Knightsbridge Asset Management, LLC

May 1, 2012

Spring Quarterly Commentary

"If something cannot go on forever, it will stop."

Herbert Stein, Ph.D., 1916-1999
Senior Fellow, American Enterprise Institute

Chairman, Council of Economic Advisors under Presidents Nixon and Ford

Professor of Economics, University of Virginia

Herbert Stein injected pragmatism into an often otherwise rigid economic policy debate. What's more, he gave us the gift of his son, Ben Stein, who has continued the family tradition of providing economic wit in entertaining fashion. Dr. Stein's The Fiscal Revolution in America, published in 1969, considered the relationship between fiscal policy and the economy. In it, Stein advocated for deficit spending when needed in order to mitigate economic downturns. For helping enlist business community support of such policy, he was anointed "the liberals' favorite conservative". At the same time, however, he championed the importance of free markets and defense spending. Called one of their own by conservatives, liberals and the business community alike, Stein was guided by logic as opposed to dogma.

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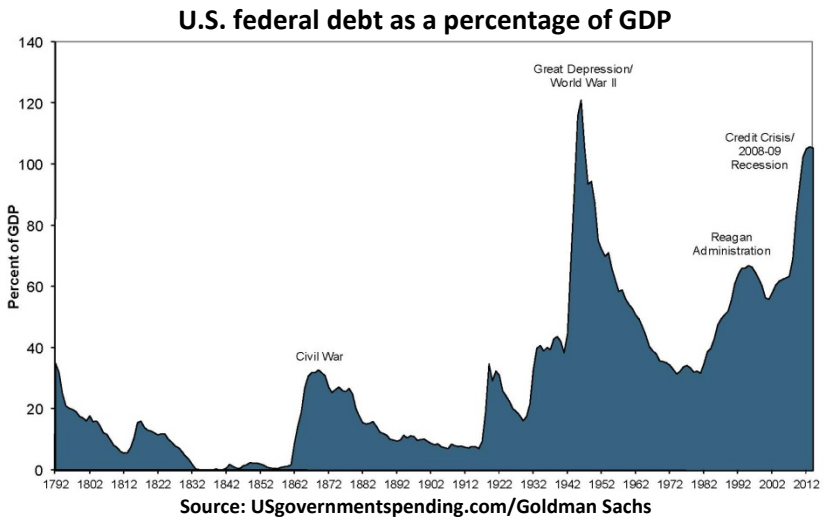


Stein pressed us to consider the fact that unsustainable trends will necessarily end, cautioning against reflexive, preemptive intervention. He made this observation with respect to a growing trade deficit. We suspect that even Dr. Stein would be concerned that this imbalance has not reversed itself. However, there is another deficit which we and others have found more troubling... the U.S. government's budget deficit which piles on more and more debt each year. This compels us to look at Stein's truism from a different perspective... if the U.S. debt situation cannot continue forever, *how* and *when* will it end?

It is all but impossible to know *when* it will end, because at this advanced stage the answer depends upon such ephemeral factors as confidence in our country's credit, the kindness of strangers who have bought up near half our outstanding debt, and the whims of a Federal Reserve Bank that buys massive amounts of our government's debt with U.S. dollars that it simply wills into existence on a computer screen.

As to *how* the debt build-up will end, there are only a limited number of options. Governments can grow their economies so fast that the debt becomes relatively small despite recurring deficits. They can go into austerity mode whereby the debt actually gets reduced by paying it back. They can engender inflation such that debts are repaid in name only. Or, they can go the way of Greece and simply not pay what was originally agreed upon (Greece's recent "voluntary" debt swap actually represented the largest default in history).

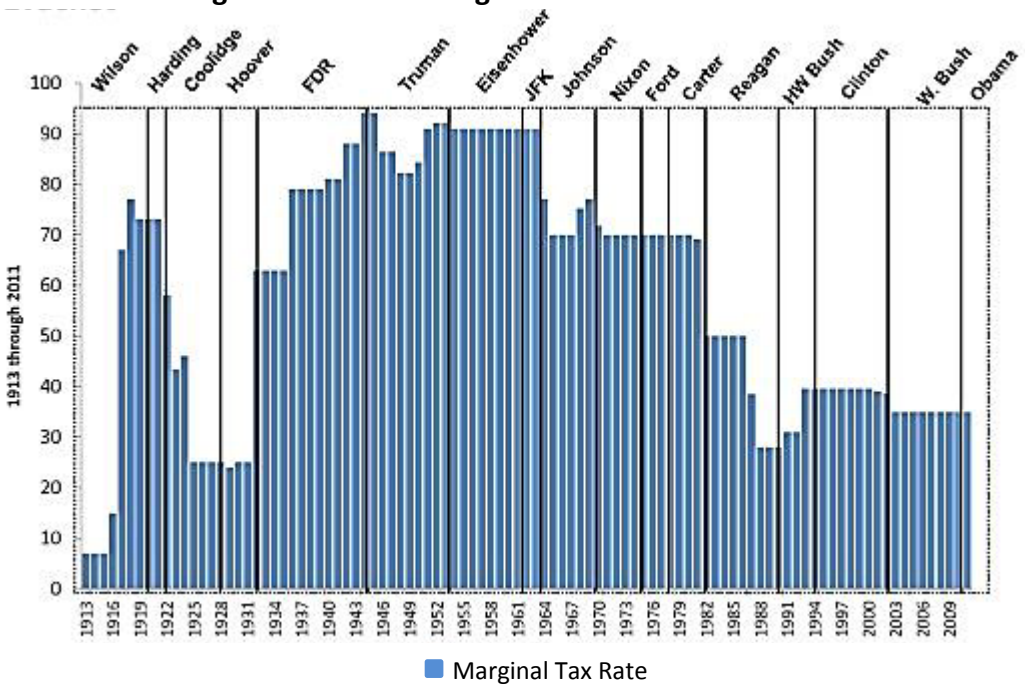
U.S. GDP rose at a disappointing 2.2% annual rate during the first quarter of 2012; so far this recovery has been too weak to reduce relative government debt levels through growth. A step toward austerity is next year's "fiscal cliff" which features automatic spending cuts and tax increases. We have been told one-third of the entire tax code is expiring at the end of this year, with payroll, income, capital gain and dividend tax burdens all set to increase. Simultaneously, automatic cuts to defense and other discretionary areas of the Federal budget are set to take

