Fellow Investors,

2009 concluded on a much brighter note than it began. The beginning of the year was marked by fears of "the next great depression" and fears of a financial meltdown. Neither of those has occurred, many banks have exited TARP funding, and the economy generally seems to be healing. We're doing better than most people thought we would.

For you and me, there is good news and bad news this quarter. The good news is that I did find three investments I like -- more on each one of those later. The bad news is the timing. Those buys were spread throughout the quarter, the most recent only a few days ago. And so, for some of you, your investments have not been able to catch up with the bull market. Last quarter I wrote about my “fat pitch” investment strategy. Well, I’ll still need a few more "fat pitch" investments before I’m satisfied with your portfolios. Until then, your cash balances will probably remain high, for better or for worse.

For me, sitting on high cash balances is something like a professional basketball player voluntarily benching themselves -- not something I like to do. It certainly hasn't benefited either your or my returns over the last few months. I'm eager to deploy your cash and mine, but in the meantime, I hope you’ll remember that I don't charge any fees on your cash balances (a rarity in this field). I don't want to be paid if I’m not making money for you.

Unfortunately, Q4 gains are relatively poor. When I started writing this letter a short time ago, they were relatively good. I like to buy companies that have a burst of short-term bad news (but whose long-term prospects remain good), and odds are against me nailing the exact bottom for you. As one of my investor friends quipped: "do what Kai does, only 4 weeks later." Insofar as I am successful, it is because I look at a longer time horizon than the average investor.

In the pages that follow this letter, I will talk about three investments I made during the last quarter. NRG is an electricity provider, and probably my favorite long-term investment today. SUAI was a short-term arbitrage where the buyer was paying a premium to SUAI's price. CIT is a lender to small businesses that just exited bankruptcy.

As some of you have already seen, I don't have any ability to predict the short-term. But I believe that I can outperform in the long-term. Because I hope that many of you will remain clients for years and even decades, I’d like for you to understand my approach so you can decide if you’re comfortable investing with me. To that end, I hope this letter has been useful.

I continue to enjoy investing on your behalf very much and I am gratified you have entrusted your money with me. I hope you all have a terrific 2010.

Kai Shih
Q4 2009

NRG

NRG is one of my favorite companies, and its recent drop in price presented an opportunity to buy. Because I believe the long-term value of the company exceeds its current price, it does not bother me when the price of the stock declines. Because NRG is a long-term, multi-year holding, I will pace myself and only write a little at a time. You're likely to lose interest in the topic far sooner than I.

NRG generates and sells electricity. The economics of electricity are simple: everyone uses it, and demand for it increases by about 2% a year. Electricity is not easily stored in large quantities, and it can't be transported across long distances, so there's no threat of Chinese or foreign competition. Power plants are expensive, time-consuming and difficult to build – particularly around population centers where they are most needed. Current owners of power plants have what amounts to a local de-facto monopoly (or perhaps oligopoly) on electricity, which everyone needs and wants in ever-increasing amounts. Currently, there is an excess supply of power plants, and that is pushing electricity prices down. Over the next few years, the demand for electricity will increase and electricity prices will move up (a double-win for the company). This process may accelerate if power plants are shut down for environmental reasons or that demand grows faster due to, for example, electric cars (both are happening now, but to a small degree).

NRG has distinguished itself by performing superbly during the downturn – their financial results have been strong while their competitors have struggled. Now, they're cherry-picking assets from financially struggling peers, and in my opinion, the company is worth a great deal more today than it was prior to the financial crisis when it was trading at nearly twice today's price.

SUAI

SUAI was acquired during Q4, giving your holdings a quick 6% gain over a month which was relatively independent of the broader market (again, for better or for worse). I bought it for you after the acquisition was announced, and exited the position when the stock-for-stock acquisition was completed. With acquisitions, I try to anticipate the probability of them completing, and with SUAI I felt the chances were high. Unlike some acquisitions (for example, Sun), I felt there was virtually no regulatory risk since both participating companies are small. Some acquisitions are blocked by the to-be-acquired company when shareholders believe it undervalues their company. Both boards of directors had approved the merger, and because SUAI's purchase price was 100% over where it was trading, I felt shareholders would resoundingly vote for the merger (and they did).

The acquisition price was based on a sliding scale, and when SUAI's price dipped below the lowest point on that scale, I bought it for your accounts. I felt fairly confident you would see at least a 1% return (it turned out through random fluctuations to be closer to 6%).

The final piece was to understand the long-term value of SUAI in the case the acquisition failed (in the short-term, of course, SUAI's price would drop if the acquisition failed). In SUAI's case, I determined that the company has substantial holdings in government bonds and other "A" or better rated bonds (meaning the highest on the safety scale). Even after discarding the value of some of their questionable assets, I felt SUAI would be fine as a long-term investment in case the acquisition somehow failed (which it didn't).

CIT

CIT is a financial company which lends to small and medium-sized businesses. It entered and exited bankruptcy all during Q4, after which I bought shares for around $26 (it is close to $29 today). In CIT's case, I believe the actual value of the business is around $40/share (their current tangible book value) and if they execute on their plans, it will be greater than that.

The shareholders of a post-bankruptcy company are usually the pre-bankruptcy bond holders. Some of those holders are unable or unwilling to hold shares after the bankruptcy is complete. Any time vast blocks of shares are sold without a natural buyer for those shares, opportunities can arise. In addition, post-bankruptcy companies are often cleaned up, simpler to understand, and have shed their debt and other obligations.

In CIT's case, the bankruptcy reorganization had the effect of, first, reducing its debt by around $10 billion (though each piece of debt pays higher interest); and second, it employed "fresh-start accounting" which knocked $6 billion off their book value. Fresh-start accounting is a process in bankruptcy in which assets are marked to their current market value. Parenthetically, if other banks were forced to undergo fresh-start accounting most would have negative net worth today.

By the way, I do not rely on book value to guide my decisions (though NRG, CIT, and SUAI all trade below their book value) and I think book value can fool investors into a false sense of security about a company's real value (a mistake I made myself years ago). Book value is an artifact of accounting which may over-state or under-state the company's real value. Some financial companies pretend like their poor investments have value, and their book-value overstates their actual value. On the other hand, a company like Apple has a book value that understates its real value because book value does not assign value to its brand. In CIT's case, the bankruptcy process severely marked down their assets, so I believe CIT's book value of $40 approximates its true value.

For those of you with CIT, it was bought at around $26, which is about a 65% from their current book value of $40. This means CIT can lose money (which is counted against their book value) and still be profitable investment for you.