Knightsbridge Asset Management, LLC

May 7, 2007

First Quarter Commentary

"For every problem there is a solution that is simple, elegant, and wrong."

- Henry Louis Mencken, 1880-1956
- (AKA H. L. Mencken)
- Journalist, satirist, social critic
- Newspaperman, The Baltimore Sun
- Prejudices, Second Series, 1920

Where was H. L. Mencken when we needed him, the man never accused of seeing the glass "half full". Regretfully, he didn't live to see Sarbanes-Oxley enacted into law, the legislation that was going to save investors by requiring greedy CEOs to exchange their vertical pinstriped suits for the horizontal wide-striped variety. It would have provided magnificent material for Mencken's pen. His opinion of politicians of the type who authored this flawed legislation would be summed up in another of his pithy comments:

"The whole aim of politics is to keep the populace alarmed (and hence clamoring to be led to safety) by menacing it with an endless series of hobgoblins, all of them imaginary."

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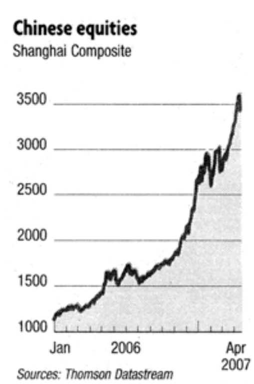
In this case, the hobgoblins were those lying and cheating CEOs who mistakenly took the advice of the army of accountants and lawyers required to interpret government regulations for them, who told them what they were doing was permissible under law.

SarBox, as it has come to be known, is anything but "simple and elegant" but most certainly "wrong", well-intended though it was at the time in 2002. The implementation and maintenance can cost a small public company an extra $3,000,000 per year, almost enough to cover a fired CEO's golden parachute. But looked at another way, that $3 million of foregone pretax earnings at a P/E ratio of 20X is $60 million of lost capital formation. Multiplied by a thousand such companies, this ratchets up to $60 billion. Real money. Therefore, one may safely conclude that the most onerous provisions of SarBox will soon be repealed, obscurely hidden as a rider attached to another bill so as not to severely embarrass its original authors, who might still be holding office. This is important because recent IPOs (initial public offerings) have been migrating to London and Hong Kong away from New York. Last year: Hong Kong, $47 billion, London, $44 billion, New York, $40 billion. The IPO dominance enjoyed by U.S. markets could have a fighting chance of regaining its former preeminent stature from the U.K., China, and other pretenders to the throne with appropriate remedial legislation. Paradoxically, the paucity of IPOs is helping the current market to rise……less supply, other factors equal.

Our shared distaste for politicians is well illustrated by the example provided by the bankruptcy of seventy (70) public companies mired in asbestos litigation. For decades, the government mandated use of asbestos as a fire retardant in naval ship and high-rise building construction. A self-serving federal law deems that one cannot sue the federal government. According to the time-honored deep-pockets theorem, the corporation then inherits responsibility. Since the claims, many of which are fraudulent but allowed by the courts, overwhelm the corporation, and bankruptcy eventually becomes the only option. Shareholders take the blows; never mind that others might be culpable or that new standards are being applied to old actions. When Congress was presented with an opportunity to introduce and pass legislation that would have rendered some element of fairness to this tremendous national problem, no solution was forthcoming as it would have been inimical to the interests of The Association of Trial Lawyers of America, one of the largest contributors if not *the* largest contributor to congressional reelection campaigns. Since the term "trial lawyer" started to get a bad name, the association changed its name to The American Association for Justice……now who can argue with that? This is a sad story, but every cloud has its silver lining. Many of these companies are now exiting bankruptcy and we have them on our radar screen.

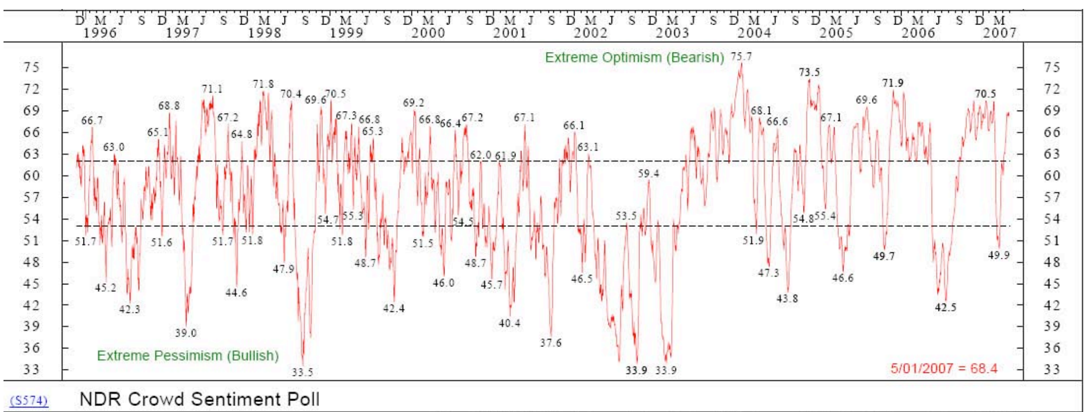
The Chinese IPO market is roaring forward, making the excesses of its U.S. cousin eight years ago pale in comparison. Moreover, the Chinese government is demanding of the more successful recent IPOs that money be refunded to investors! Imagine that! Instead of underwriting syndicates controlling the number of shares floated in an IPO, we have the government. And why? Because the Shanghai market is bubbling over with speculative fever, e.g.,

1) The Shanghai market index has tripled……yes, tripled, from about 1200 to 3600 in the past sixteen months……not years, MONTHS!
2) In January 2007, the number of investors speculating on the Chinese exchanges grew by 1.38 million, up 134% from December 2006 a MONTH earlier.
3) Stock turnover on the Chinese exchanges was up 700% from a year earlier.
4) Trading was halted February 27th on the Shanghai exchange in 800 out of 1400 stocks.
5) The Shanghai exchange dropped 8.8% on February 27th, the largest single-day drop in a decade.



