Knightsbridge Asset Management, LLC

July 20, 2016

Summer Quarterly Commentary

"Interest rates act on asset values like gravity acts on physical matter. If you had zero interest rates and you knew you were going to have them forever, stocks should sell at, you know, 100 times earnings or 200 times earnings."

The Oracle of Omaha needs no introduction. We finally succumb to quoting Buffett in hopes he will lend credence to some of the heretical possibilities we are going to raise. At the very least we expect that even a devoted Buffett-o-phile may be unfamiliar with the above quote. Read it again. Even though it carries an enormous "if", it is a striking statement to which we will return later.

But first, after dangling the prospect of such a tantalizing conversation about interest rates (if such a thing can be deemed tantalizing), we address the recent stock market environment.

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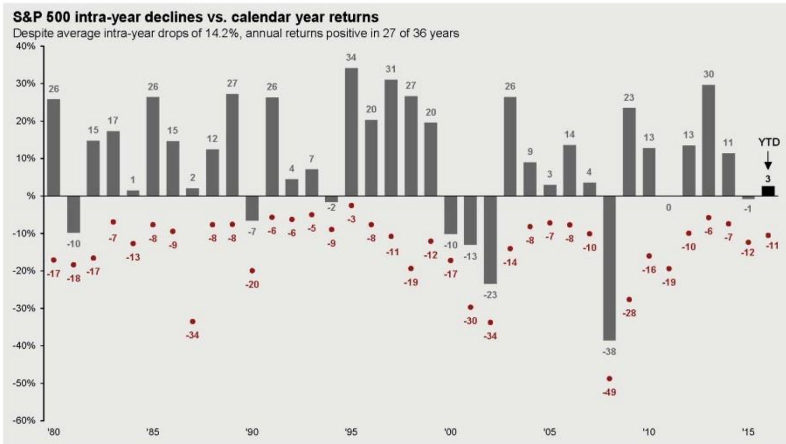


Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

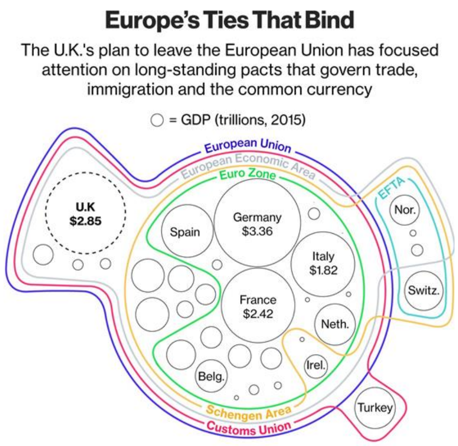
Crazy markets this year, right? Well, not really. The S&P 500 Index, down 11% at one point early in 2016, is now tracking toward a double digit gain for the year.[1] How does this compare with market history? The chart to the left shows the largest decline by the S&P 500 Index during each year (the red dots) and the full year return (the grey bars). A double digit intra-year pullback happens almost every year and it is no strange thing for that same year to deliver a double digit gain overall. We bring this up to remind readers that 1) the stock market has a tendency to increase in value most years and 2) there are always periodic losses along the way.

"The British are leaving! The British are Leaving!" was of course one of the biggest pieces of news this past quarter as the citizens of the United Kingdom delivered a surprise vote to leave the European Union, thereby sending global markets into a tailspin. We think that economically many Brexit fears are overdone, or at least we should be no more scared than we normally are.[2] When it comes to straightforward, first-order economic effects from Brexit, they are indeed negative but not disastrous. Mostly, it just raises uncertainty. This will lead to businesses delaying investment in the U.K., possibly leading to a recession there, and will drive up the safe-haven dollar thereby limiting the competitiveness of U.S. export businesses and generally tightening financial conditions. But these direct effects are manageable, as uncertainty-inducing events occur all the time. Furthermore, Britain hasn't actually left anything yet. They have to formally announce their Brexish intentions to the E.U. ("invoke article 50") and they then have two years to negotiate the details around departure. We would not be very surprised if, after 18 months of negotiation, the public takes a look at the new deal and

[1] The market continued to advance between the publication of the image and the writing of this letter.

