COLBERT
INVESTMENT
MANAGEMENT

Annual Letter to Clients
December 31, 2011

Since 2008 we have been watching three things: 1) how advanced economies (the U.S., Europe, Japan) handle the enormous additional debt they incurred in the past 2 decades; 2) how emerging economies (China, Brazil, India) might manage the landing from their government stimulus-spending boom, and the resultant high inflation; and, particularly, 3) the evolution of businesses in this notoriously rapidly changing environment. All three issues came to the forefront in the summer of 2011.

Euro Zone Postpone

How long will we moan, and groan, as our Dear European Leaders take us to the edge of the cliff, only to pull us back one meter, and bring us back to the edge of the abyss, only to pull us back two meters? Will they (we) slip next time?

Europe is like a bad horror movie, with some pretty bad actors (politicians), a wobbly storyline (the Euro Zone), where a pretty party girl (Greece) is devoured by an enormous ogre (too much debt).

You might have spent the last 6 months trying to figure out what may happen, having read many newspapers, magazines, books, even tea leaves on the subject of Europe, and have come to the conclusion that much of it is impossible to analyze. And markets seem to agree: we like what we hear on the evening news, only to dislike it the next morning.

In spite of it all, no current European lender really wants to be the one who presided over a Euro collapse. The stronger countries are holding out from completely bailing out the weaker ones until they have a strong(er) fiscal union, while preserving national sovereignty. If Europe can achieve this in the next few months, a full-blown crisis would be avoided.

> **Small sacrifice early, or Big sacrifice later**
>
> The formation of the Euro Zone (the 17 countries that now share the Euro currency) allowed all members to issue bonds to help finance their respective deficits. Between 1999 and 2007 some countries were growing faster than others, and, some borrowed proportionally more than others. Some countries exercised restraint in the size of their annual deficits, while others were

imprudent.How was that possible? Because, until 2008, markets (or buyers of Euro-denominated sovereign debt instruments) treated ALL countries as having a similar risk profile. And, investors required very similar levels of interest rates on the debt, without differentiating the good from the bad. What politician can resist the siren song of cheap credit to finance electoral promises, promises they really can't afford?

When Lehman Brothers went bankrupt in 2008 — bringing the global financial structure to its knees — markets were forced to differentiate risks. So interest rates started going up for the riskier countries like Greece, Ireland, Portugal, and later, Spain and Italy. Now the pendulum has swung the other way where markets see risk almost everywhere. In some cases markets have priced the risks appropriately. In other cases risks are over priced. Over time, the mispricing of risk (or interest rates) will correct itself.

BRICs Constricting

Brazil, Russia and India have hit a speed bump. In fact, every other country that exports natural resources (Canada, Australia, Chile, Peru, etc.) has some sand in the gears of their economic motor. The locomotive kicking up the sand is China (the "C" in BRICs). Since 2008, China has used its accumulated riches from exports to the rest of the world to hyper stimulate their local economy. They have put every project, including bridges, roads, airports, trains, houses, apartments and offices on Viagra. A truly amazing performance, with unpleasant side effects, such as inflation, and possibilities of a real estate bubble.

Chinese authorities have hesitantly rationed the inflationary stimulants, while hoping to avoid a crash landing. Just like betting against the U.S. has proven historically costly, betting against China successfully managing this economic transition would not be wise.

As emerging markets guru Mark Mobius said when asked if China was going to have a soft-landing or a hard-landing, China is just not going to land.

******QUIZ******

U.S. quarterly corporate profits before tax:

Sept 30 2000	Sept 30 2006	Dec 31 2008	Sept 30 2011
$814 billion	$1,655 billion	$971 billion	?

Guess how much U.S. corporate profits before taxes were during the September 30, 2011 quarter?

a) $700 billion b) $1,000 billion c) $1,500 billion d) $2,000 billion

(Remember your choice. The answer is revealed below).

USA Recovering

In spite of a widely feared recession in the largest economy in the world, almost every economic indicator or statistic has remained on an uptrend. Things are not getting better fast enough to reduce unemployment yet, but things are getting gradually, slowly, better. One way of thinking about U.S. economic performance today, is that maybe 15% of all sectors are in depression or near-depression, while perhaps roughly 85% are actually doing well. On one hand, the depressed 15% is on a very long road to normalcy, although at a reduced level compared to the peaks reached during the residential real estate (and banking) bubble years. For example, housing construction has gone from about 6% of GDP to 2% now.

On the 85% hand, if you look at train loads, truck loads, container loads, plane loads, hotel occupancy, telecommunication data, automobile sales, in fact, just about anything unrelated to residential real estate, you would think the country is booming! But, it is not. It's more like a marathon runner with a parachute attached to its back.

It ain't pretty, it may be hard to believe (good news doesn't sell as well as bad news), but the U.S. will be OK. In fact, U.S. corporate profits before taxes hit a record quarterly high of almost $2,000 billion as of September 30, 2011.

"Fracking"

Technological advances have changed the world in many obvious ways; the internet, email, iPhones, iTunes, Facebook. Some changes are harder to notice. Up until 2008, the U.S. had been building LNG (Liquid Natural Gas) terminals to import natural gas, as a way to satisfy increased electricity generating capacity and industrial demand. A novel technological application called hydraulic fracturing has revolutionalized oil and gas exploration in the USA. The "fracking" technique has transformed gas drilling so much that a glut in supply has developed, to a point that the U.S. will now <u>export</u> natural gas. Domestic natural gas went from over $8 per BTU in 2007 to around $3 per BTU nowadays. Consumers and businesses are benefitting from this unspoken deflation in energy costs.

This technology has been applied to oil production in the same type of rock formation where pockets of resources are trapped in previously difficult to reach areas. The horizontal fracking technique has dislodged enormous commercial quantities of "tight" gas and "tight" oil. So much that the U.S., which was known to import 9 million barrels of oil per day, is on its way to importing 2 million *less* barrels of oil per day. An economic (and political) benefit of appreciable importance.

Volatile Markets

Markets are very difficult to understand in the short term. A famous economist (now deceased), John Kenneth Galbraith once tried to explain markets by comparing them to a contest in the newspaper to vote for the prettiest girl. The winner would not necessarily be the prettiest girl, but rather the one *voted* prettiest by *most* voters. Markets are like a voting machine, whereby every minute, millions of votes are cast for and against all kinds of investments.

Value investors normally find it futile to guess which way market participants will vote any given day, month, or year. By focusing on the underlying merits of a business, by estimating the intrinsic value of an asset, we aim to be a weighing machine. A weighing machine delivers something more rational, not something entirely subject to the whims of voters. When voters cast their votes appreciably above the underlying intrinsic value, we don't buy, we prefer to sell. When the voting pushes prices sufficiently below intrinsic value, we don't sell, we prefer to buy.

While our portfolios will inevitably bend to market winds, we try to ultimately profit from times of dislocation. When crowds zigzag, when people grow frustrated, when they don't know what to even think anymore, when investors throw in the towel, this is when we do our best work.

Where does that leave us? Perhaps in one of the more fertile investing environment in years. While several bonds and stock prices have had a bad year in 2011, the underlying businesses have often not deteriorated as much, they may have even improved in some cases.

Best wishes,

Karim Armand
President

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