Knightsbridge Asset Management, LLC

January 22, 2009

Winter Quarterly Commentary

"In the knowledge derived from experience...the knowledge imposes a pattern, and falsifies, for the pattern is new in every moment...and every moment is a new and shocking valuation of all we have been...do not let me hear of the wisdom of old men, but rather of their folly...their fear of fear and frenzy, their fear of possession, of belonging to another, or to others, or to God. The only wisdom we can hope to acquire is the wisdom of humility."

T. S. Eliot, 1888-1965
Essayist, Critic, Poet
Nobel Laureate in Literature
Collected Poems, Quartet,
"East Coker", part II

Scarring the American psyche like a glowing branding iron searing hair and flesh, 2008 was the year of financial calamities and catastrophes. A year wherein "knowledge derived from experience" became superfluous, trivial and impotent.

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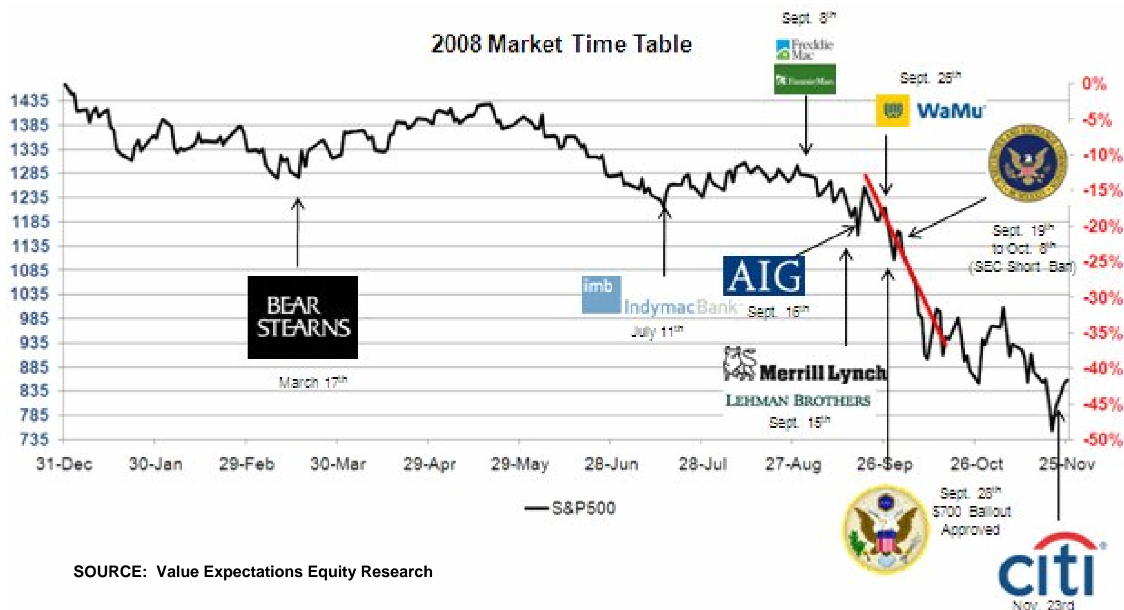
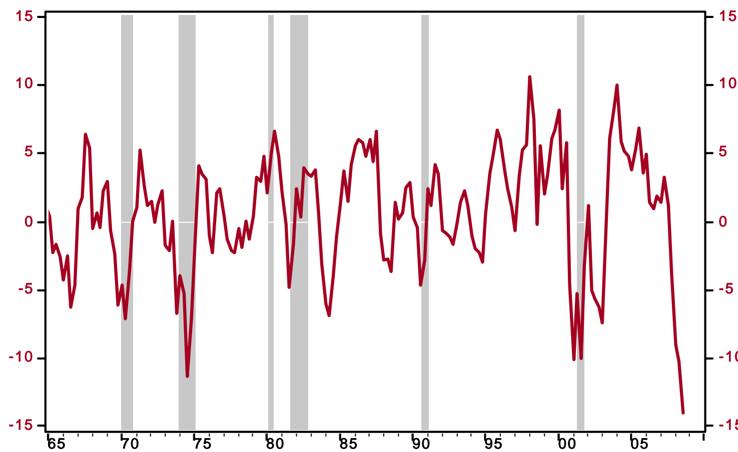
A year where practically everything that could go wrong did. A year that rendered inadequate that familiar phrase "in the post-war period". A year that has caused thinking Americans to question the myths with which they were raised. A year that left behind as detritus the concept of long-term investing. A year that decimated the retirement plans of all boomers. A year that punished all those struggling to save for a better future. A year that called into question assurances that societal safety nets created by our grandparents' generation would save us. We are unprepared for the brave new world that arrived last year, and most are eager and willing to toss overboard hard-won benefits of unfettered capitalism for a glimmer of good old socialistic economic security. Not many dig deep enough to consider that democracy could yet prove to be a fragile experiment with these heavy-handed intrusions. But as 2008 may have proven, and as T. S. Eliot concluded, "the only wisdom we can hope to acquire is the wisdom of humility".