[2] While the U.K. will survive economically, we personally were saddened by the vote as it was a step in the direction of disunity. The European Union was always a political project first, designed in the aftermath of World War II to keep the continent from tearing itself apart again. Let us hope that in its weakened state it can still achieve that goal.

decides they don't like it so much. Given that the vast majority of U.K. legislators are against Brexit, if public opinion turns heavily against it as well, we would expect it not to happen, democratic propriety and referendum results notwithstanding.



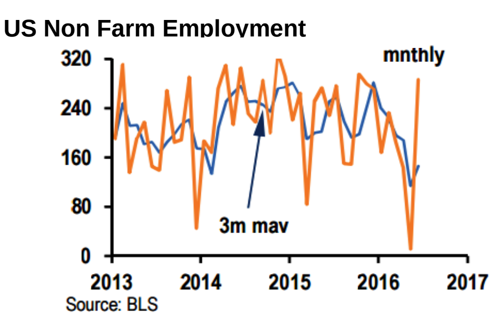
Source: Bloomberg

The bigger and more legitimate worries about Brexit are that it might spark something else. The disaster scenario most often mentioned is a further disintegration of the E.U. in the event of, say, a Departugal, Polout, Italeave, or Byegium. This would be far more disruptive economically because these countries share a common currency, which as we have seen in Greece, cannot be easily untangled. However, we are skeptical regarding any breakup contagion effect, because while various right wing parties have seized on the referendum result to renew their own calls for independence, the vast majority of the global outcry has been for unity. People have also suggested that Brexit could set off a financial panic in Europe's weakened banking system, and this is indeed a possibility. But really, this was a risk before Brexit and will remain one after. If we're going to worry about Brexit triggering disasters waiting to happen, we prefer to worry about the big one: China, which we haven't talked about in a while (and won't rehash now) but whose banking system is still the world's biggest ticking time bomb. Risks continue to build in the system. We continue to prefer companies with strong balance sheets that can withstand financial turbulence.

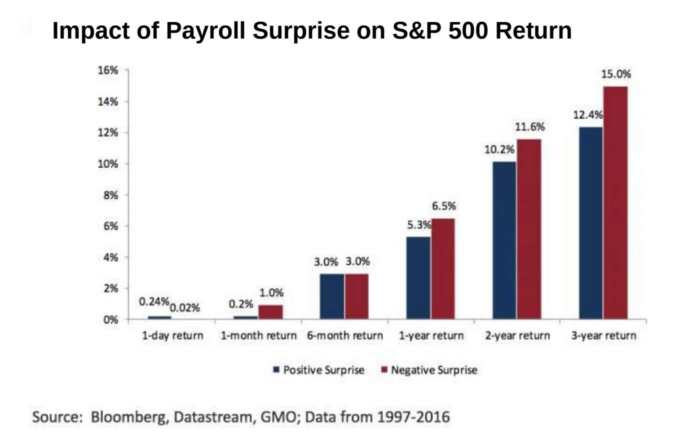
European banks have lost >€200bn (22%) in market cap since the UK referendum

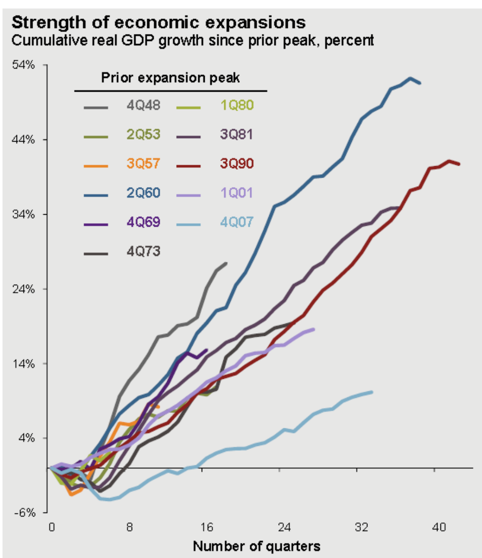
Change in market cap since June 23rd (in % and €bn)

