COLBERT INVESTMENT MANAGEMENT

Annual Letter to Clients
December 31, 2010

Togrog

Jim Chanos, a hedge fund manager known for correctly betting against Enron, Tyco and the recent real estate mortgage bubble, told Fortune Magazine the reason he had become bearish on China. Sometime in 2009 he gathered that China was building 5 billion square meters (50 billion square feet) of new office and residential space. He posits that even 1.3 billion Chinese can't productively use all that real estate, and as a result, a major bust is bound to happen. Without getting into the merits of his thesis, I would rather focus on what you need to build 5 billion of anything.

China needs copper, iron for steel and a myriad of other commodities, including coal, tin, zinc. In other words, lots of dirt. The countries currently booming economically are mostly natural resources rich: Russia, Australia, Indonesia, Canada, Peru, Chile, Brazil. These countries also have mostly large populations whom are now consuming more protein, dressing according to their improving incomes, consuming wheat, soybean, corn, beef, pork, cotton, crude oil. Countries in Africa too are benefitting from the commodities boom, so are Argentina, Ukraine, even the U.S.A. Except for Venezuela, blessed with enormous oil wealth, along with a comfortingly named currency (Bolivar Fuerte) but whose stock market was the worst-performing in 2010, and whose currency was also the worst (decidedly not fuerte).

Mongolia obviously stands out, not just because of its famous son Genghis Khan, but also because of its geography. Mongolia was under Chinese control from 1691 to the early nineteenth century when it came under the protection of the USSR. Talk about a bear hug! After three hundred years of hibernation, China is now shaking the world with an insatiable thirst for what Mongolia has the mountains of: natural resources (including coal, gold, etc.). Mongolia's geographic luck has finally turned, enabling it to finish 2010 with the best-performing stock market and the star currency, the togrog.

For Richer, For Poorer

Too of a good thing lasting too long can have negative side effects. Booming demand causes pressure on supply, production constraints result in higher prices for commodities, clothing, food. Inflation is rearing its ugly head in emerging markets, whose central bankers will attempt to choke with higher interest rates. Higher interest rates cause horrible pain to investors with long-term bonds bearing low interest rates. Creeping inflation is just one of the many risks we face.

The faster growing economies account to roughly 42% of world GDP, with about 85% of the global population now straining commodity markets. On the other side, the richer half of the world (U.S., Europe, Japan) faces huge budget deficits, heavy national debts, and deflation. How it all shakes out is an evolving dilemma we are preoccupied with.

Speed

Things happen faster now. News is global, twenty-four x seven, instantaneous. Competition is intense. Information (and disinformation) circulates at lightning speed. Capital (money) flows rapidly, back and forth, around the world. Risk becomes opportunity turns into risk in the blink of an eye. What took years takes months, months turn into days.

We have witnessed the very complex bankruptcy re-organization of General Motors, whereby its shareholders lost 100% of their investment, whereas its bondholders lost 90%. Unionized employees lost many of their gold-plated benefits (benefits that killed the golden goose). Experts said bankruptcy would destroy GM, millions of jobs would be lost. GM is actually thriving now. Within 16 short months of entering bankruptcy, GM completed an IPO (Initial Public Offering) which might (maybe) enable the government to recoup its $50 billion bailout (eventually).

Citigroup received a $45 billion bailout from the U.S. government which, when converted into shares, made Uncle Sam its biggest shareholder. The government sold all its shares 27 months later for a stunning $12 billion profit. Yes, a profit.

American International Group (AIG) whom had received a gargantuan $120 billion in government support has nearly repaid it all, and the U.S. Treasury may actually earn a profit on the whole thing. A mind-boggling turnaround in only 30 months (although it would be another year or two for a full government exit).

> *N.B.: In order to save the global financial system (and economies) from collapse, a massive transfer of debt from the private sector to the government has occurred. The debt obviously hasn't simply vanished. Therefore some of the gains on one side of the balance sheet have equivalent potential losses on the other side.*
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> *The U.S. government has already contributed $130 billion in capital to Fannie Mae and Freddie Mac, with more surely to be required, all never to be recouped. Ever. Ironically real estate mortgage giants Fannie Mae and Freddie Mac were directly (un)monitored, regulated and (un)supervised by the U.S. Congress. This fact renders the much ballyhooed argument that the crisis was due to a lack of regulation as a rather tenuous theory.*

The Verdict

Holding lots of cash, or safe short-term bank deposits have proven costly. Costly in a discrete, stealthy, muted fashion, something sneaky called loss of purchasing power. Diversified Fixed Income (bonds) portfolios we manage have done quite well in 2010. Our Core Equity Composite (stocks) beat the market by a handsome margin. (Read more about this in our Core Equity Portfolio Annual Report).