effect. This budgetary "discipline" only *reduces* but doesn't *eliminate* the deficit and yet is so drastic that it's projected to erase two to three percent from GDP in 2013. Imagine what devastation would be wreaked by sudden and full deficit elimination as might be required in a crisis (alternatively visit Europe for a partial demonstration if you're short on imagination). These realities illustrate both the difficulty and the importance of eventually eliminating perennial deficits. Can policy makers carefully apply the brakes to deliver measured debt reduction without us screeching to a recessionary halt? Or is this path so painful in the short term that we won't pursue any cutbacks until absolutely forced? If so, the inevitable "stop", while perhaps occurring further down the road, may arrive in the form of a brick wall crisis of unsustainably high interest rates erected by market forces.

In this election year, no doubt you have already been bombarded with news stories, editorials, and diatribes concerning the one thing in life you can definitely count on besides death: taxes. Instead of adding our voice to the cacophony of opinions and recommendations in this complex area, we intend to make only a few neutral fact-based observations that hopefully will be interesting and helpful to readers in making up their own minds as November approaches.

The first observation is a warning related to top marginal income tax rates, which are often referred to in historical examples by pundits on both sides of the aisle. A record of such rates appears below.

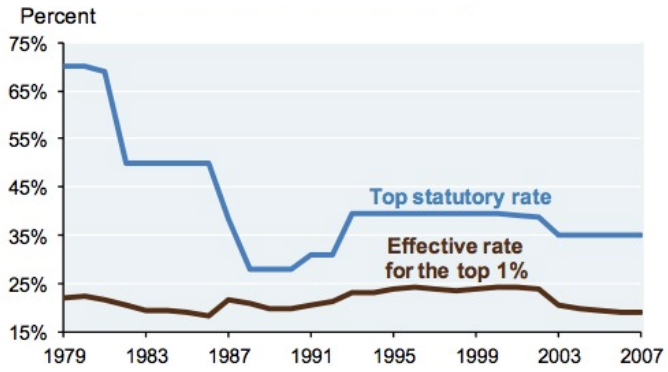
Marginal Tax Rate on Highest Individual Income Bracket



Source: DoubleLine Funds/Internal Revenue Service

Unfortunately, on their own these rates tell one almost nothing about the real tax burden; to cite top marginal rates is to almost deliberately mislead. To get an idea of how much tax is actually collected in relation to incomes (the effective tax rate) one would also need to see the bracket cutoff level, demographic data on how many taxpayers exceed the cutoff, what the rates are on income before that threshold is hit, what all the applicable tax loopholes are, and finally how often those loopholes are utilized. Even then, one would only know the real tax rate of the top bracket! Unless you are a tax policy expert who knows all these other variables, the top marginal rate, presented alone, tells you almost nothing.

Effective tax rate: what people really pay

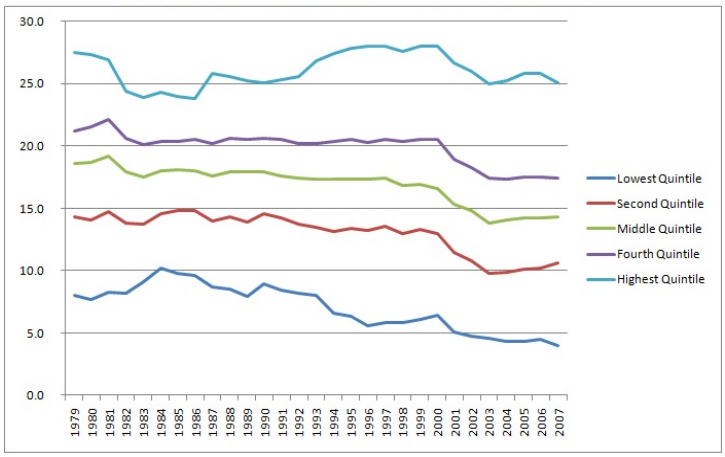


Source: JP Morgan/Congressional Budget Office

What *is* informative is the "effective tax rate": the total tax paid divided by total income at the end of the day. Note the chart on the left which shows both the top marginal rate and the top effective rate. Looking only at the top marginal rate, one might have concluded that tax collected from top earners in the Clinton era was almost half that during the Carter administration. However, because Carter's top rate was applied to relatively few actual dollars earned, the effective rate of tax paid for the top 1% was actually much higher during the Clinton years. Because top marginal rates only tell such a small part of the total tax story, we turn off our ears whenever these rates are used as the basis of an argument.