SOURCE: Value Expectations Equity Research

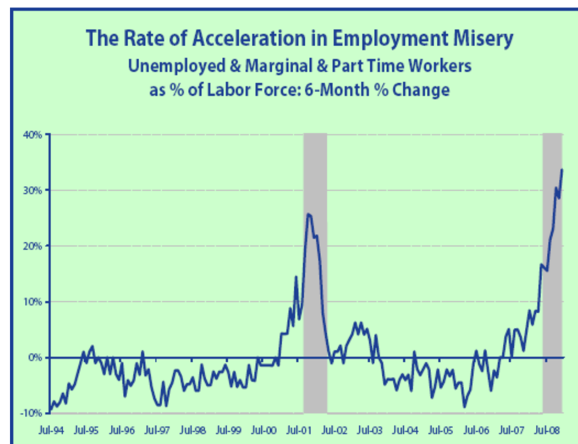
Investors pulled a record $320 billion from mutual funds in 2008, a record in both percentage and dollar amounts. Hedge funds are thought to have shrunk 50% from $2 trillion to $1 trillion by year's end with a little help from Mr. Madoff. In a number of cases, hedge fund redemption requests are either being denied or made "in kind" by parceling out small pieces of illiquid securities. Commodity prices dropped 41% in the fourth quarter alone. A total of 288 U.S. publicly-owned companies cut or eliminated dividends during the quarter, a quarterly record.

World equity markets have lost over 50%, dropping from $60 trillion to less than $30 trillion in market capitalization. To the extent markets require "confidence in the system", there is precious little. The S&P 500 dropped as much as 48% by November 20th from peak values 13 months earlier, was down 22.6% for the quarter and 37.0% for the year.



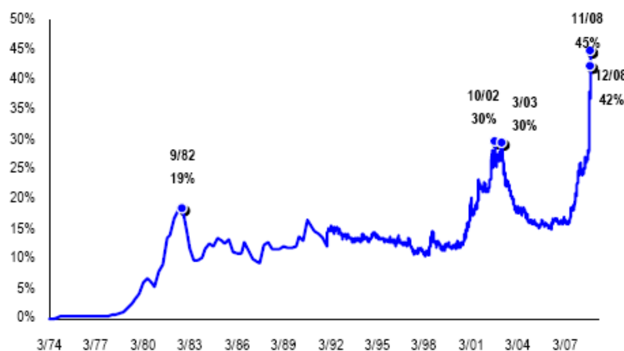
The chart at left shows U.S. household net-worth as a percentage of GDP (Gross Domestic Product), GDP itself declining, to have experienced the greatest drop in over 40 years. Small wonder U.S. investors have pulled in their horns. *(Chart courtesy Strategas Research Partners)*

Unemployment increased almost every month in 2008, ending at 7.2%, a 26-year high. Most economists predict unemployment will reach 9.0% by mid-year. Even more telling is the chart *(Courtesy Sixth Man Research)* on the right which includes part-time and marginal (at home) workers, and expresses the rate of increase in the number of these workers.



Heat is on politicians to "do something". And falling American consumer demand has had its ripple effect. In China's Guangdong province, 8500 factories closed in October alone.

Falling real property and equity markets were accompanied by an investor stampede to safe havens in treasury paper. The shortest term treasury bills reached yields of 0% on more than one occasion. This extreme degree of risk aversion in the fourth quarter of 2008 accompanied a spiking of volatility to levels heretofore never seen as investors wanted out at any price and sold into an "evaporating bid" market, bumping elbows with mutual funds and hedge funds in a rush for the exits. In a vicious cycle, the volatility drove even more to seek the safety of t-bills and money-market funds which the government was forced to guarantee after a run on the bank at several of these funds. According to The Leuthold Group, $8.9 trillion is held in cash, bank deposits and money-market funds, a record, equal to 74% of the market value of all U.S. companies.