In order to succeed in this fast-moving, rapidly-changing, risk-laden, intensely competitive world, one must stay nimble, be on the defensive, while on the offensive. I believe it is those traits which helped us navigate the extraordinary 3 years gone by. The opportunities are here, albeit harder to find, not as cheap as before. The next few years are expected to remain bumpy, surprising, selectively rewarding.

Best wishes,

Karim Armand

Our company manages Fixed-Income, Balanced and Equity portfolios. This report refers only to the Equity portion of client assets.

Core Equity Composite Portfolio Annual Report
December 31, 2010

"Cult of equity said to be dead. Investors fall out of love with asset class."
-Financial Times, September 2010

"Stock picking is a dead art form."
-Wall Street Journal, September 2010

Our core equity composite portfolio performance increased 25.15% (net), while the S&P 500 index including dividends was up 15.06% (gross).

Throughout the year stocks were trading at lower prices than their own bond prices indicated. In other words, companies were more valuable to private ownership than as publicly-traded entities. Whenever such a situation exists, buying stocks is a better alternative to bonds or cash. I believe it is still the case today, as do companies using their cash to buy publicly-traded businesses at relatively low valuations.

On a percentage basis our worst performers were Forest Laboratories (-13%), WellPoint (-17%), WellCare Health Plans (-18%) and BYD Company (-27%). Our "galacticos" included SandRidge Energy (+30%), IDT (+55%), United Rentals (+150%), Liberty Capital (+172%) and Air Transport Services Group. (+211%).

During the year we completely exited from CapitalSource, Contango Oil & Gas, Dell, Forest Laboratories, Humana, IDT, Pfizer, United Health Group, United Rentals, WellPoint and Yahoo mainly because other investments offered better risk-reward relationships. New positions include AIA Group, Biglari Holdings (formerly Steak N Shake), BYD Company, Charles River Labs, Citigroup, Goldman Sachs, and Omnicare.

Our client portfolios outperformed the index in spite of some of our largest holdings having negative stock returns. I think that bodes well for the future.

CHANGES MADE DURING THE 4TH QUARTER 2010

New positions established:
AIA Group

Eliminations:
Humana
United Rentals

Increases in existing positions:
Citigroup
Goldman Sachs
Sand Ridge Energy

Reductions in existing positions:
Air Transport Services Group
DISH Network
DirecTV
Liberty Capital
Potash Corporation of Saskatchewan

FULL YEAR 2010

Top contributors to performance
Liberty Capital (reduced)
United Rentals (increased then eliminated)
Air Transport Services Group (reduced)
Berkshire Hathaway (reduced)
Potash Corporation of Saskatchewan (increased then reduced)

Top detractors from performance
BYD Company (new holding)
Sears Holdings
WellCare Health Plans
Forest Laboratories (eliminated)
WellPoint (eliminated)

TOP TEN EQUITY HOLDINGS
(44% OF TOTAL)

Sears Holdings, RHJ International, ATP Oil & Gas, Liberty Capital, Leucadia National, Hertz Global, CNO Financial, WellCare Health Plans, Citigroup, Omnicare.

Sears Holdings (SHLD)
Third-largest retailer in the United States, including brand names DieHard, Craftsman, Kenmore and Lands' End. Largest appliance replacement parts company (PartsDirect.com). Growing, profitable on-line (internet) presence (Sears.com, Landsend.com and PartsDirect.com). Substantial real estate holdings in mostly prime locations which I estimate are worth over $70 per share in today's depressed environment, for the real estate *alone*. Strong cash flows, excellent owner/managers. Disliked by most, reviled by many, should prove its critics wrong in a big way. (I also said that last year, and so far, so wrong). Our average cost is $76.15.
Price per share 12/31/2009: $83.45 Price per share 12/31/2010: $73.75

RHJ International (RHJIF)
Its executives and management have an excellent track record. In 2010 RHJI purchased Kleinwort Benson, an eminent British private bank with a 200-year history, from Commerzbank of Germany in a forced sale as part of a government bailout after losses during the financial crisis. In the midst of transformation towards financial services, the company looks to divest itself of its other investments (57% of total assets) and opportunistically take advantage of the once-in-a-generation massive forced sellers of European financial assets (banking, asset management). Its conservatively estimated book value per share is $13.39, while our average cost is $11.11.
Price per share 12/31/2009: $7.65 Price per share 12/31/2010: $8.32

