

## Potemkin Villages Everywhere

The year was 1787. Empress Catherine the Great was touring Crimea, now part of her Russian Empire. General Grigori Potemkin hosted her excursion, where she saw from her carriage, flourishing villages off in the distance. She concluded Crimea was a valuable asset and the General was doing a fine job managing her bounty. For him, initially this meant accolades. Eventually he became the most powerful man in Russia. Legend has it that General Potemkin staged the entire thing. Crimea was utterly impoverished. In a desperate attempt to impress the Empress, he had portable stage fronts built and moved along the landscape. These facades were elaborate, complete with eye-catching structures and actors. No one knows for sure whether or not the Potemkin village story is true, but the term "Potemkin village" lives on to describe false fronts in both the material and metaphoric sense.

Three centuries later, developers of Potemkin villages appear to be busier than ever. I can't escape a day in this business without getting the latest Madoff update. He is the master mind of a \$50 billion New York based ponzi scheme. The media has laid out details of some SEC insider relationships with the Madoff family. One SEC official married into the Madoff clan, another was on a board with one SEC official. It all begs the following question: Was the Securities Exchange Commission simply too far off in the distance or was it actually living in Madoff's Potemkin village? Either way, the Securities and Exchange Commission has severely failed to serve the American people.

Potemkin villages aren't only in America, all humans are capable of building them. In India last week the Chairman of Satyam, a global IT outsourcing firm, admitted that company finances were one big sham and that the company had overstated its financial statements by over a billion dollars. Satyam's Potemkin village was built so well that even the name of the company was an ironic farce. Apparently, Satyam means "truth" in Sanskrit. In explaining the fraud Satyam's Chairman Ramalinga Raju said:

*"What started as a marginal gap between actual operating profit and the one reflected in the books of accounts continued to grow over the years...it was like riding a tiger, not knowing how to get off without being eaten."*

These villages aren't just found in business. They tend to pop up frequently in political settings as well. Take Illinois, home of the recent Rod Blagojevich scandal. He is the governor of Illinois who allegedly tried to sell President-elect Obama's senate seat. What is even more alarming than his behavior is the consistent pattern of poor conduct of Illinois governors.

Three Illinois governors in the past fifty years have served time for fraud. These individuals pretended to act in the best interest of their constituents while they line their own pockets.

In today's market, there is a battle going on. The Potemkin villages built by the excesses of the last cycle are burning down. Nowhere is this more evident than in the banking system. The sector is riddled with political jiggling and overpaid executives. Seeing former Treasury Secretary Robert Rubin resign from Citigroup last week symbolizes a significant victory against the gluttony. Mr. Rubin was a director of Citigroup for the past decade. Under his directorship the market capitalization of Citigroup fizzled from \$125 billion to less than \$25 billion. Despite this, he collected around \$150 million in compensation.

## 10 Year Chart of Citigroup Inc (NYSE)



Source: Bigcharts.com

Credit card and prime loan default rates are increasing, retail sales are contracting, the unemployment rate is climbing and corporate bankruptcies are accelerating. These are severe headwinds for a banking system that is already on its knees. The US Bank Index reached a new low this week as more banks faced with today's reality deplete their reserves and become wards of the state.

We fully expect that we are in for a prolonged period of economic hardship. Recovery from yesterday's excesses means moving back to less profitable but simpler banking. This means more restrictive lending and slower economic growth. This is a step in the right direction. Ending the reign of deceit brought on by the latest Potemkin village builders will ultimately result in improved confidence. Improved confidence will ultimately lead us out of this.