Having espoused the advantages of observing effective tax rates over top marginal rates, in the chart to the right, we present a recent history of effective tax rates as an informative background for our readers.

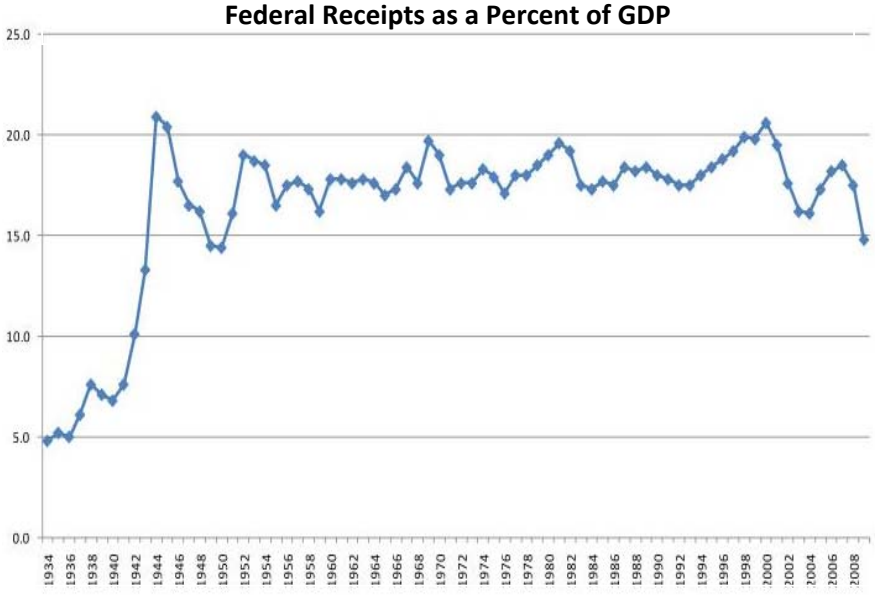
Household Effective Tax Rates 1979-2009



Source: Internal Revenue Service

Even effective tax rates can be misleading because, as rightly cited by conservative commentators, attempts to increase taxes can have the

Federal Receipts as a Percent of GDP

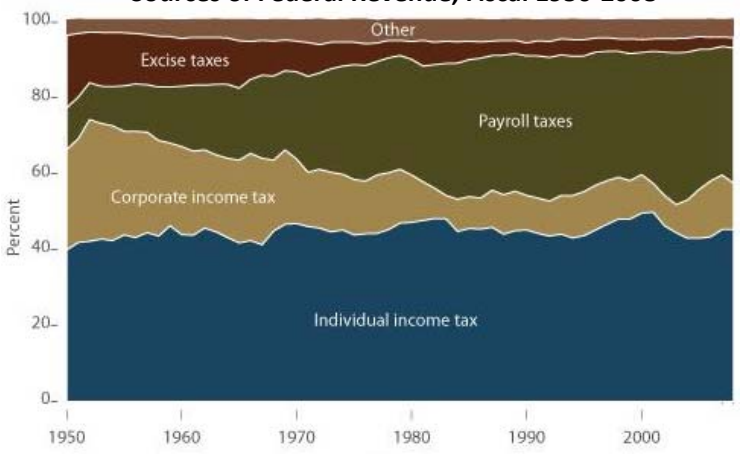


Source: Economic Report of the President (www.whitehouse.gov/omb//budget/historicals)

effect of dampening economic activity and increasing tax avoidance efforts. After a certain point, increasing the tax rate does not actually increase taxes collected, so it is most useful to look at the overall portion of taxes collected compared to the entire country's income (GDP). This information appears to the above, and as you can see, during the modern income tax era federal revenues have remained remarkably stable in the range around 17% of GDP. This observation lends weight to the argument that you can only raise taxes so far. However, given that recent tics are coming in below 15%, the evidence suggests there currently is room for increased tax revenue of about 2-4% of GDP. And yet, given that current deficits are above 8% of GDP, it seems extremely unlikely that the deficit could be closed by raising taxes alone.

Of course, income taxes are not the only taxes, a fact that those who claim "half of Americans don't pay taxes" have overlooked. Let's continue our broad view of U.S. tax trends by looking at the differing sources of federal revenue over time.

