May 2, 2012

"Your young friend could use some help. This is it. One dollar a bottle. It works wonders on wounds." – Carpetbagger

"Works wonders on just about everything, huh?" – Josey Wales

"It can do most anything." – Carpetbagger

"How's it with stains?" – Josey Wales
[spitting brown tobacco juice on the Carpetbagger's white suit]

Dear Client,

2012's first quarter produced gangbuster returns for the broad equity markets. The lift from the European Central Bank's long term refinancing operations (LTROs) that began in the fourth quarter of 2011 continued through early 2012 and only seems to have petered out as we write this letter in late April. The market has developed a Pavlovian response to central bank intervention. Apparently, "money printing"[1] can "do most anything."

As one would now come to expect on the back of central bank intervention, financial securities led the market; while financials are only 15% of the S&P 500 index, they contributed 24% of the index's returns. As far as individual securities go, Apple was the single largest contributor, providing 15% of the index's returns, despite a weight of only 4%. We do not own depository financials, nor do we own Apple.

Given the moderate level of risk we have taken (per the strategy we articulated in our fourth quarter 2012 letter), we are pleased with our first quarter results. Here is our performance table as of March, 2012[2]:

	Q1	TTM	Cumulative Since 10/06
Grey Owl Opportunity Strategy (net fees)	**8.08%**	**2.34%**	**32.14%**
Spider Trust S&P 500 (SPY)	12.69%	8.43%	14.63%
iShares MSCI World (ACWI and MXWD)	11.93%	-0.16%	8.23%

[1] We generally agree with the pundits who label the LTROs "backdoor" quantitative easing (QE).
[2] For more information regarding performance, please refer to the performance disclosure at the end of this letter.

Executive Summary

The overall equity market's strong first quarter rally was narrowly focused and, from our perspective, fragile. Below we discuss our concerns and specifically explore our thoughts on broad equity and fixed income valuations. Cutting to the chase, we think both stocks and bonds are expensive. During the quarter, we used opportunities presented by "Mr. Market" to trim some of our lower quality positions and to add starter positions in a few high quality businesses. We also added to our short-term, high-yield fixed income holdings, sources of return that we expect to show less volatility but results equal to or better than the broad equity market indices. We have discussed our approach to and theses regarding numerous equity investments in past letters. This quarter, we will spend the majority of ink discussing our three new fixed income positions. We end the quarter up nicely for the year and with a defensive and upgraded portfolio.

Flashback

When we first sit down to write this letter each quarter, we typically reread our last few letters in order to follow up on issues we have raised previously. When we reread our first quarter 2011 letter, we were tempted to mail it out again with no changes. The situation today is almost exactly as it was one year ago. Here is the relevant summary taken verbatim from that year-ago letter:

- We believe most asset classes are at least modestly overvalued
- Excessive debt and government intervention will continue to hold real economic growth below its historical trend
- The same extreme leverage will also lead to greater asset price and economic volatility
- While the political calculus and current fiscal and monetary behavior will continue to lead to inflation, if popular support favors a pivot, we must be aware that deflation is possible (again due to excessive debt levels)

The letter is full of charts that illustrate our rationale for making these points. Unfortunately, the charts look very similar this year. The US economy has barely improved; Europe and China are probably worse off. Rather than take up several pages to recreate these charts, we recommend you review that letter. In short order, we will look to provide updated versions on our blog.

What is it worth?

"In God we trust, all others bring data."
- Dr. W. Edwards Deming, American Statistician

As we have written numerous times, a simple model based on mean-reversion[3] of both corporate profit margins and price-to-earnings (PE) multiples does an extraordinary job of forecasting investment returns over a multi-year period.[4] The logic is straightforward. Elevated profit margins bring competition that causes margins to contract. Likewise, investors eventually demand prices low enough to provide meaningful returns for risky equity investments which explains the PE multiple's tendency to mean-revert.

