the skinniest differential since 1926.

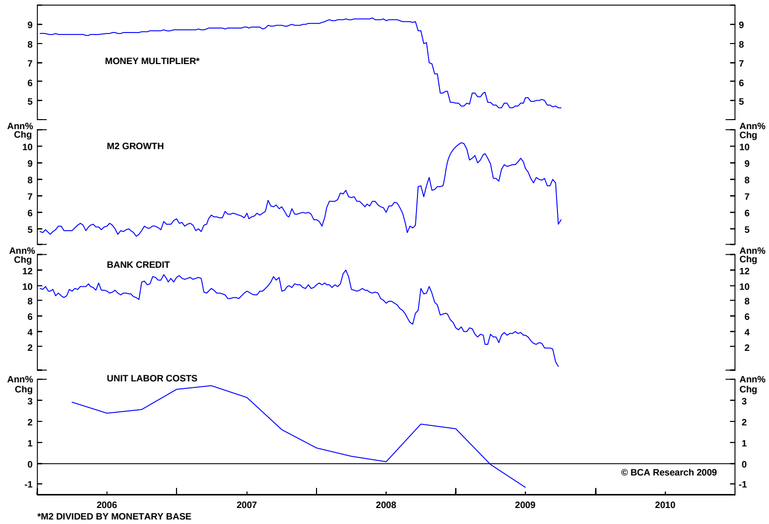
As seen in the charts below, the performance for the S&P 500 over the decade ending June 30, 2009 lagged the return on 10-year treasuries by an astounding 8.7% per annum, and on an absolute basis, returned a negative 2.7% per year. Small wonder equities are despised.



ACR = annualized compounded return



Avoidance of equity ownership has brought with it its twin brother, the love of bonds, particularly treasuries. The latest three-year treasury auction brought an interest rate of 1.375%. Market Watch informs us that bond market timing newsletters were more bullish on bonds than at any time in 8½ years. Can this crowd be right? We doubt it. Clearly the treasury market is absent any fear of an inflationary resurgence. And after all, inflationary indications are well hidden, as seen above.



The battle between deflation and reflation is just warming up, and we are inclined to the position that reflation will be the ultimate winner. In order to protect oneself from the declining bond prices that would ensue should interest rates rise and a reflation occur, today's bond investor must accept miniscule yields in nearby maturities. Apparently China believes this to be a serious matter: as can be seen here, China has departed from past practice and dramatically opted for the shortest maturities.

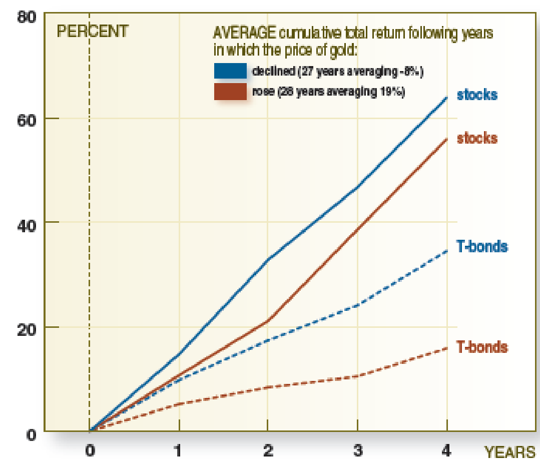
We can only conclude from below one of two things: either they have alternative uses for the money (like buying gold preparatory to floating a convertible yuan) and plan on liquidating soon to facilitate the alternative use, or, they see some risks that were not before present, possibly reflation risks to longer maturities which could be related to a declining dollar. This is worth watching because its implications are so far reaching and profound.

Bretton Woods Research claims that $960 (now $1047) gold prices are predictive of 6% to 6¼% inflation per annum over the next 10 to 15 years. Gold price moves upward have a long history of being highly correlated to, and predictive of, future inflation. Clearly this line of thinking is 180 degrees from the majority of today's bond investors and should be given some credence. For its part, the Fed is doing all it can to produce a little inflation and break the back of the mind-set that only sees lower prices on real estate, the collateral for the nation's banking system.

Gold has just broken out to fresh all-time highs at $1047 per ounce. We note that H.C. Wainwright Economics is using gold prices to predict which asset classes will underperform and outperform. As one might guess, rising gold prices are predictive of the underperformance of bonds relative to stocks, commodities and real estate.