Sources of Federal Revenue, Fiscal 1950-2008



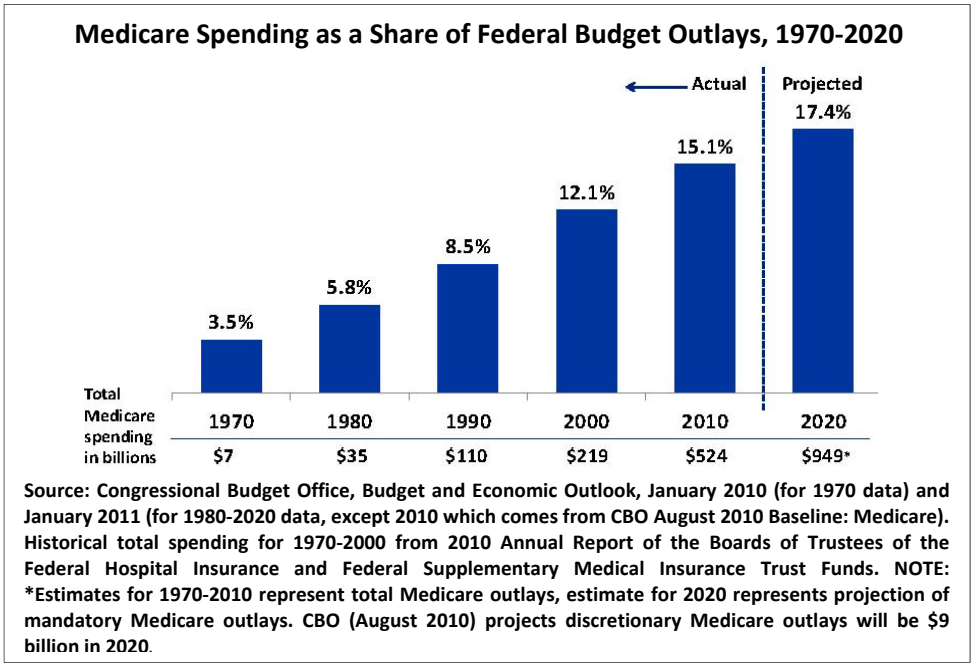
Source: 1950-2006: Budget of the United States Government (www.whitehouse.gov/omb/budget/fy2008/sheets/hist02z3.xls)

The broadest pattern you see here is the rise of the payroll tax, and the decline of the corporate tax. The first trend is explained by the rise of social security and the welfare state, but many readers might be surprised by the second trend. Haven't we all heard that the "U.S. has nearly the world's highest corporate tax rate coming in at a free-enterprise suffocating 35%"? Aspiring industrialists may relax; almost no corporation actually pays those rates because of the innumerable breaks and loopholes that keep the lobbyists busy and campaign coffers brimming. Again, *effective* tax rates tell the story much better than the statutory rates ever could, and you can see to the left that these rates have declined significantly in recent years.

Certainly raising corporate tax rates (or effectively doing so by eliminating loopholes) would make it more difficult for businesses to operate, and any change to marginal rates, corporate or otherwise, would have complicated and unintended ripple effects. Knightsbridge does not have the answers and does not pretend to. However, we do know that we cannot run deficits forever. Sooner or later we will be forced to pay for the government we have, or we will be forced to have the sort of government we pay for.

On the spending front, we postulate there is another trend that cannot continue: federal spending on healthcare, particularly Medicare. Note the chart below showing the steady growth of Medicare as a percentage of Federal Budget Outlays from 3.5% in 1970 to 15.1% in 2010. Projections of healthcare spending under Medicare have been notoriously difficult (previous estimates have often turned out to have been almost laughable underestimates), but current Congressional Budget Office (CBO) projections put the 2020 Medicare share of the budget at 17.4%. According to the OECD for 2007, public funding for health care was actually higher in the U.S. (7.2% of GDP or $3,321 per capita) than in the supposedly über-socialist Sweden (6.6% of GDP or $2,527 per capita).

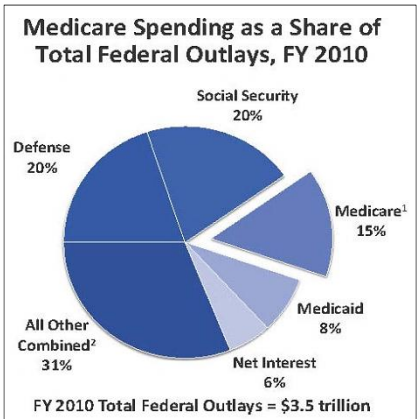
So far, Medicare spending has been politically untouchable for both parties. On the right, pundits decry Obama's "death panels" and on the left commentators brand any proposal to alter benefits as implementing "savage cuts". Obama's newest budget calls for defense and domestic discretionary spending to be reduced by an astonishing 43% by 2022. During the same period, Social Security spending rises 27% with eye-popping 41% increases for Medicare and Medicaid. This dynamic caused us to wonder, as we observed the 100th anniversary of the sinking of the Titanic this April, whether the priorities embodied in the crisis mantra of "women and children first!" have changed.



