Knightsbridge Asset Management, LLC

May 11, 2009

Spring Quarterly Commentary

"Remember, democracy never lasts long. It soon wastes, exhausts, and murders itself. There was never a democracy that did not commit suicide."

John Adams, 1735-1826

Second President of the United States, 1797-1801

Massachusetts delegate to the Continental Congress

Constitutional lawyer, Federalist, Unitarian

In addition to the fragility of democracy, Adams believed in "an empire of laws, and not of men", and espoused the independence of the judiciary from the executive branch. Last year's HBO seven part mini-series on John Adams was an exceptional treat amidst the usual television refuse, and served to remind us that our nation was founded on extraordinary ideals if not by extraordinary people as well, some 200 plus years ago. Certainly we should not dismiss Adams' thoughts on "laws and not men" merely because his opinions on "democracy" have yet to materialize. Sadly, many of the ideas and ideals for which our nation's founders fought have been usurped by revisionism in the name of pragmatism, politics and the modern state.

The current executive branch has demonstrated its conditional respect for "laws and not men". Nor should Congress be excluded. When it comes to capitalism and corporate America, new sets of rules are being applied, almost daily.

Supposed "bonus payment abuse" resulted in a stupefying piece of legislation being passed by the House of Representatives that would have taxed all bonus compensation in excess of $250,000 at a 90% rate, proving that populist pressures in a democracy are capable of converting the rule of men into the rule of law by changing the law.

After the defenestration of Rick Wagoner as CEO of General Motors (where was the ratifying shareholder vote?), the administration attempted to muscle a bankruptcy settlement without resorting to the bankruptcy courts where outcomes might be less predictable. So much for the "nation of laws". These moves of desperation ostensibly were well intended, and designed to prevent the reorganizations from being made to the complete detriment of employment and labor, particularly in light of the 2 million U.S. jobs lost in the first quarter, a shocking tally. But the proposed ownership post-reorganization was a bit imbalanced.

The reorganization proposed by the administration would preempt the bankruptcy courts, and for Chrysler would give the U.A.W. fifty-five percent (55%) ownership and 43 cents on the dollar lent while banks would get no ownership and 29 cents on the dollar lent. Fiat (Italy) would get 35% for free.

In the case of General Motors, the U.A.W. would get thirty-nine percent (39%) ownership and $10 billion of future payments for the $20 billion lent, and banks would get 10% ownership and no future payments for the $27 billion lent.

This was seen as unduly punitive in the eyes of bondholders and bankers, and reinforced the notion that the administration was engaged in a war on capitalism. Earlier excoriations of corporate, banking and Wall Street leaders from the bully pulpit had left investors wondering what the next agenda item would bring. They found out. One administration official (according to the Wall Street Journal) was quoted as saying "you don't need banks and bondholders to make cars".   As libertarian author James Bovard states, "Democracy must be something more than two wolves and a sheep voting on what to have for dinner". In this case, the senior secured lenders became the sheep. Baaaaaaaaaah. Mutton anyone?

This raises the question why the present administration, inundated with a daunting avalanche of problems in its first one hundred days, would attempt to finesse such a solution, charges of partiality to labor unions aside. The answer undoubtedly lies in the administration's fear of cascading unemployment, should both General Motors and Chrysler go into bankruptcy at the same time, taking with them a good portion of the entire auto parts industry. There may also be an element of fear as regards the further erosion of the American industrial base and its ability to respond to possible future national defense challenges. But once again we ask, should the end justify the means?

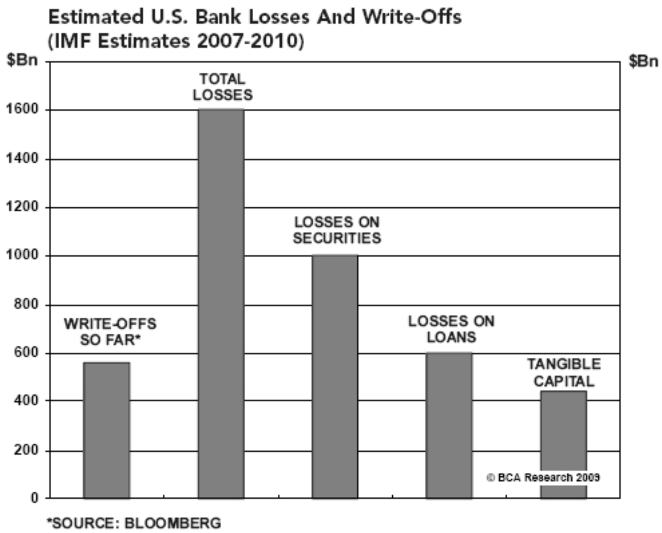
In addition, the banking industry is currently at odds with elements of the administration over capital adequacy issues. For example, whether Troubled Asset Relief Program (T.A.R.P.) funds can be repaid and if so under what conditions has yet to be determined. We find it amusing that Goldman Sachs had executed a secondary offering of its stock, inflicting deliberate shareholder dilution, in order to pay back T.A.R.P. monies and get out from under the damaging compensation limitations set as preconditions for taking such money. We surmise dilution is preferable to government whimsy.

