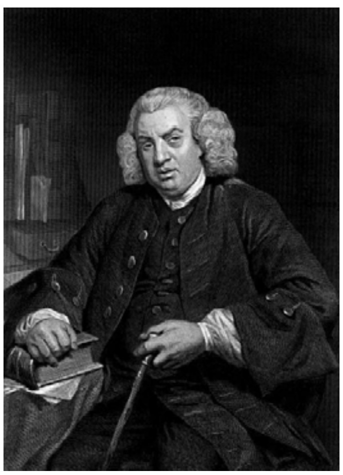
Knightsbridge Asset Management, LLC

August 8, 2007

Second Quarter Commentary



"The whole world is put in motion by the wish for riches and dread of poverty. Who, then, would not imagine that such conduct as will inevitably destroy what all are thus laboring to acquire must generally be avoided?"

- **Samuel Johnson, 1709 – 1784**
- **Rambler # 178**
- **November 30, 1751**
- **British Essayist and Author**

Samuel Johnson was an extraordinary British intellect, a sickly child whose father owned a bookstore. An Oxford College dropout, he narrowly avoided debtor's prison. So says Wikipedia. We are mindful they once threw borrowers in jail for reneging on debt obligations. So we are tempted to contrast this past with today's reality whereby generally low lending standards have prevailed and so-called sub-prime "liar loans", those with no income verification, are coming home to roost. The primary difference between borrowing in the 1750s and 2000s seems to be that certain U.S. Congresspersons want to imprison

the lenders rather than the borrowers. Instead of "debtor's prison" perhaps "creditor's prison". My how things can change in a quarter of a millennium!

But some things have not changed. To paraphrase Mr. Johnson, "the avoidance of conduct that would inevitably destroy wealth" seemed to have been forgotten with the creation of Bear Stearns' High Grade Structured Credit Strategies Enhanced Leverage Fund……which, sadly, turned out to be of lower grade. We confess that our analytical armamentarium includes twenty-twenty hindsight. Nevertheless, it would seem that in addition to violating the covenant of logic that would preclude an investment product requiring eight words in its title, that the rating agencies were complicit. All their bonds were supposedly rated AA or AAA. Apparently Bear Stearns notified investors July 17th that there was "effectively no value left" in this fund. How rude! "Leveraged Fund" implies that money is going to be borrowed at a lower rate to purchase securities providing a higher rate, thereby beefing up the bottom line return. However, if the borrowing costs increase to a point exceeding the return on the typically longer-dated instruments owned, and/or, if some of those longer-dated instruments can no longer pay, and/or, if the owned instruments drop in value for other reasons, then the leverage is negative. Small drops in overall value have a greatly magnified effect on the residual equity. Further, if others are experiencing the same pain and decide to protect themselves from further decline by unwinding some of these positions, i.e., selling, then the instrument's market value drops when a concentration of sellers overwhelms buyers, irrespective of ratings.

In the CDO (collateralized debt obligation) market, which grew by $130 billion last year, pricing may not be what it is on the New York Stock Exchange as frequently there is no "last trade" occurring from which to judge, and no bid into which one can sell, short of a specific solicitation from a seller in need. Prices are often theoretical or driven off treasury levels based on rating and maturity. In the case of the High Grade Structured Credit Strategies Enhanced Leverage Fund, it had $638 million of capital four months earlier and had borrowed……………hang on to your hat……………$11 billion, for a debt/equity ratio of 17x! In other words, for every dollar the investors had in ownership equity, they had borrowed seventeen more. One must have

extraordinary *chutzpah* to believe nothing could go wrong in such a scenario, even though this fund began life with about half the leverage described above, perhaps 8 to 1 debt to equity.

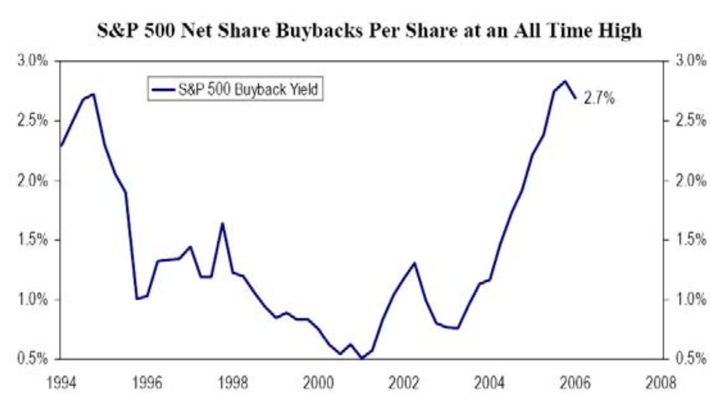
These episodes remind us of former Orange County Treasurer Robert Citron telling the author in a phone conversation during the summer of 1994 that everything was "OK" because Moody's had reaffirmed Orange County's bond ratings at AA-. Orange County filed the largest municipal bankruptcy in U.S. history five months later in December 1994. Their investment pool had been leveraged to a degree that did not allow for the interest rate increases engineered by the Federal Reserve at that time; the rest is history.