Source: Congressional Budget Office, Budget and Economic Outlook, January 2010 (for 1970 data) and January 2011 (for 1980-2020 data, except 2010 which comes from CBO August 2010 Baseline: Medicare). Historical total spending for 1970-2000 from 2010 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds. NOTE: *Estimates for 1970-2010 represent total Medicare outlays, estimate for 2020 represents projection of mandatory Medicare outlays. CBO (August 2010) projects discretionary Medicare outlays will be $9 billion in 2020.

As difficult, unpleasant, and politically impossible as it is to discuss lowering benefits (and again particularly for Medicare), we suspect this may soon happen due to pure mathematics. Politicians can only deny the problem for so long. We present a very simple example to give an idea of how room for options, other than decreasing healthcare benefits, may be shrinking. We admit, budget analysis is extremely complex and forecasting even more so, but the following over-simplified example from only one mid-crisis stimulus-filled year should give readers an idea of the scope of the problem.

Total government revenue in 2010 was $2.2 trillion dollars as compared with total outlays of $3.5 trillion. Thus in order to balance the budget in that year, one would have had to eliminate 37% of all spending ($1.3 trillion). Contrast the 37% figure with the below pie



SOURCE: Kaiser Family Foundation based from Congressional Budget Office, Historical Budget Data, January 2011.NOTE: FY is fiscal year. 1Amount for Medicare is mandatory spending and excludes offsetting premium receipts (premiums paid by beneficiaries, amounts paid to providers and later recovered, and state contribution (clawback) payments to Medicare Part D). 2"All Other Combined" category includes other mandatory outlays, offsetting receipts, and negative outlays for Troubled Asset Relief Program.

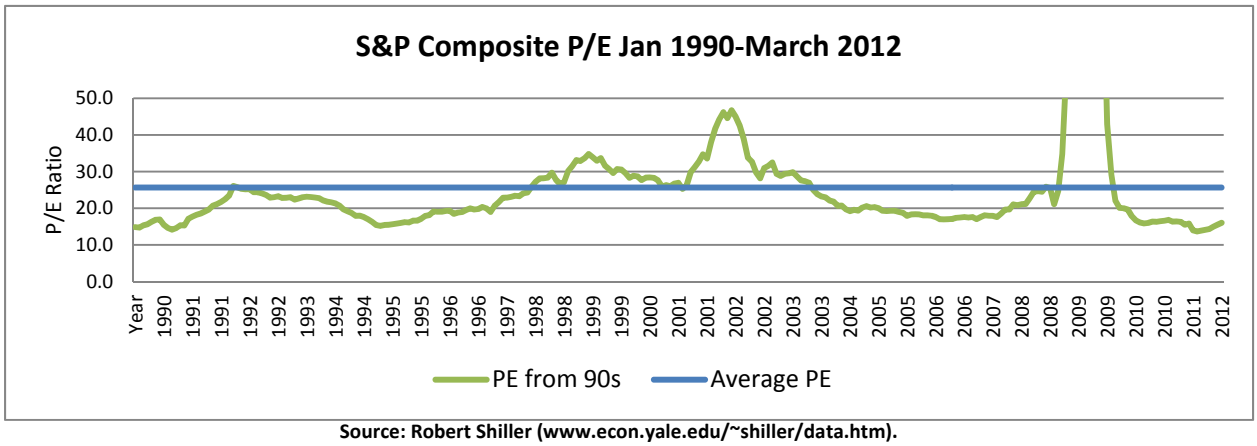
chart showing total federal outlays in 2010. The "All Other Combined" slice covers all non-defense core services typically associated with government: the federal court system, federal law enforcement, the FAA, the FDA, infrastructure spending, research spending, disaster recovery spending, the IRS, the federal prison system, the departments of education, energy, and another third forgotten entity, right down to the White House's lawn-cutting budget. All these government programs together amounted to only 31% of total federal outlays in 2010. This means that *in 2010 you could have cut the entire federal non-defense discretionary budget, nearly every single traditional service that the federal government actually provides to citizens, and you still wouldn't have balanced the budget*. Given current projections in Medicare spending growth, even if every other government program were to be eliminated first, health care spending would still have to be cut. We don't know how long the healthcare spending growth can last, but even under extreme assumptions we know it can't last forever.

Contrast with these realities that healthcare is considered a defensive investment sector. Why? Because earnings aren't volatile, or more correctly, earnings *haven't been* volatile in the past. And no wonder, considering the constant increase in U.S. government expenditures on healthcare services. Modern Portfolio Theory, taught in the hallowed halls of business schools and universities, teaches (or misteaches) that volatility all but equals risk, and by such measure healthcare stocks are not risky. We prefer a more colloquial definition that risk is the chance you might lose your money, and will seek to limit (though not eliminate) our exposure to healthcare companies that could have the rug pulled out from under them.