Today, S&P 500 profit margins are well over 8%. The post-war average is around 6%. The PE on the S&P 500 is just over 16.[5] The historical average PE multiple is just over 15.[6] If these measures mean-revert over a 7-year period, the S&P 500 will compound at an annual rate of just 2%. If it only takes 3-years for mean reversion, the S&P 500 will compound at an ugly -5%. Both of these scenarios are real possibilities, which investors must consider.[7]

From our vantage point, fixed income instruments are similarly overvalued. The yield on the 10-year US Treasury is currently 2%. From 1962 through 2011, the 10-year note yield has averaged 6%.[8] Again, the logic is straightforward. Over that period (and much longer) the economy has grown at a real rate of 3% and inflation has been 2-3%. Add in a few basis points for the maturity risk (there is no default risk on a US government bond given the Federal government's ability to print money) and a mid-6 percentage yield on the 10-year Treasury makes sense. If the 10-year yield mean-reverts to 6% over a 7-year period, the total return on the "risk-free" 10-year US Treasury will be 1% annualized. If the mean reversion occurs in 3 years, the total return will be -5%. Now you know why Jim Grant refers to US Treasury debt as "return free risk." (The typical description is "risk free return.")

To summarize, let's look at a table of possible outcomes for a balanced account invested 50% in the S&P 500 (i.e. equities) and 50% in the 10-year US Treasury (i.e. fixed income):

[3] Mean reversion is a statistical term that refers to the tendency of certain variables to return consistently to their long-run average (i.e. mean).
[4] The two best summaries of our thoughts on this are in our fourth quarter 2009 letter and our 2011 white paper. Numerous article available free at www.hussmanfunds.com and www.gmo.com describe similar approaches. Finally, a Barclays Global Investors InvestmentInsights piece from 2002 titled "The Equity Risk Premium" by Richard Grinold and Kenneth Kroner does an excellent job of describing this framework.
[5] This is the PE on trailing twelve-month GAAP earnings.
[6] From 1871 through 2011 via Robert Shiller's website at http://www.econ.yale.edu/~shiller/data/chapt26.xls
[7] A longer period of 10 years would produce returns of 3.6%. GMO has concluded based on historical data that the 7-year period creates the most accurate forecast.
[8] The actual average is 6.7%, but to make the math a bit more straight forward and the downside analysis a bit less drastic, we use 6%. http://www.federalreserve.gov/releases/h15/data.htm

Annualized Investment Returns for Three Potential Scenarios

	Mean Reversion		
	None	7-yr	3-yr
S&P 500	8%	-2%	-5%
10-year US Treas.	2%	1%	-5%
Balanced Account	**5%**	**-0.5%**	**-5%**

Investing in a Low-Return Environment

The obvious question is what is an investor to do? Our approach has been three-pronged. First, we look for undervalued securities that can achieve long-run returns far above what we expect for the broad equity market. Second, we have begun investing in very short dated high-yield fixed income securities where the yield-to-maturity is greater than our estimate of long-run broad equity market returns from current valuations. Third, we continue to hold plenty of dry-powder (i.e. cash) because we believe the future opportunity set of investments has a strong possibility of providing greater prospective returns than the current opportunity set.

We have discussed many of our equity market investments in past letters and on our blog, so let's examine our recent fixed income investments first. Many value investors are event or catalyst-driven. In non-technical language, this means they only invest in situations where they believe there is a specific event that will unlock mispriced value. Absent a catalyst, value investors must wait for the market to come around to their viewpoint.[9] In the case of fixed income, there is always a catalyst: the maturity date of the security. This provides investors a very tight range when estimating prospective returns and the investor can have a high degree of certainty about when they will have cash to redeploy.

MGM Resorts 6.75% of September 2012

In early December of 2011, we purchased the 6.75% bonds due in September 2012 of MGM Resorts International. We paid 101.38 for a yield to maturity of 4.75% annualized. At the end of 2011, MGM had net debt to EBITDA[10] of 7.5x. In 2009, it barely avoided bankruptcy as it worked to complete its $9.2B City Center project amidst the worst recession since the Great Depression and an even more extreme decrease in Las Vegas visitor traffic (where MGM earns 80% of their revenue). We recognize this does not sound like a solid business to lend money to. However, the new CEO, Jim Murren, has done an excellent job of stabilizing the company. 2011 EBITDA was approximately $1.4B, which was enough to cover $1B in interest payments.

[9] We are perfectly fine with non-event driven equity investments. Warren Buffett and many other very successful value investors have had spectacular careers investing in "time-arbitrage" situations. It certainly requires patience of both the investor and their client as businesses can compound intrinsic value for years before the market awards the business a "deserved" multiple.
[10] Earnings before interest, taxes, depreciation, and amortization

Additionally, the company ended the year with $2.8B in cash, more than enough to retire this $542mm issue when it comes due in September 2012. There are no debt issues coming due before this issue and we believe that even if a double-dip recession were to occur, it is unlikely business could deteriorate quickly enough to eat sufficiently into their cash hoard. Subsequent to our investment, the company raised additional capital in a longer-term bond offering and the Macau subsidiary issued a cash dividend, both of which increased our margin of safety.