Delayed Response of Stocks and T-bonds to Changes in the Gold Price

from 1950



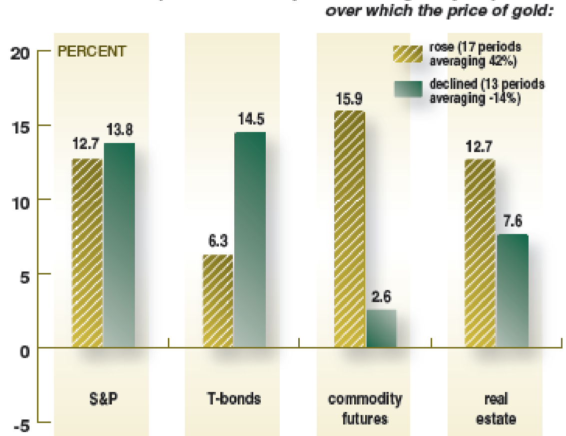
Data: Calendar-year averages of daily prices for gold (*Metals Week/Wall Street Journal*) and of month-end total return indices for the S&P 500 and long Treasury bonds (University of Chicago/Dimensional Fund Advisors).

Source: H.C. Wainwright & Co. Economics Inc.

Gold as a Leading Indicator of Asset Performance

stocks, bonds and inflation resistant assets
from 1978

AVERAGE performance for years following two-year periods over which the price of gold:



Data: As for Figures One and Two.

Source: H.C. Wainwright & Co. Economics Inc.

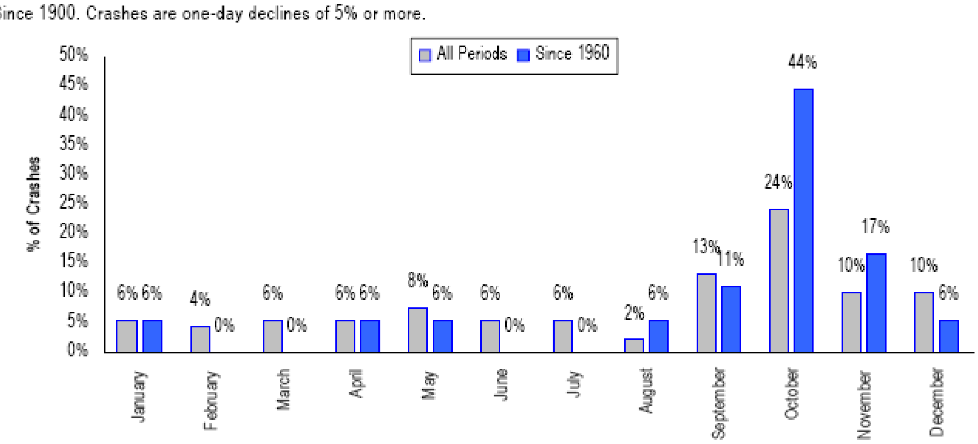
Although a two-year rising gold price does not affect aggregate stock price returns significantly, or at least hasn't over the past 32 years, the same cannot be said for bond returns, where it is a strongly negative factor.

Going back in time we have been on record saying: 1) the euro would be a success, and 2) the U.S. dollar was destined to eventually lose its privileged perch as the world's reserve currency. We did not anticipate the second line item to come into focus quite so quickly. But it seems it has.

The move to new highs in gold came on the heels of a British newspaper article that claimed certain finance ministers were meeting secretly without U.S. participation to construct a new world "reserve currency" to consist of a basket of euros, yuan, yen, dollars, etc. Also of importance, last month China floated its first yuan-denominated sovereign bond issue. In the meeting referenced above, China has asked for a transitional period within the envisioned nine-year time frame for implementation wherein gold would have a role. The transition would be complete by 2018. Apparently Treasury Secretary Timothy Geithner has given these people the green light from stunning comments made last March. China owns very little gold. Recently the IMF sold 14 million ounces of gold, almost three times the annual production of Newmont Mining, to fund a world poverty eradication program. We suspect China was the buyer, paid for it with unwanted U.S. dollars, and that this is the beginning of a program to facilitate the path to yuan convertibility, where partial gold backing may be needed. We expect gold to be going higher for these and other reasons.

The end of the third quarter and the coming of October had the market on tenterhooks. As can be seen here, a disproportionate percentage of market "crashes", defined as a daily drop in excess of 5%, have taken place in October.

Since 1900. Crashes are one-day declines of 5% or more.



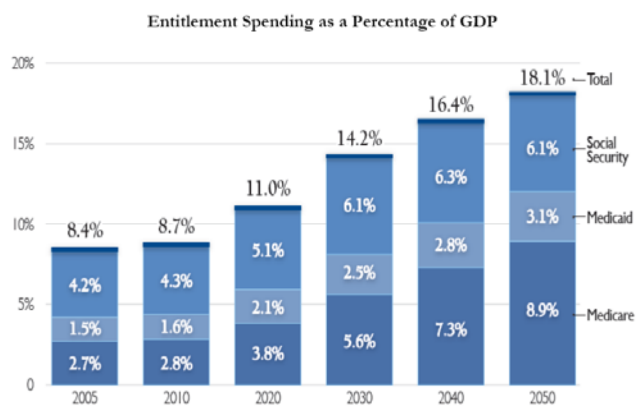
Source: Bloomberg.