Turning from government to the markets, one variant of the "if it can't keep going, it will stop" idea is that certain values are destined to return to their long run averages. While there is certainly some truth to this idea, it must be used with caution because like many things in finance, the devil is in the details. In the following charts, we will use the same historical dataset to show you that stocks are all at once currently highly undervalued, undervalued, fairly valued, and overvalued. For this exercise we will employ that ubiquitously used and misused metric, the price to

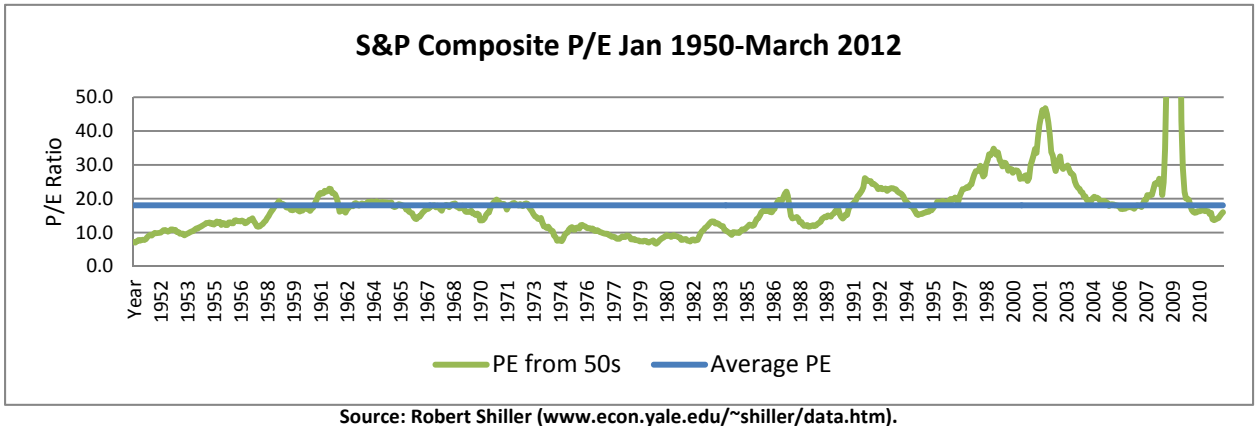
earnings (P/E) ratio, but the logic extends to any value compared to its average. In preview, the moral of this exercise is that whenever someone purports to tell you that something is above its long-term average, with the implication that it therefore must decline (or vice versa), the correct response is to immediately ask, "what do you mean by *long-term*?"

Observe the following charts of the S&P Composite Index's price to trailing 12 month earnings (P/E) which we created using eminent Yale Economist Robert Shiller's data (www.econ.yale.edu/~shiller/data.htm). The below chart clearly shows that stocks are near the cheapest they've been in decades. Max out your credit cards to take advantage of this fire sale because stocks cost well below average!



Source: Robert Shiller (www.econ.yale.edu/~shiller/data.htm).

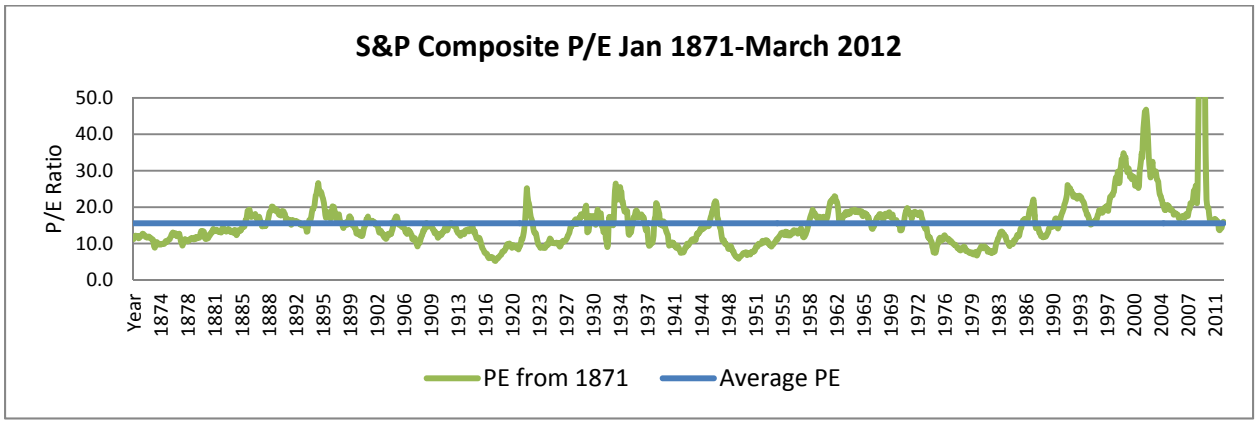
With over 20 years of data in the above graph, many an honest man would deem it long-term. And yet, observe what happens below when the period is extended back to the 1950's. Stocks now look only kind of cheap.



Source: Robert Shiller (www.econ.yale.edu/~shiller/data.htm).

With over 60 years of data, the above graph must be all-inclusive, right? Given the typical max range of historical financial charts,

1950 might as well be the beginning of time. But was the common stock a post-war invention? The answer, of course, is "no". We need not even go across the pond to get stock market data back to the 19th century. Behold, a "true" long term history of the P/E ratio!