CSC 5.5% of March 2013

In early January, we purchased the 5.5% bonds due in March 2013 at 100.44 for a yield to maturity of 5.1% annualized. CSC is one of the oldest and largest IT services providers in the world. Fear of federal government budget cuts and complicated accounting around a disputed contract with the UK's National Health Service (NHS) caused CSC stock to sell off throughout most of 2011. Likewise, spreads on its various debt issues widened.[11] Adjusting for the non-cash accounting charge related to the UK NHS project, net debt to EBITDA was 1.8x at the end of 2011. There is a small piece of debt due one-month prior to our bonds. This piece is $300mm and our piece totals $679mm. While their current cash levels could not fully retire both pieces of paper, we expect CSC to continue to generate approximately $225mm in cash per quarter. Unlike MGM Resorts, CSC's business is not economically sensitive. CSC's business involves the outsourcing of large portions of clients' IT operations. Thus, CSC develops significant institutional knowledge that is hard to replicate. We estimate 60-75% of their business is on long-term contracts and they have 90-95% visibility at the beginning of each quarter. While CSC is a steadier business with significantly less debt than MGM, the bonds are six months longer in maturity and thus provide a slightly higher yield.

Western Alliance Bancorp 10% of September 2015

As we hinted in our first page introduction, we are not particularly bullish on depository financials (i.e. banks). The community banks have too much capacity, significantly limiting growth. The large "money-center" banks are subject to vast new legislation by the name of Dodd-Frank that we believe will significantly reduce their returns relative to historical trends. In addition, the big banks are essentially black boxes. They may trade below stated book value, but does anyone, including the CEOs and CFOs of these immensely complex institutions with their myriad derivative positions, *really* know what book value is? However, in a small enough niche opportunities often exist.

Western Alliance Bancorp is a small regional bank with just under $7B in assets. Branches cover Nevada, Arizona, and California. The bank funds the majority of loans via their strong deposit

---

[11] That is, the price of its bonds went down and thus the yield that they offered to investors went up.

franchise, but they also have one *tiny*, $75mm, debt issue.[12] In early April, we purchased the 10% bonds due in 2015 at 108.5 for an annualized yield-to-maturity of 7.12%.

While Western Alliance's loan exposure is in some of the hardest hit states in the western Sun Belt, we believe the bank has worked over the past several years to establish a solid capital position. It holds tangible common equity of $481mm (7% of assets) as well as $98mm in allowances for credit losses against $185mm of non-performing assets (which are down 13% year-over-year).[13] Furthermore, the $185mm of non-performing assets includes $81mm in "other real estate owned." At $81mm, these assets are already marked down considerably from their origination amount (the land is at 16% of its original appraisal and the non-land assets are at 41%). It is reasonable to expect the bank will sell these assets without taking an additional meaningful capital hit. Finally, the bank is profitable, having earned $11mm in the first quarter of 2012, adding to its capital levels.

These three high-yield bonds make up approximately 7.5% of our typical separately managed account portfolio. With the S&P 500 at 1400, we expect the returns from these bonds will be higher than the annual return on the S&P 500 over a 7-year period. We continue to look for these types of opportunities, but companies are smart too. They are using the current low interest rate environment to refinance debt tes and doing so at longer maturities to "lock-in" these favorable costs. Supply has become limited and we are of course very choosey, but we expect opportunities to continue to surface.

What about Individual Equities?

Throughout the quarter, we continued the process of "high-grading" our portfolio. As we wrote last quarter:

> "Despite 2011's outperformance, US High Quality is cheaper today than it was in December 2010. We will still hold some 'show-me' names of lower quality, but they will be smaller positions and we will require them to be even cheaper before initiating a position. We believe many of the remaining low-quality names in our portfolio have become 'coiled springs' after 2011's sell-off."

In that vein, we closed out two positions: Apollo Residential Mortgage (AMTG) and Western Union (WU) and trimmed five others: Apollo Group (APOL), Bridge Point Education (BPI), Market Vectors Gold Miners (GDX), Lexmark (LXK), and Transocean (RIG). Each of these

---

[12] In addition to deposits and the one publicly traded debt issue we have invested in, the bank has a modest amount of TARP funding and trust preferred shares.

