COLBERT
INVESTMENT
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# Annual Letter to Clients
# December 31, 2009

**The horrible and terrifying deeds and words of the very renowned Pantagruel King of the Dipsodes, son of the giant Gargantua**

Should Lehman Brothers have been saved from bankruptcy? Why wasn't American International Group (AIG) allowed to fail?

There are two basic reasons for bankruptcy: lack of liquidity or insolvency. A good business could run out of cash due to a temporary or a cyclical reason, or due to poor (but reversible) business decisions. Coming to the rescue of such a business with fresh cash from shareholders, lenders or government makes sense. Existing shareholders may lose some, creditors usually come out OK. Nearly every business manager has gone through a liquidity crisis, emerging wiser, with a stronger company.

Insolvency concerns a company whose viability will not be restored by throwing money at it. Its problems are more permanent in nature, like a structurally uncompetitive high cost structure, or assets that would not produce enough cash or cash flow to cover expenses or debts. The best option is liquidation or a restructuring where shareholders may be wiped out, creditors take big hits, possibly losing everything as well.

Lehman Brothers, the broker-dealer-investment-bank, had some good assets (or businesses) but its reckless management ran the corporation into the ground, having borrowed excessively to buy investments that turned out to have little value. Just like Tony Montana – Al Pacino's character in the movie Scarface – a pusher who consumes his own smack is doomed.

Of course, the government *could* have saved Lehman Brothers (governments do whatever they want, legal or not). However, Lehman Brothers was undeniably insolvent. It was toast.

The gargantuan AIG had a liquidity crisis, a giant one, as well as some sizable insolvent activities. To make a long story short, many international banks had bought insurance from an AIG subsidiary to protect them against losses on packages of dubious loans. AIG had sold so much of this protection to the Who's Who of the world banking industry that it was running out of cash to pay on their claims. The global financial system, already weakened by the debacles of Bear Stearns, Fannie Mae, Freddie Mac – and now the Lehman Brothers bombshell – was utterly wobbly. Big Brother had to step in.

Immense amounts of liquidity would be required to stabilize the staggering global financial system. Or as then President George Bush said in a brilliant piece of economic analysis: “If money is not loosened up, this sucker could go down” (alluding to the economy on September 25, 2008).

**Little Dutch Boy**

Alan Blinder, former Federal Reserve Vice Chairman, told the following story referring to the actions taken by the central bank’s Chairman, Ben Bernake:

> *One day a little Dutch boy was walking home when he noticed a small leak in a dike that protected the people in the surrounding town. He started to stick his finger in the hole, but then he remembered his moral hazard lesson. “The companies that built this dike did a terrible job,” the boy said. “They don’t deserve a bailout. And doing that would just encourage more shoddy construction. Besides, the dumb people who live here should never have built their homes on a floodplain.” The boy continued on his way home. Before he arrived, the dike burst and everyone for miles around drowned, including the little Dutch boy.*
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> *Perhaps, You’ve have heard Fed’s an alternative version of this story. In this kindler, gentler version, the little Dutch boy, somewhat desperate and very worried about the horrors of the flood, stuck his finger in the dike and held it there until help arrived. It was painful. The little Dutch boy would much rather have been somewhere else. But he did it anyway. And all the foolish people who live behind the dike were saved from the error of their ways.*

The ongoing debate about how the government handled the financial crisis of 2008-2009 will probably outlast all of us. Opinions abound, nobody really knows. I side with the Fed’s Dutch boy. We were <u>all</u> bailed out.

**2008, What a year…**

Nobody needs a reminder of dismal 2008 performances. Revisiting bad times helps better understand where one had gone wrong, what correct actions were taken. For example, here is what I wrote when the liquidity crisis was in full bloom in November 2008:

> *Two months ago I wrote that it was an ideal time to invest. The painful drop in market prices of gold, bonds, commodities and equities since then shows how early I was. For this, and other mistakes, I accept full responsibility. Every way I look at this though, no matter how much I turn things upside down, the evidence at hand <u>screams</u> that we are presented with opportunities many of us may never see again in equities and in bonds.*
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> . . .

*I can’t guarantee you anything specific. I don’t know what may happen in the next year or two or three. But I am resolute, working ceaselessly, and devoting all my resources to a positive outcome. I will not let you down.*
*Colbert Investment Management November 30, 2008 Letter*

**2009, What a year!**
Never in my life has it been safer to take the proverbial calculated risk. Like shooting fish in a barrel. Value investing heaven. Our bond portfolios have generally performed splendidly. Our equity portfolios have rebounded commendably. (Read more about it in our Core Equity Composite Portfolio Annual Report).

Thank you for your patience and your confidence.

With kindest regards and every good wish,

Karim Armand

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