Last week's market action demonstrated the degree to which markets are built upon confidence as investors came to question the integrity of bond ratings after a series of belated downgrades by Moody's, Fitch and Standard & Poor's. By Thursday July 26th, investment grade BBB/Baa rated bond issues, hardly junk, were being pulled from offering status due to the spread of uncertainties, a remarkable event. The stampede to safety created a sizable rally in the U.S. Treasury market as well as a widening of all spreads of instruments whose value is driven from treasury levels.

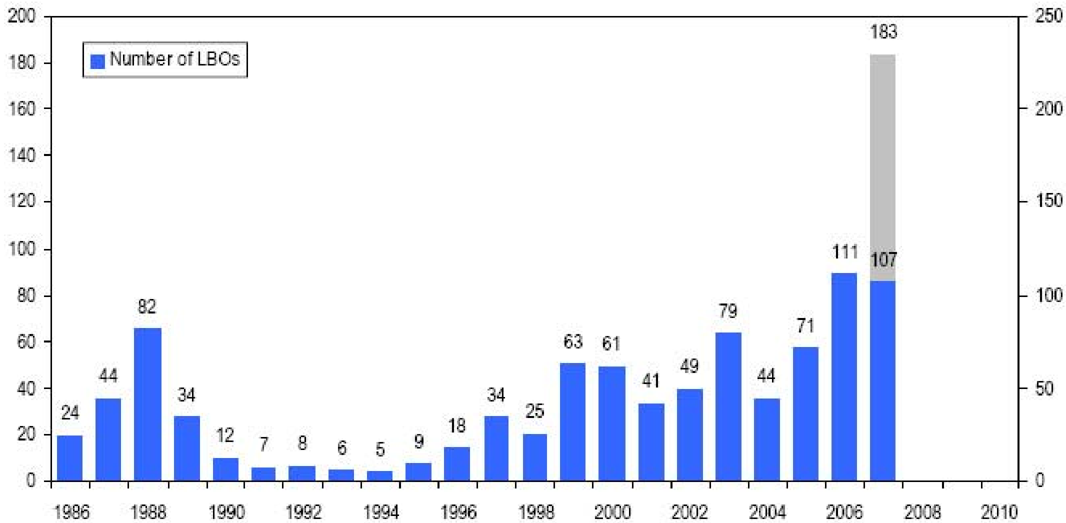
In response to the spreading contagion of the debt markets, the stock market began to swoon, resulting in a 4% to 5% drop in the major indices for the week ending July 27th. A trillion dollar haircut.

We believe this debt-market panic will create an important opportunity to deploy funds to the equity markets for the following reasons:

1) Corporate equity buybacks (net of issuance) continue to hover near all-time highs, running 2.7% of the S&P 500 as seen here and shrinking available supply of shares outstanding.



2) Leveraged buy-outs continue on a pace to greatly exceed the 2006 record of 111 deals. Although we expect the current debt market paroxysm to stall this pace temporarily as debt investors jettison some of the 'covenant lite" types of lending (lending with bond indentures featuring relaxed ratios of cash flows to interest expense, for example). Nevertheless, real (after inflation) borrowing costs remain low, incentivizing borrowing.