Following an unusually robust advance from the March bottoms, a certain acrophobia has set in as investors prepared for something in excess of a 5% aggregate market retracement, the largest experienced so far in the past six months. Disappointed they were as new highs arrived early in October displacing earlier fears of a crash.

Get ready for the V.A.T., the value added tax. This is a stealth tax perfected by the Europeans, where one will barely notice that the tax is being paid because you can't see it.

As this line of thinking goes, budget imbalances only get worse with the passage of time, so the country will need a big tax revenue generator to plug the hole. After all, irrespective of changes in marginal tax rates, which have varied from 29% to 91% over the past 50 years, Federal income tax collections have never exceeded 20% of GDP. The following charts depict the problem:

1) Entitlement spending is out-of-control.

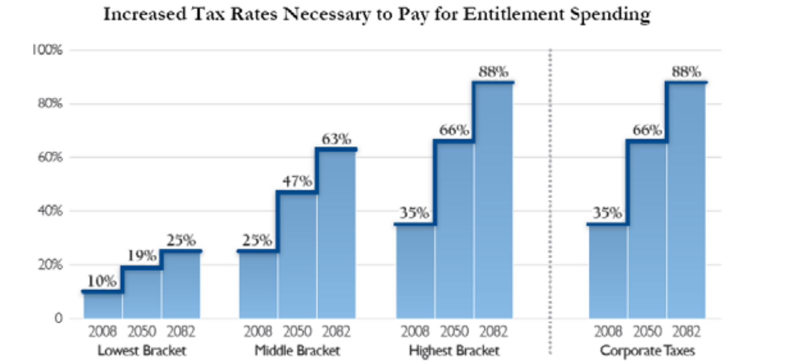


Source: The Heritage Foundation 2009 Federal Revenue and Spending Book of Charts; and Congressional Budget Office

Chart source: PGPF, Congressional Budget Office, US Treasury, Office of Management and Budget as at January 2009

2) Federal debt levels are out-of-control. Forty percent of every dollar spent is currently borrowed.

3) **The Federal income tax rates required to pay for out-of-control entitlement spending are not practical.**



Source: The Heritage Foundation 2009 Federal Revenue and Spending Book of Charts; and Congressional Budget Office

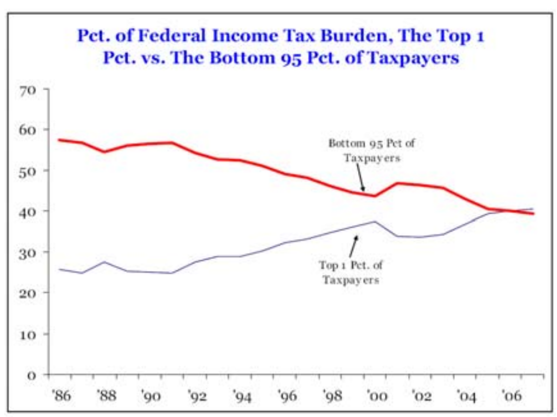
Distribution of the Federal Income Tax Burden

2006	Income Earned	Taxes Paid
Top 1%	22.7%	38.7%
Top 5%	38.3%	59.2%
Top 10%	49.0%	70.1%
Top 25%	69.3%	85.8%
Top 50%	87.7%	96.9%
Bot 50%	12.3%	3.1%

Source: Strategas Research Partners, LLC

4) **Federal Income Tax: Top 10% of earners pay 70% of total taxes already.**

5) **Federal Income Tax: Top 1% of earners pay as much as bottom 95% of earners.**



Source: Strategas Research Partners, LLC

6) **Raising income taxes alone will not raise enough money to plug the hole...we are currently spending 28% of GDP, collecting income taxes of 20% of GDP.**

We do not know if the administration and Congress will follow through on the V.A.T. Recent indications are that a financial transactions tax is also being considered. In either event, the magnitude of the problem created is severe and *something* has to give, or *somebody* has to give, or both.

In the first eight months of 2009, bond funds attracted $209 billion in fresh monies and equity funds only $15 billion. Of the ten best selling funds, only one was an equity fund. Normally equity fund purchases exceed bond fund purchases by 2:1. For these and other reasons, we believe the stock market has more upside than experienced to date.

John Maynard Keynes espoused and practiced a "buy and hold" investment strategy...he walked his talk. He proved that superior returns could be achieved in flat markets. "Buy and hold" is a strategy discredited by the past year's market action in the eyes of many, but one to which Mr. Keynes adhered. He also rejected portfolio rebalancing in favor of letting winners run. He apparently believed that selling winners to add to losers was not a winning prescription.

We have great respect for Mr. Keynes even though free-market Friedmanites might object to his interventionist philosophy. We believe that investors would be well advised to memorialize the words of John Maynard Keynes. We believe they are every bit as true today as they were in the first half of the 20th Century.

We especially thank our investor constituents for "staying the course" through the past months and believe the rewards have been self evident.

Very Truly Yours,

Alan T. Beimfohr **John G. Prichard, CFA**

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