Source: Datastream, Goldman Sachs Global Invt. Research (7/11/2016)



Fears of Brexit appeared to be quickly forgotten after the June jobs report was a blowout, with 287,000 new jobs (orange line on chart) eclipsing the 175,000 expected; the Dow jumped 250 points in response. However, we think the market may have overreacted here too. Employment data is volatile, backward looking and subject to revision. While the report showed an increase in June, the May number was revised down sharply, meaning the three-month average paints a much worse picture (blue line on the same prior chart). Interestingly, while the S&P 500 Index delivered bigger gains on the day of positive rather than negative payroll surprises, longer-term equity returns were greater following *negative* payroll surprises!

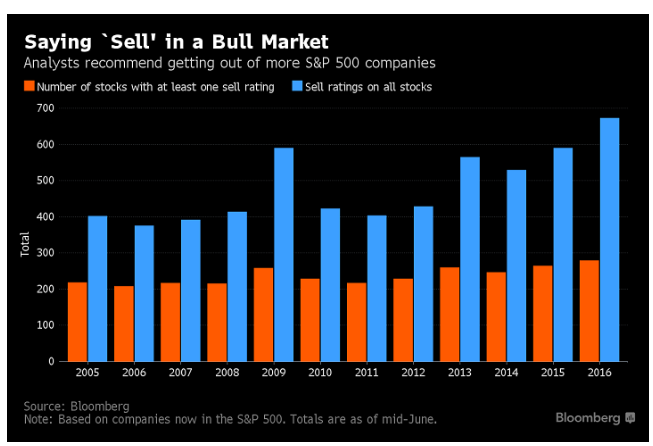




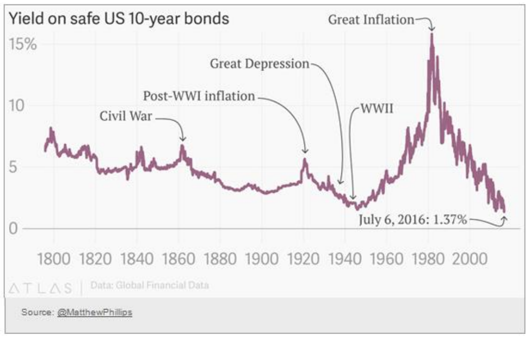
Source: BEA, NBER & JPMorgan Asset

Turning to other concerns, we hear much talk that we are "due" for a recession. There are many arguments and data points on both sides, but we think we can neatly sum up the debate in a single chart, which shows the strength of previous economic recoveries. The argument for a recession is the X axis and the argument against a recession is the Y axis. Time-wise most economic recoveries didn't last this long, but then again most economic recoveries delievered more growth before petering out. We nervously stand on the side of "no recession" but continue to purchase stocks with the uneasy knowledge that we will probably have to hold them through an unruly pullback at some point.

For now, however, the market is hitting all-time highs and yet sentiment is negative. Looking forward, one reassuring indicator is that investment managers hold more cash in their portfolios than any time since 2001, according to a recent Bank of America survey. Also, Wall Street analysts currently tag more "sell" recommendations on stocks than during any of the

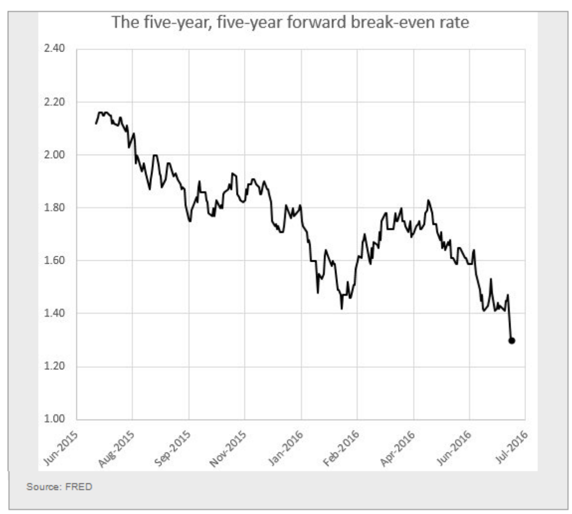


past 10 years. We believe the markets are actually safer when those who follow them are fearful.