The old system of requiring banks to have differing levels of reserves for Tier 3 (risky), Tier 2 (less risky) and Tier 1 (least risky) assets now appears to be out the same window from which Mr. Wagoner was thrown, having failed to protect book equity under today's economic stresses. In vogue is the "tangible common equity" calculation, which requires a percentage of assets be maintained as equity, after all assets have been "marked to market"...a 6% tangible equity to assets ratio would be good at the nadir of a severe economic cycle. Regulatory authorities had taken this a step further to look at "what if" scenarios in attempting to determine how much capital banks should have. Some bankers were complaining that these stress tests were too draconian, too conservative, would reduce profitability by requiring overcapitalization, and that extremes to which an economy could go were unknowable in advance anyway. Apparently the administration caved-in to this pressure and the capital-raising calculations resulted in smaller numbers than investors expected, igniting an explosive rally in many bank stocks. In two months, Citigroup has gone from "certain to be nationalized" to "shareholders will be diluted into oblivion" to "they only need $5 billion of additional capital, a pittance!". Citigroup CEO Vikram Pandit deserves restitution of his corporate jet. The stock has rallied from $1 to almost $5.

All is not blue skies just yet. Few can make a case that the $6.5 trillion commercial real estate market with $3.1 trillion in loans, has been marked down as severely as it will ultimately need to be, even if residential mortgages have. With delinquencies running 2% in commercial real estate, many estimates are that 8% will be seen before a reversal is underway, which would mean an additional $180 billion in losses, much of which would accrue to the banking system whose tangible equity capital at the moment is about $500 billion excluding preferred stock equity.

The stock market is divided into two camps at the moment: 1) those who believe we are seeing a bear market rally and that banking industry losses, subsequent recapitalizations, and possible nationalizations will cause new overall stock market lows down the road, and 2) those who believe the losses taken and yet to be taken have been discounted in the current price structure, that dilutive equity raises will be accomplished, and that the market lows were seen March 9th.

Some of the discrepancy between the two camps has arisen from the differences between statements made by the more bearish International Monetary Fund (IMF) and more bullish U.S. Treasury Secretary Timothy Geithner.



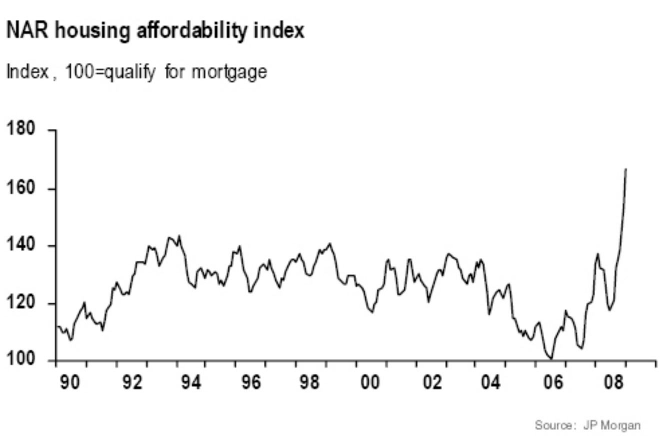
The IMF claims 2007-2010 losses to U.S. banks will be $1.6 trillion of which slightly less than $600 billion have been written off so far. $1 trillion to go. Tangible capital is slightly less than $500 billion, and represents about 3% of $14 trillion in tangible assets (Citigroup and BankAmerica account for about 30% of this asset total). If over the next two remaining years earnings of 1% on assets accrued, as well as a 1% loan loss reserve depletion experienced, then that 4% (2 years X 2%) would absorb about $600 billion (4% X $14 trillion) of the remaining $1 trillion mentioned above, leaving $400 billion to be raised in the equity markets, or to be converted from preferreds into common equity, or some combination thereof. Therefore, today's bank stock prices would on average be anticipating 40% to 50% dilution from an equity raise, with some, of course, much worse. Again, if Citigoup and BankAmerica account for about 30% of the total, they would have to be planning on raising .3 x $400 billion or $120 billion. The fact that the stress tests required only that they raise $39 billion conjointly shows the degree to which the current administration changed their tune at the last minute, after squawking from bankers.

