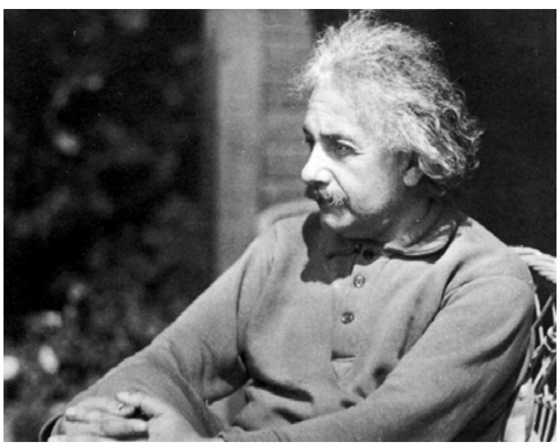
Knightsbridge Asset Management, LLC

May 27th, 2005

First Quarter Commentary

> ***"Only two things are infinite, the universe and human stupidity, and I'm not sure about the former."***



Albert Einstein 1879-1955
Professor of Physics
University of Berlin
Nobel Laureate, Physics, 1921

Such cynicism regarding the human condition might be expected of H.L. Mencken or Mark Twain, but Doktor Einstein? Einstein quotations conjure up an intellectual authority of the highest order...it was only a matter of time until the politicians sought his wise counsel from the grave to bolster their agendas. So it was that President Bush enlisted Dr. Einstein's authority to help sell the "ownership society" and Social Security reform. "The most powerful force in the universe is compound interest", so Einstein supposedly said.

Others claim he said "the magic of compound interest is the eighth wonder of the world" (can anyone recall the first seven?). No records, however, appear to unquestionably verify Einstein ever said anything about compound interest, but the attribution has been accepted into the lore nevertheless. We were hopeful Mr. Bush would realize his selling job engages this infinite pool of human stupidity but perhaps we ask too much. Congress is loathe to touch the social security hot potato cleverly having created their own system for themselves to assure they would not be part of a system doling out paltry benefits for the common citizen, a system that grants themselves outrageous and extraordinary benefits for part-time work, but that is another subject for another day.

The Bush Social Security plan makes investment return assumptions as follows: stock market 6.5% after inflation, corporate bonds 3.5% after inflation, and inflation-adjusted Treasuries (TIPS), 3.0%.

The 200-year average inflation rate has been 2.8% (GDP deflator). Therefore the gross returns from the three (3) aforementioned security classes adding this number for inflation would be: stocks 9.3% return, corporate bonds 6.3% return and TIPS, 3.0% return. The Bush plan assumes a 60/20/20 mix for a blended gross return of 7.4%. Subtracting 2.8% inflation from the first two categories produces an after-inflation return requirement of 5.2% for the blend envisioned. Subtracting fees reduces the return to about 5.0% net. Such a funded system produces under these assumptions a pool of capital of $361,000 for every working American, which, if annuitized on the 66th birthday produces income of $28,400/year. The current Social Security benefit is $25,000/year.

We bother you with this math because the enactment of such a system has implications for both stock and bond markets.

Since FICA or payroll tax generates $600 billion annually, can 60% of this, the proposed stock market investment component, be added year after year without distorting valuation levels? Since the total domestic stock market is valued at perhaps $12 trillion, $600 billion is 5%. Would adding an incremental 3% (60% x 5%) of fresh liquidity year after year to the stock market distort P/E ratios upward over time? Maybe. All factors equal, one might argue it would take only 24 years for P/E ratios to double. Then, once

doubled, returns from the stock market going forward would be cut in half. Instead of 6.5% after inflation, only maybe 3.3% after inflation. In short, theoretical returns would eventually be cut in half by this crude calculation. Wonderful for the next 24 years and hell thereafter. The inflow of fresh capital could inflate equity returns at first to the 12%-13% level before dropping them down to the 6% level. However, a phase-in could postpone this problem to some degree.

The only escape from this dilemma is if 1) national payroll growth were to be 3% less than stock market earnings growth, or, 2) the eventual liquidation of baby-boomer assets in retirement offsets the new liquidity inflows. One would expect payroll growth to be the sum of inflation plus workforce population growth which should be less than earnings growth by a percentage that approximates annual productivity growth percentages. And it is. About 4.5% (2.8% inflation plus 1.7% population growth) versus 6% earnings growth, a difference of about 1.5%, which is very close to the average annual productivity growth rate. But it is very improbable that productivity growth could ever be sustained at a level of 3.0%. Therefore with this modifier, the problem is less extreme by about half, but the problem still exists.