Given all this, why is the stock market reaching new all-time highs? We believe this action is explained by the main economic story of the quarter: interest rates shocked many by hitting all-time lows around the globe, including the U.S. 10-year hitting an all-time low of 1.36%, and the Dutch and German 10-year bonds hiting 0.0% for the first time ever.[3]

The big news isn't just that low rates prevail, it's that people are finally seeming to accept them. We believe this may be the main reason the U.S. stock market recently hit all-time highs. Why might people be finally accepting that we are stuck with low rates? Perhaps it is because the Fed is no longer talking about raising short-term rates soon. More likely, it is the fact that some longer-term rates had been in a "false start" climb before recently crashing lower. In any case, we now see Wall Street Journal articles with such titles as "Why Ultralow Interest Rates are Here to Stay" and "Coming to Terms with Low Bond Yields". We have also seen a subtle change in the language of investment pitches, with what used to be "as rates rise", first turning into "when rates rise", and finally now becoming "<u>if</u> rates rise". More concretely, the bond market's assessment of what future inflation will be, the so-called "five-year, five-year forward" has lowered, which means inflation isn't expected to be forcing up rates any time soon.



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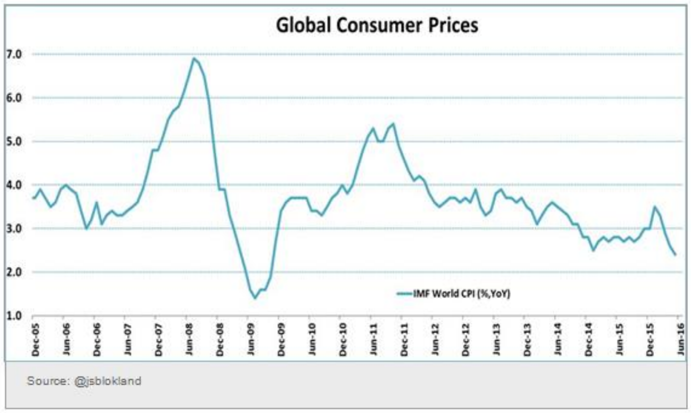
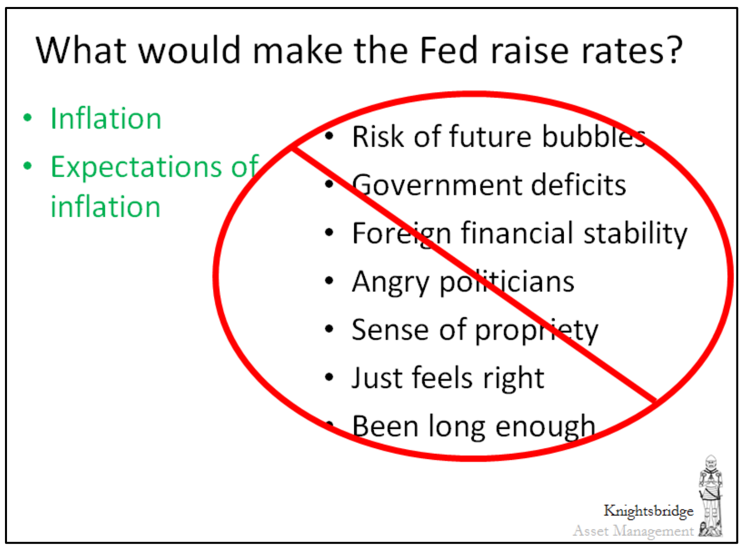
[3] To clarify, in this section we're not just talking about the very short-term rates which central banks directly control, but rather the many longer-term rates which are ultimately more important to the economy and are only indirectly influenced by central banks such as the Federal Reserve.