With the equity market up seven of the past eight weeks, investors are breathing a huge sigh of relief, warranted or not. After all, it was reported there were 37% fewer millionaires at the end of 2008 than there were at the end of 2007 in the U.S. So any glimmers of hope have been welcomed with open arms by investors. Clearly the mood has made a dramatic shift, bolstered by economic data showing the rates of economic decline to be lessening. Risk appetites are returning.

For example, corporate non-investment grade bond offerings in the first 13 weeks of 2009 have exceeded those in like period 2008 by almost $5 billion or about 65%! This was in spite of a 19-year low in stock offerings for the 13-week period ending mid-February. But since then, even equity offerings have returned to levels previously prevailing in the 2000-2008 period.

Jumbo mortgage spreads have fallen from over 500 basis points (5%) above treasuries to almost 300 basis points (3%) above, indicating banks are lending to this profitable activity, although they may still be avoiding other types of lending.

The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) has dropped from over 80 in November to almost 30 in April, showing an abatement of the fear factor.



There is even a silver lining to the housing crisis. With new house prices down 27% nationally, and existing house prices in California down a whopping 54%, affordability is now the best it has been in over twenty years relative to household incomes.

Moreover, first quarter earnings in the aggregate have come in above analyst estimates. Surprise, surprise!

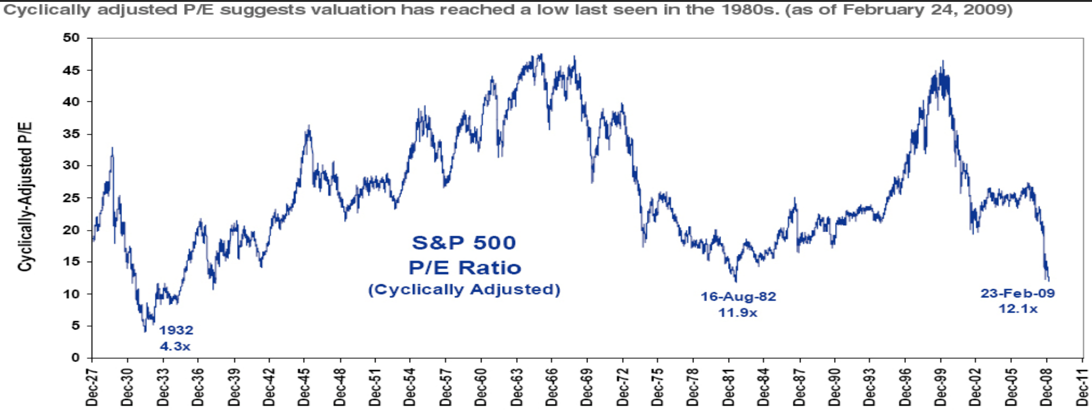
We remind our readership that the market cycle occurs in four phases:

1) Stock prices are going up, and earnings are still going down...confused, investors are asking why...
2) Stock prices are still going up, and earnings are going up...because they are in synch, no one asks why
3) Stock prices are going down, and earnings are going up...confused, investors are asking why...
4) Stock prices are going down, and earnings are going down...because they are in synch, no one asks why

So, 1) is the early phase of a bull market, 2) is the later phase of a bull market, 3) is the early phase of a bear market, and 4) is the later phase of a bear market. It would appear that currently we are transitioning from 4) to 1). Maybe.

Recently it has become popular to look at Price/Earnings Ratios using a ten-year average of earnings in order to smooth out the dramatic fluctuations that can occur as a result of a single year of poor earnings. These P/E calculations are referred to as "cyclically adjusted". In this chart, one can observe that the cyclically adjusted P/E reached a level of 12 times earnings for the market, a level seen only in 1982 and 1932 (when it was as low as 4.3 times such earnings). Also of interest on this chart is that this cyclically adjusted P/E got to 47 times earnings in 2000, so the cyclically adjusted P/E has dropped almost 75% in the past nine years.

Cyclically adjusted P/E suggests valuation has reached a low last seen in the 1980s. (as of February 24, 2009)



Source: Compustat, Robert Shiller, Goldman Sachs Research.

In conclusion, we observe many reasons to become less defensive but feel the market has come up so fast, the fastest since 1938, that a period of digestion is in order. We are hopeful that less severe economic times will allow for the return of "a nation of laws and not men", and that the current populist stridency abates. While we take no issue with the comment that the financial capital has migrated from New York City to Washington, we are hopeful this will reverse in the future.

We thank our constituents for their loyalty, support and faith: most importantly, we have all lived to fight another day.

Very truly yours,

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

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