[13] When it comes to bad assets, decreases are good!

securities now trade at lower prices than when we sold/trimmed them. We also added to one position during the quarter: Ebay (EBAY) and initiated four new positions: Blackrock (BLK), BMC Software (BMC), Excelon (EXC), and Pepsico (PEP). Each of these positions today trades at a higher price than when we made our purchases.

While positive, the precision of these buys and sells over such a short period is more representative of luck than skill. More important than the short-term results, the above changes increased the quality of our portfolio and slightly lowered our overall equity market exposure increasing our defensive posture. Equity securities continue to represent the majority of our portfolio (~63%). While we are not excited about the range of likely returns for the overall equity market, we are very excited about the prospects for the individual companies we own.

Going Forward

The US economy remains on life support. Unsustainable deficit-funded government transfer payments, not just earned income, contribute a significant portion of consumer spending. (This partially explains the very wide corporate profit margins.) "Money printing" remains the other tonic; "it can do most anything" seems to be the mantra. Spain is the new Greece and, unfortunately, she is five times the size. Despite this, there are strong businesses with secular[14] growth stories and fair valuations and debt instruments (mostly small, quirky issues) with reasonable yields. We remain defensive, but optimistic about our current holdings and the opportunities that will present themselves over the coming months.

As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC

[14] As opposed to cyclical or economically sensitive.

This newsletter contains general information that is not suitable for everyone. The information contained herein should not be construed as personalized investment advice. Past performance is no guarantee of future results. There is no guarantee that the views and opinions expressed in this newsletter will come to pass. Investing in the stock market involves the potential for gains and the risk of losses and may not be suitable for all investors. Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. Any information prepared by any unaffiliated third party, whether linked to this newsletter or incorporated herein, is included for informational purposes only, and no representation is made as to the accuracy, timeliness, suitability, completeness, or relevance of that information.

The securities discussed above were holdings during the year ended December 31, 2011. The stocks we elect to highlight each quarter will not always be the highest performing stocks in the portfolio, but rather will have had some reported news or event of significance or are either new purchases or significant holdings (relative to position size) for which we choose to discuss our investment tactics. They do not necessarily represent all of the securities purchased, sold or recommended by the adviser, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. A complete list of recommendations by Grey Owl Capital Management, LLC may be obtained by contacting the adviser at 1-888-473-9695.

Grey Owl Capital Management, LLC ("Grey Owl") is an SEC registered investment adviser with its principal place of business in the Commonwealth of Virginia. Grey Owl and its representatives are in compliance with the current notice filing requirements imposed upon registered investment advisers by those states in which Grey Owl maintains clients. Grey Owl may only transact business in those states in which it is notice filed, or qualifies for an exemption or exclusion from notice filing requirements. This newsletter is limited to the dissemination of general information pertaining to its investment advisory services. Any subsequent, direct communication by Grey Owl with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of Grey Owl, please contact Grey Owl or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov).

For additional information about Grey Owl, including fees and services, send for our disclosure statement as set forth on Form ADV using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

The performance information for the Grey Owl Opportunity Strategy presented in the table above is reflective of one account invested in our model and is not representative of all clients. While clients were invested in the same securities, this chart does not reflect a composite return. The returns presented are net of all adviser fees and include the reinvestment of dividends and income. Clients may also incur other transactions costs such as brokerage commissions, custodial costs, and other expenses. The net compounded impact of the deduction of such fees over time will be affected by the amount of the fees, the time period, and the investment performance. Grey Owl Capital Management registered as an investment adviser in May 2009. The performance results shown prior to May 2009 represent performance results of the account as managed by current Grey Owl investment adviser representatives during their employment with a prior firm. THE DATA SHOWN REPRESENTS PAST PERFORMANCE AND IS NO GUARANTEE OF FUTURE RESULTS. NO CURRENT OR PROSPECTIVE CLIENT SHOULD ASSUME THAT FUTURE PERFORMANCE RESULTS WILL BE PROFITABLE OR EQUAL THE PERFORMANCE PRESENTED HEREIN. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable. For additional performance data, please visit our website at www.greyowlcapital.com.

The indices used are for comparing performance of the Grey Owl Opportunity Strategy ("Strategy") on a relative basis. Reference to the indices is provided for your information only. There are significant differences between the indices and the Strategy, which does not invest in all or necessarily any of the securities that comprise the indices. In addition, the Strategy may have different and higher levels of risk. Reference to the indices does not imply that the Strategy will achieve returns or other results similar to the indices. The performance shown for the iShares MSCI World Index Fund ("Fund") includes performance of the MSCI World Index prior to March 26, 2008, inception date of the Fund.