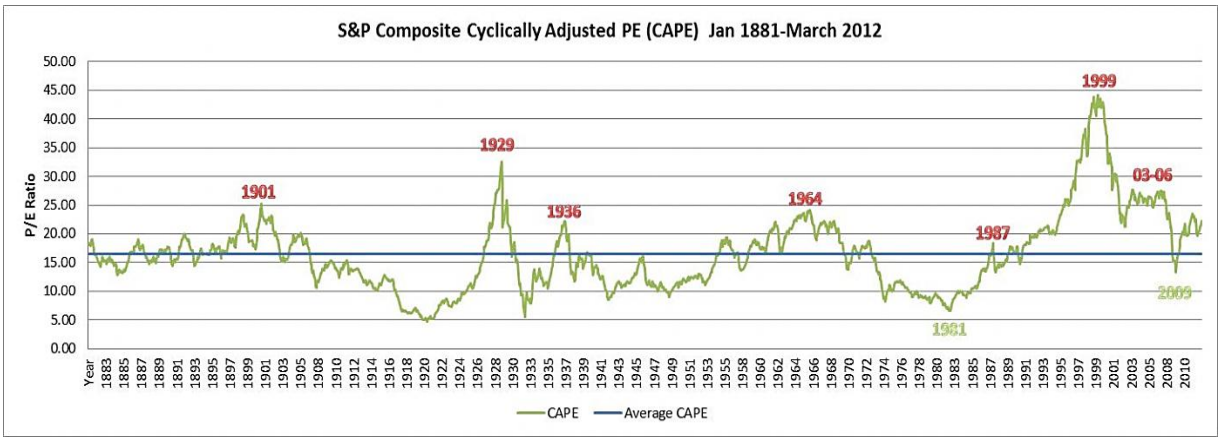
Source: Robert Shiller (www.econ.yale.edu/~shiller/data.htm).

At the final March 2012 data point, the trailing P/E stands at 16, marginally above the long-term average of 15.6. Investors be warned: conclusions can change dramatically depending on observation period! It makes one wonder if the typical financial media measuring period is short because old data is difficult to obtain, or if because a long measuring period might result in unwanted conclusions?

Having come this far, it's worth pointing out a few things about the P/E ratio. Looking back at the incredible spikes in recent history, one might assume the quarterly P/E was flashing danger signs before the tech bubble and 2008 crashes. However, a closer look reveals that the highest P/Es were reached in 2002 and 2009, both post-crash periods that turned out to be excellent times to invest. This illustrates a major shortcoming of this favorite ratio: earnings fluctuate along with prices, and often more violently. The spike in P/Es happened of course not because prices had become unsustainably high, but rather because earnings had become unsustainably low. This also solves the mystery of why your supposedly value-oriented investment advisor often purchases stocks with rather high P/E ratios. Many times these are the cheapest of stocks that only look expensive when compared to recent or projected earnings (which are not indicative of true earnings power or company value).

This doesn't mean P/E ratios aren't useful. One way to mitigate the illusion of transitory earning trends is to use an average of earnings over a longer time period, say ten years. This measure is called the

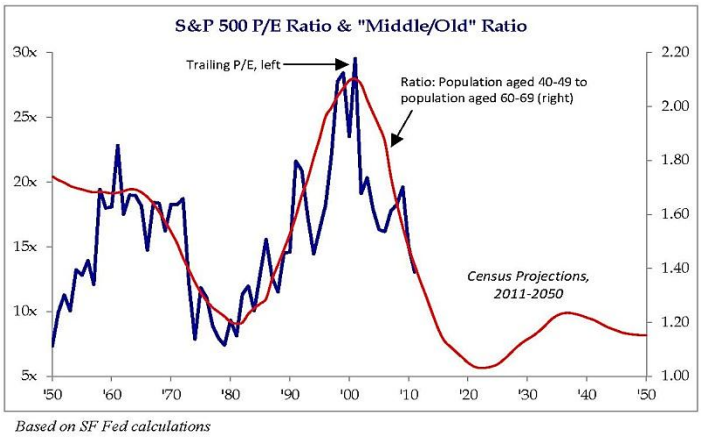
Cyclically Adjusted Price Earnings Ratio or CAPE, and it appears below.



Source: Robert Shiller (www.econ.yale.edu/~shiller/data.htm).

By this measure, stocks appear overvalued. However, a lot has changed since 1871. Despite hand-wringing over China, America is the global hegemon; because of the Securities and Exchange Commission, investors enjoy significant protection relative to the manipulations before 1930; low interest rates make claims on future rewards from stocks more valuable. A historically higher P/E today may very well be justified.

One argument for a lower P/E is based on demograhic trends. A recent San Francisco Fed study notes that since the 1950's P/E ratios have generally tracked the difference in population between those in their 40s vs those aged 60 to 69; this a result of retirement age migration from stocks to bonds according to the hallowed rules of asset allocation.