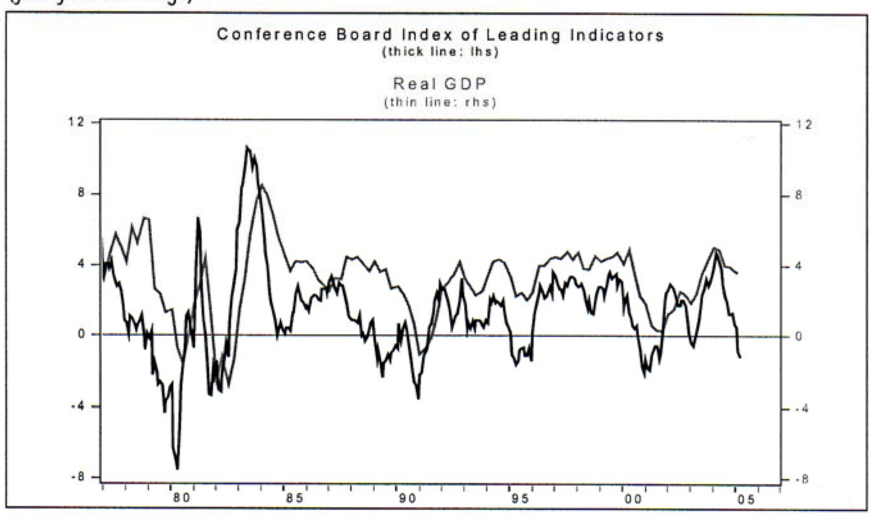
Moreover, selling the American public on the wonders of the stock market just a few years after the puncturing of the internet-inspired NASDAQ bubble is a tall order. Layer on the current general bearishness, and it becomes "mission impossible". Mr. Bush might have conceived a plan to invest FICA taxes in real estate. Had he done this, the resultant enthusiasm among the public at large would have been overwhelming, and no right-thinking congressperson would have dared stand in its way.

"No used universal joints, but we just got in a big load of GM bonds."

The recent downgrading by Standard & Poors of General Motors bonds from BBB– to "junk" at BB caused $40 billion of paper to be added to the junk market, a near record. Shortly thereafter GM bonds traded at a wider spread to the ten-year Treasury than 75% of the non-investment grade market even though Moody's has yet to follow suit! With these quantities being added to the gray zone of junk rated by one rating service and still investment grade by another, the rush to the exit is likely incomplete, and the only buyers of size are likely to be hedge funds. Or maybe Kirk Kirkorian.

Meanwhile, according to Ned Davis Research, 100% of economists on May 6th believed rates of interest on ten-year Treasuries were going higher, forecasting an interest rate six months from now of 4.75%. True to form, these bonds promptly marched off in the opposite direction by rallying to the now-current 4.09% yield. Bill Gross at PIMCO is predicting rates in the 3's, which is why he manages money and economists pontificate.

The Leading Indicator Does Just That ... It Leads
(year/year % change)



Source: Bureau of Economic Analysis, The Conference Board, Merrill Lynch

Such rates predict economic weakness upcoming. As do other data, such as "leading economic indicators" (LEI) showing here a good-sized drop over the past few months. Even in China where GDP growth is still supposedly running 9% per annum, it is noteworthy that the Shanghai's A-share Index is down 40% in the past 13 months. We therefore believe the U.S. market weakness of the first five months of 2005 to be related to 1) slowing real GDP growth expectations in the second half, and 2) nervousness over how high Chairman Greenspan might wish to take short-term interest rates.

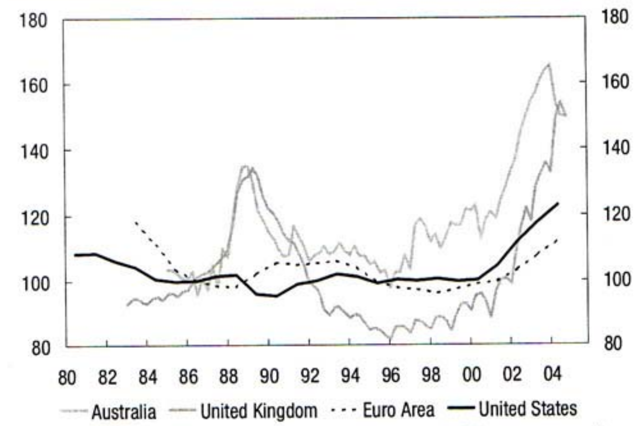


Figure 3. Australia, Euro Area, United Kingdom, and United States — Ratio of House Prices to Household Incomes (1986=100), 1980-04

Note: House price-household income ratios are defined as the ratio of the average or median house price to the average or median household income.
Sources: ECB, national sources and Citigroup.

Ironically, the real estate market may be having a greater-than-normal influence on the equity market. Tiny bubbles. Mr. Greenspan finally confessed he saw some of these, and it wasn't in his champagne glass. It was in selected regional real estate – like California, New York, Boston, Washington D.C., Florida and Arizona. Rest easy, because price stability still reigns in Ohio, Iowa, Kansas and South Dakota. Anecdotal evidence of real estate popularity abounds:

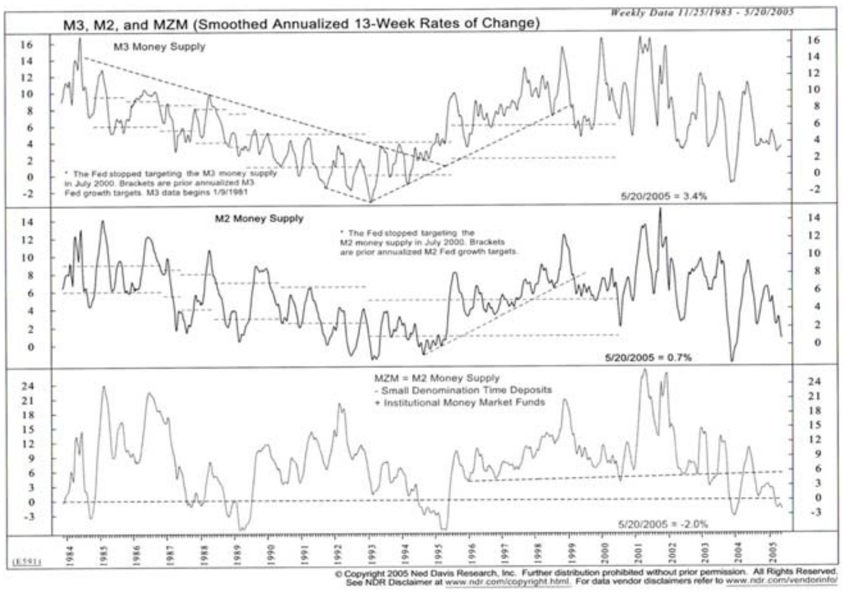
1. **Between May '03 and May '04 the number of houses sold that had been owned for less than six months sky-rocketed 47%,**
2. **The N.Y. Times reports 70% of buyers of Miami's South Beach condos are "investors",**
3. **Investors now represent 23% of all buyers nationally, up from a historic norm of 6%,**
4. **The number of chapters of the National Real Estate Investors Association since 2002 has risen from 44 to 170,**
5. **In 2004, 86 books on real estate were published versus 29 in 1999,**
6. **Since 2000, the median price of a single family home in San Diego is up 105%, in Miami up 92%, in New York City 77%,**
7. **June 6th, 2005 cover of Forbes "Real Estate: Make a Killing in Resorts",**
8. **May 30th, 2005 cover of Fortune "Real Estate Gold Rush: Inside the hot-money world of housing speculations, condo flippers, and get-rich-quick schemes...is it too late to get in?"**
9. **65 of 136 cities had double digit home price gains in 2004.**

We believe that short-term rates will likely be held at a level high enough to induce a reduction in the real estate feeding-frenzy currently being witnessed. So that rather

than looking at the more conventional economic measures such as unemployment, inflation, commodity prices, treasury yields, purchasing manager's index (PMI), etc., it may be more important to keep an eye on housing inventory, days on the market before sale, and signs of a contraction of available credit to the least credit-worthy borrowers via structural restrictions rather than the usual interest rate rationing of credit.

We cannot let the quarter pass without commenting on the new CNBC television program "Mad Money" hosted by the irrepressible Jim Cramer. Jim is formerly of "Kudlow & Cramer": (AKA "Crud-low & Screamer" to some veterans). One night I am watching. My wife says "that guy is horribly obnoxious". I quietly agree. "Mad Money" for those of you who haven't had the pleasure, is one half-hour of mostly non-stop screaming (clearly the Toprol and Norvasc aren't working here). The arterial protrusion from his perspiration-beaded forehead is only matched by his foaming-at-the-mouth. He frantically paces back and forth gesticulating at the camera, occasional spittle projectiles finding their way to the studio floor. In the middle of the program he becomes truly manic with a segue to "Lightning Round", a session wherein callers ask him about a stock. In the span of only three seconds he flashes a one-year chart and shouts "bullish" or "bearish" followed by a one-second picture of rampaging bulls or foaming-at-the-mouth bears. Should he need to come up for oxygen, he lurches right to a bank of red-buttoned pneumatically actuated surrogate sounds, like, if you're really bearish, the sound of a submarine doing an emergency dive – ooooouugaah, ooooouugaah! This means he doesn't like the stock. Occasionally a caller stumps him by asking for an opinion on something obscure, resulting in a severe verbal tongue-lashing. Yes, Jim is a sight to behold and our prediction is that Louis Rukeyser can rest easy, longest running TV record intact, as Jim will likely have the shortest running TV program ever, second only to former tennis impresario John McEnroe.

Evidence strongly suggests equity markets discount the economic environment six to nine months forward. Therefore one would expect current market action to reflect conditions expected in early 2006 wherein the Fed will have finished tightening and may in fact be in the initial stages of easing. Otherwise they run the risk of overstaying their hand and initiating a recession. With “M2” monetary growth having slowed to 0.7% and “MZM” (money of zero maturity) having slipped to -2.0% for the fifth time in 22 years as seen here, the Fed has little room left for further tightening without bringing on a recession, in spite of having preannounced further increases in rates.



We weakly object to Dr. Einstein’s characterization of human stupidity as being infinite. Perhaps it is finite but perpetually ubiquitous. We look forward to a better stock market performance in the months ahead in the belief that early 2006 will be bringing better economic news.

Very truly yours,

Alan T. Beimfohr John G. Prichard, CFA