The February 27th "correction" spilled over to world markets with the S&P 500 dropping some 7% peak to trough and the DJIA falling 500 points in one day. The fact that the Shanghai market, fueled by investors buying stock with credit cards and home equity loans, has gone on to new highs following the February 27th action, demonstrates that so far, the Chinese government does *not* have this under control. More draconian measures should be anticipated. Whether world markets again respond as before, one should anticipate that this will be the case, as inter-market linkages and correlations have only become stronger with the passage of time. This Chinese story, though not over yet, is one that will not have a happy ending.

U.S. equity markets have surged to new highs following the February 27th scare, and the April 30th cover of Barron's is trumpeting "Dow 14,000?". In fact, as of May 7th, the Dow Jones Industrial Average has traded higher 24 of the last 27 trading days eclipsing records going back to 1927 (Calvin Coolidge was President). Our contrary nature compels us to consider, along with the investor sentiment indicator shown here, that "Dow 14,000" is unlikely to happen right now.



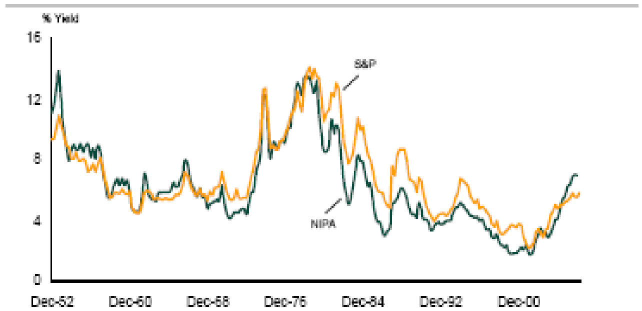
This conclusion is also bolstered by the diminishing number of new highs being made as the market has gone higher. In fact the speed with which this turnaround has occurred is surprising, particularly in light of recent FOMC (Federal Open Market Committee) meeting minutes revealing a Fed disturbed by inflationary tendencies (by the time you receive this postage will have gone up from 39 to 41 cents, but Knightsbridge still has you on our mailing list!). Such Fed comments leave open the chance that further increases in the Fed Funds Target Rate could be required to stanch inflationary forces, particularly if the Fed becomes convinced that the meltdown of the sub-prime mortgage market is controlled. The Fed claims to see no evidence of contagion to other parts of the mortgage market, and has not expressed concern for the values of real estate collateral upon which the lending institutions depend. Also, one must consider that a "correction" in the Shanghai market could take a fair amount of inflationary steam out of the world economy.

Should the Fed see fit to raise interest rates further, the odds of a full-blown recession are enhanced. We believe the equity markets are assuming the Fed will not take this action so as to preempt more serious erosion of real estate values that underlie bank lending collateral.

The positive case for equities is supported by low-enough valuation levels to allow the market to go higher:

1) Earnings yields on the S&P 500 are at 7%.

Figure 6: US Earnings Yields



Source: NIPA, S&P, Lehman Brothers

Earnings Growth Forecasts

	2006 %	2007 %
US	16	6
UK	9	3
Europe ex UK	15	8
Japan	14	12
Asia ex Japan	12	6
Global	14	7

Source: Worldscope, Lehman Brothers research

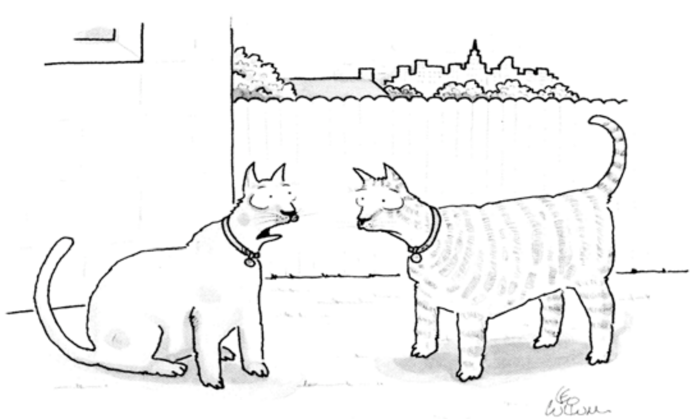
2) Although EPS growth rate estimates for 2007 have been reduced to the 6% to 7% area, substantially below the abnormally high rates of the past few years, this growth is on par with EPS growth averages over the past sixty (60) years.

3) Private equity activity and corporate buybacks are reducing supply of publicly traded equity, and such equity is not being replaced with IPOs discouraged by SarBox.

The growth in private equity may be reaching a peak. Those who may have read of Blackstone, the largest private equity player, undoubtedly were surprised to learn of plans to……go public! What? Go public? Were not these people the high priests of privatization? Typical of deals purchased is a 2% per annum management fee and if the company can be sold for more than purchased, an additional 20% of the increased value, taxed at capital gains rates. This "carried interest" of 20% is now about to be reconsidered by Congress for a change in tax treatment from capital gains rates to ordinary income rates. It seems some people are getting just too rich, and as Vladimir Putin has shown us, really wealthy people who don't agree with the politicians in power are vulnerable to having the rules of the game changed without notice.

We thank our readership for tolerating our diatribes and lending us their ears. We wish you all the best.

Alan T. Beimfohr John G. Prichard, CFA



"The problem is, I'm on life #6, but my money's on #9."