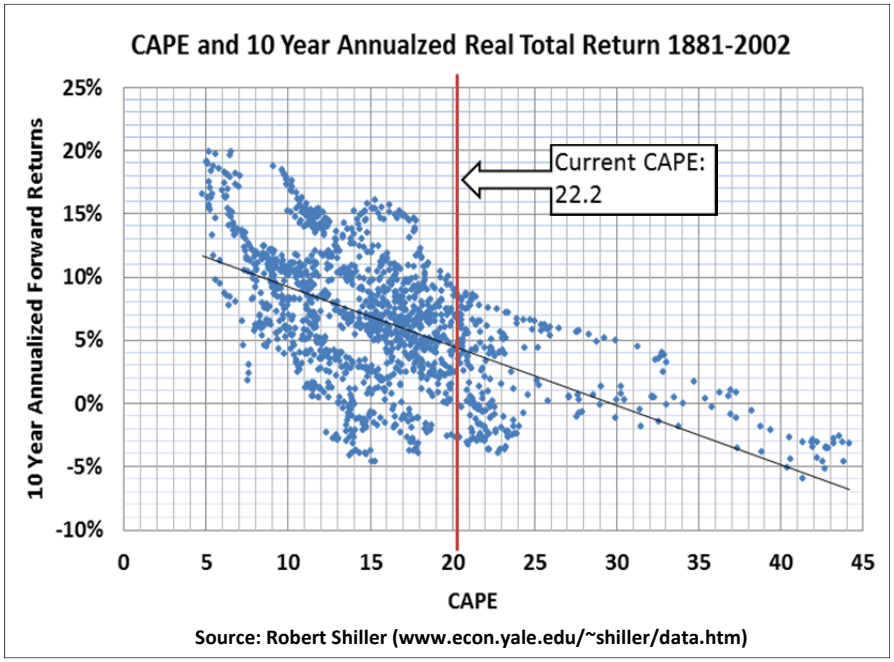


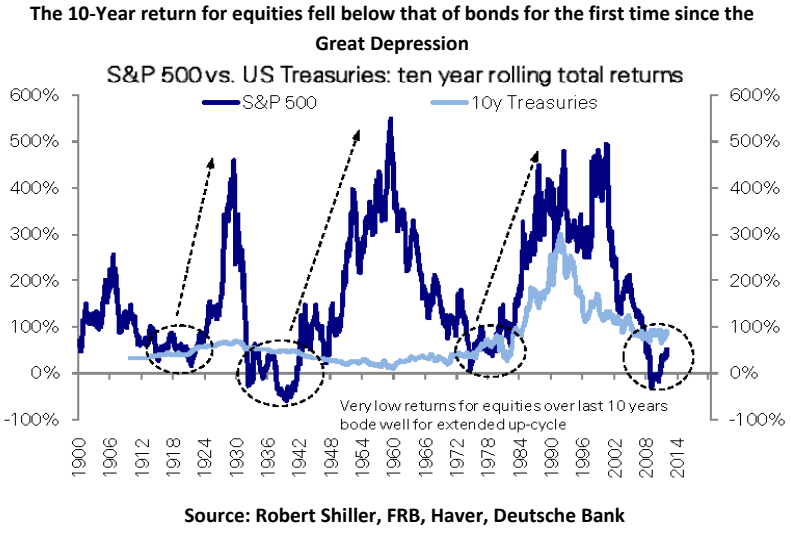
Source: Strategas Research Partners

Many point to highly elevated and typically mean reverting profit margins as a headwind to earnings growth. Actually, there is little correlation between earnings growth and equity gains during a given year. During many of the stock market's best years, earnings declined, implying an expansion in the P/E multiple.

Starting P/E has meaningful implications for forward long term returns, but it gives a somewhat wide range when used as forecasting

tool. Using the same data as cited above, we present the chart on the right, which we consider to be the gold standard of P/E historical performance comparison. It has data going back to the 1800s, uses an average of ten year's earnings to decrease variability, and importantly shows *real* returns, which take inflation into account (remember, 10% appreciation benefits you nothing if inflation is 15%). Historically, when the US market has been priced similarly, it has delivered anywhere from 8.5% to -3%. 8.5% to -3% may sound like too large a range to be useful, but consider that if the CAPE was 10 we would be talking about a range from 18% to 4%.





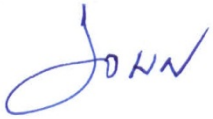
Rosier expectations for equity returns are suggested by the fact that the S&P 500 Index delivered virtually no total return over the past decade and was trounced by US Treasuries by a magnitude not seen since the Great Depression. Such conditions have occurred only three previous times in the last century, and were eventually followed by some of the most significant bull markets of the period.

The equity market does not appear to us to be at an "extreme" and as a whole may be headed up or down. Regardless, we are finding individual

stocks trading at compelling valuation. Especially exciting to us are companies in specific situations which we believe render them less likely to trade with the overall market.

On April 17th, my retired partner, Alan Beimfohr, passed away. I am thankful for the fifteen years we spent working together and know he will be missed by the many whose lives he touched. Al was exceedingly proud of the organization we have built and the trust clients place in us. We continue to invest based upon an investment framework he helped pioneer. I am also grateful to my colleagues, Chad Neault and Miles Yourman, for their contributions to this quarter's commentary.

Very Truly Yours,



John G. Prichard, CFA

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