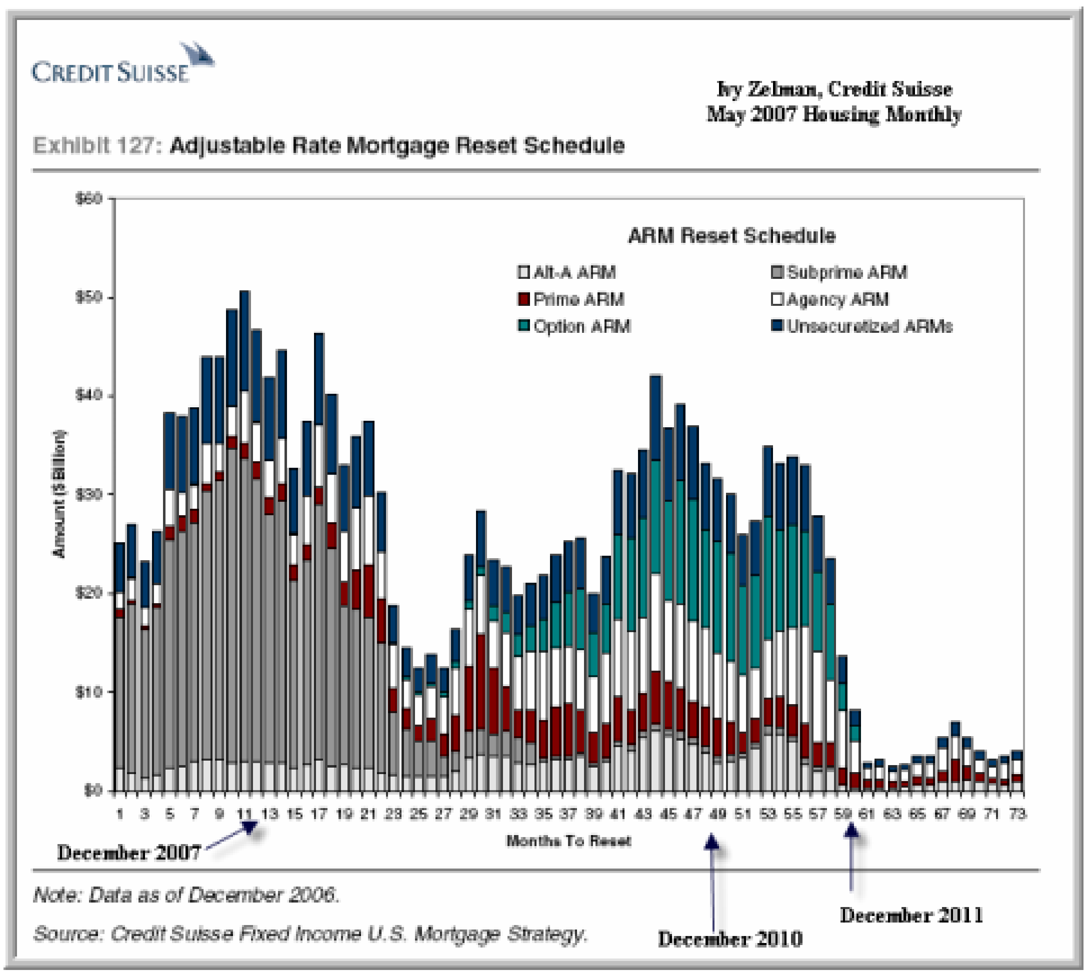
3) Worldwide money growth has gone ballistic (or should we say "postal"?) Nominal (pre-inflation adjusted) M2 annualized rates of money growth as of June 30th were as follows: Europe, 8.7%; U.K., 15.6%, and as of 5-31-07; China, 17.1%. For the year ending 7-27-07, U.S. MZM (money of zero maturity) annual growth is 8.6%. One way or another, this explosive world-wide money supply growth will spill over into the equity and real estate markets.

4) After the recent market decline, P/E ratios are about 16 times trailing earnings and 15 times expected forward earnings. These are low P/E ratios given interest rates, and should allow for appreciation beyond just earnings growth.

Although financial stocks have been hit hard in the recent decline, insiders of financial sector companies were already behaving bullishly earlier in the month. Although one might argue they have been wrong in the short run, we expect their behavior to be exonerated in upcoming months.

←Weekly Insider Sentiment of Regional Banks – above the blue line represents buying sentiment. This week's sentiment was nearly 6x standard deviations above the average.

The peak in sub-prime mortgage "resets" will not occur until the end of the year as seen below. We would imagine



this is further out than some might have been expecting, and raises the question of whether the Fed might be

persuaded by the politics of the situation to be abandoning the current fixation on core inflation fighting in favor of some help by way of lower short-term rates for what is already an incredibly distressed industry situation. Arguing against such action is not only inflation, but 1) high employment levels 2) a budding upturn in leading economic indicators, and 3) a booming commercial real estate market. Furthermore, the currency markets are signaling strong economic growth ahead with strength in the most economically sensitive currencies. It is still possible that further rate increases could be in store.

The past quarter saw euphoria as the DJIA broke 14,000 to the upside rotating swiftly to despair amid the broadly-based decline of the past two weeks. We make every attempt to avoid the emotional rollercoaster that comes with getting caught up in such extremes and continue to persist in leaning against these extremes whenever we can identify them as such. Hopefully this inures to the benefit of our clients. We thank you for allowing us the luxury of such heresies and plow ahead making all efforts to avoid "such conduct as will inevitably destroy what all are thus laboring to acquire".

Very truly yours,

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

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