As seen at left, money-market funds as a percentage of the broad based Wilshire 5000 Index, reached 45% in November, a record. *(Chart courtesy JP Morgan Research)* The fact that there is essentially no yield to these investments proves the Mark Twain adage "I'm more concerned about the return of my money than the return on my money".

Cash is king. The love of cash equivalents is also reflected in the latest poll by AAII (American Association of Individual Investors). The average allocation to cash is now 42%, well above the mean of 25%, and the highest such allocation ever seen in this survey. It seems that every metric is at some sort of negative extreme. In many cases such extremes have not been seen since the early 1930's and in some cases since the 1800's.

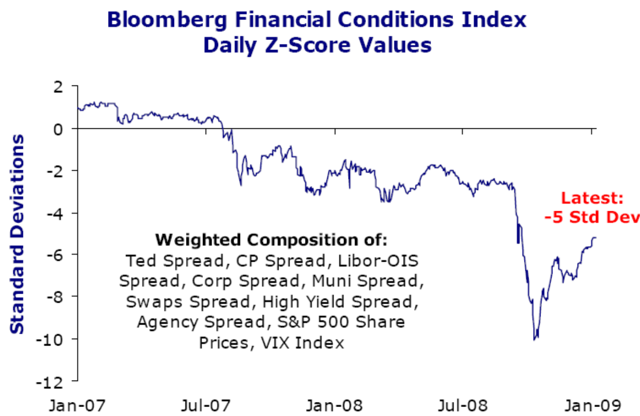
Following the fall of Lehman Bros., which was supposed to reintroduce the concept of "moral hazard" (i.e., that investors should not assume the government will save their bacon, and make investments with a certain respect for downside risk) panic ensued, causing a dramatic spike in all credit spreads. Authorities quickly concluded that so much damage had been done worldwide that "moral hazard" needed to be back-burnered, and fast. Next came a cornucopia of rescue packages designed to forestall deflated assets from being sent into forced liquidation mode.

All evidence suggests that the bailout mentality remains in full flowering with the Obama administration, barely having taken a breath from the retiring Bush administration. In a swift return to the 1930's thinking of John Maynard Keynes and Franklin Delano Roosevelt, resurgent monetarism is the call of the day. Reaganomics is dead. We only wait for the dusting off and renaming of the Works Progress Administration and the Civilian Conservation Corps. All hopes are unreasonably pinned on President Obama, and his popularity will arm him with political capital to pursue his agenda unlike his so unpopular predecessor. We hope he chooses wisely.

With the ballooning of the Federal Reserve balance sheet from $0.8 trillion last summer to $2.4 trillion by quarter's end, there is no end yet in sight. Casey Research claims that announced commitments total $10.1 trillion (compared to the inflation-adjusted cost of World War II at $4.1 trillion). The quasi-nationalization of the banking system in the U.S. is on all minds as honored institutions such as Citigroup and BankAmerica gasp for fresh capital.

Investors are left to wonder if the fiscal and monetary policy stimulus being created to fill the void left by falling asset prices and shriveling consumer spending will do the trick. We think that it will. Only because all stops are being pulled, and if you throw enough money at the problem, eventually, you will solve that problem. We are much more worried about unintended consequences such as inflation down the road, should the government overstay their hand and wait too long before

siphoning off the liquidity so created once the system has stabilized. We will leave those discussions for the future.



Initial evidence is that only some of the government's actions have gotten traction. However, we remain of the opinion that newer bailout ventures, even if with blunt force, will provide necessary healing given time. Traumas of the past quarter should be replaced with nascent traces of a return to moderate risk-taking. Armageddon will have been narrowly avoided. November 20th may prove to have been the market bottom or a bottom has yet to be created that will be not far from that level. We look for leading economic indicators to turn up several months prior to recession's end. Given that we have been in recession for 13 months and expect an 18-month recession (longest since 1930's), the equity markets should be turning about now.

We never imagined the scenario that unfolded in 2008, particularly in the fourth quarter, and to that extent we failed to protect investors to the degree we would have liked, we apologize. Perhaps Thomas Stearns Eliot was right, that looking for a repeat of patterns from the past is an exercise in futility, and, "the only wisdom we can hope to acquire is the wisdom of humility".

Very truly yours,

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

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