Indeed, with both world and U.S. inflation currently low, and expected to remain low in the future, there is little reason for policy makers to try and raise rates, as can be seen in what is probably our all-time favorite slide from a presentation we gave in January 2016 (see below).



These events have been a vindication for our "rates are never going up, ever" half-joke that we first published in our October 2015 quarterly letter. To clarify, we don't really believe that nominal interest rates will never rise. In fact, from our understanding of the economics we were taught in school, we would expect rates *already* to have risen, spurred by inflation arising from years of easy monetary policy. So we reach the conclusion... that the models are broken and do not help us understand what is going on![4] The joke serves to remind us that we do not know that rates will go up (or at least we don't know when, which is the same thing) and therefore we should not cling to models of the world that are clearly misleading or incomplete. The joke, which achieves its intended effect by 1) sounding



[4] There are some interesting theories going around which posit that there may be more behind low rates than just the extreme monetary actions of central banks. Given that low rates are observed globally, and also at long maturities (which central banks usually do not influence directly), we are inclined to be receptive to these theories. To grossly oversimplify, low rates may be a natural result of the world trying to defer more of its consumption into the future than is really possible. Two drivers of the desire to defer would be the increased concentration of wealth among the ultra-rich (who cannot and do not wish to spend all their money in the present) and the aging demographics of the world's economically powerful countries (older people often stop working and live off savings, i.e. deferred consumption).

absurd, while 2) being accurate (so far), doesn't help us gain knowledge about what will happen, but rather helps us expunge false certainty about what we *think* will happen.

This may sound esoteric, but minimizing "what you know that just ain't so" has helped us this year. We didn't build the portfolio around this agnostic view, but in attempting to make sure that our exposure didn't veer too far from rate-agnostic, we avoided the same (wrong) bet on higher interest rates that many others were making. We trimmed appreciated positions that were perceived as benefitting from a rising rate environment, and we held onto a position that we might otherwise have sold because we knew it would benefit from falling rates. We were not entirely successful in reminding ourselves that rates were never going up ever: in January we almost bought a certain utility company because we liked the business prospects, but ultimately we held off because the various valuation measures we examined were solidly above the historical range (due to low interest rates). It is up some 30 percent year-to-date due at least in part to today's even lower interest rates.

In a low rate environment, stocks become "expensive" but *deservingly* so. When rates are high, it is easy to produce future cash flows (just lend out your money at the prevailing high interest rates and wait for it to come back); when rates are low, it's much tougher to produce future cash flows by new lending, so existing stocks and bonds become all the more valuable and rise in price. Warren Buffett suggests in our opening that if rates were zero and were expected to stay there, stocks might logically trade at 100 to 200 times earnings. What if today's low but non-zero rates were expected to continue? How expensive would stocks deserve to be? We have been working on a project to answer just this question (and a few others). While we expect to more fully discuss this topic in the next quarterly letter, our preliminary results suggest if the stock market was worth $100 in 1996, then the same stock market would be worth about $130 given the interest rates that we had in 2006[5], and given the interest rates we have today would be worth about $200, more than twice as much![6] Stated differently, if in 1996 the stock market had a "fair" price to earnings (P/E) ratio of 17, by 2016 the change in interest rates alone would indicate that same market should "fairly" trade at a lofty 35 times earnings! Today's actual S&P 500 trades at 25 times trailing

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[5] And by this we mean the same set of future cash flows.

[6] These estimates embed a lot of assumptions. Under less conservative assumptions, one might conclude that today's interest rate environment would imply that same stream of cash flows would be worth $400, or four times as much as under the 1996 interest rate regime.

earnings. So yes, today's stock market looks expensive, but *unless you believe higher interest rates are coming soon, perhaps the market really ought to look even more expensive*. For now, our attempt is to remain neuteral and not unconsciously place bets on one side or another, so we can prosper in whatever environment tomorrow brings.

We appreciate your confidence as we endeavor to prudently navigate these uncharted waters.

Sincerely,

John Prichard

John G. Prichard

Miles E. Yourman

Miles E. Yourman

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