ATP Oil & Gas (ATPG)
ATP ranks fourth overall, after Shell, BP and Anadarko in deepwater (water depths greater than 1000 feet) Gulf of Mexico well bores. Unfortunately for ATP their main well is about 60 miles from BP's infamous Macondo well that blew up in April 2010. Since then, no deep water permits have been issued by the US government. ATP owns some of the safest infrastructure technology (re-usable platforms) with several redundancies built in to prevent oil spills (BP only had one level of blow out preventer "BOP"). ATP has never had an accident (ATP also operates in the North Sea). ATP should be one of the first to be allowed to drill in the deep water Gulf of Mexico, and its prospective growth is sizeable. Our average cost is $13.88.
Price per share 12/31/2009: $18.28 Price per share 12/31/2010: $16.74

Liberty Capital (LCAPA)
John Malone and Greg Maffei made the investment of the decade by lending $400 million to then moribund Sirius XM Radio (SIRI) in March 2009, when most people were losing their head. Within a few months, Sirius repaid $460 million, having previously also awarded LCAPA with a $12,500 security convertible into 2.6 billion Sirius shares now worth $4.2 billion (as of December 2010). We had double our number of shares in Liberty Capital in December 2008, in the depths of the financial crisis, at roughly $3 per share (it was selling for $15 before the Lehman Brothers bankruptcy). We have sold shares from time to time since then. Our average cost is $6.10.
Price per share 12/31/2009: $23.88 Price per share 12/31/2010: $62.56

Leucadia National (LUK)
Sometimes called a mini-Berkshire Hathaway, Leucadia owns stakes in diverse industries like Australian iron ore mining, Spanish copper mining, real estate, financial services. Principal owner/managers have compiled a lumpy, yet enriching track record. Mining operations have been big winners. Our average cost is $20.78.
Price per share 12/31/2009: $27.79 Price per share 12/31/2010: $29.19

Hertz Global (HTZ)
The world's largest general use rental brand operating out of 8,000 locations in 145 countries. Also operates one of the world's largest equipment rental businesses through 350 branches (US, Canada, China, France, Spain). We purchased Hertz's convertible bonds on May 21, 2009, then swapped them for common shares on November 4, 2009. Average cost is $9.56.
Price per share 12/31/2009: $11.92 Price per share 12/31/2010: $14.49

CNO Financial (CNO)
CNO (formerly known as Conseco) is an insurance holding company that sells life, long-term care, and fixed and variable annuities (Bankers Life, Washington National, Colonial Penn, etc.). It survived a near-death experience during the financial crisis due to depressed investment portfolios and substantial debt, forcing the company to raise fresh capital from shareholders. It sells for 40% of book value (an complex accounting measure of its estimated liquidation value) while insurance companies on average sell for 90% of book value currently. The business is well managed and we expect the company's shares will approach book value within a few years. We doubled our position when the stock dropped to 30% of book value in May 2010. Our average cost is $5.25.
Price per share 12/31/2009: $5.00 Price per share 12/31/2010: $6.78

WellCare Health Plans (WCG)
The company operates health plans in multiple states targeted exclusively to government-sponsored programs (Medicare and Medicaid). This health insurance company serves about 2.3 million members. We increased our stake when the company's stock traded below $7 per share in March 2009. Average cost $14.35.
Price per share 12/31/2009: $36.76 Price per share 12/31/2010: $30.22

Citigroup (C)
Who doesn't hate big banks? Who stands to make big bucks? As investors, we aim to keep our emotions in check. Citigroup should have normalized earnings of $1 per share in a few years, resulting in a stock price of at least $10 per share. Our average cost is $4.07.
New holding May 6, 2010 Price per share 12/31/2010: $4.73

Omnicare (OCR)
Omnicare is in the institutional pharmacy business, running pharmacy services in long-term care facilities, chronic care and other settings comprising 1.4 million beds. Its previous CEO took the company from $150 million in sales to $6 billion in almost 30 years, its stock price went from $4 in 1981 to $60 in 2006. The company's management then stumbled badly with the stock floundering between $20-$30 in the last three years. The abrupt resignation of the CEO paved the way for our purchase of this fine business, now in the hands of a very capable Chairman, and its recently hired, well respected replacement CEO. It might take a few years to turn around the business, but we are thrilled to own it at such a reasonable price ($20.38) relative to temporarily depressed cash flow. New position August 19, 2010 Price per share 12/31/2010: $25.39

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