



August 19, 2009

*Sophistry: a subtle, tricky, superficially plausible,
but generally fallacious method of reasoning.*

Dear Client,

The “cash for clunkers,” so-successful-they-tripled-its-size, component of the \$787 billion second government stimulus plan requires dealers who accept clunker trade-ins to destroy the car’s engine. See page 39 of the 136 page “Final Rule” on the program at the National Highway Traffic Safety Administration’s website: www.nhtsa.dot.gov for the details of a “quick, inexpensive, and environmentally safe process” for destroying a car engine with only \$7 of sodium silicate. By our simple analysis, on a scale that ranks economic stimulus ideas, “cash for clunkers” belongs slightly above President Roosevelt’s “Agricultural Adjustment Act” of 1933. This was an equally creative plan to raise prices of specific items through manufactured scarcity. In 1933 the government let crops rot and killed six million baby pigs in an attempt to raise prices of foodstuffs. An argument calling for the destruction of productive resources in an attempt to boost the overall economy by stimulating demand for the very product destroyed is sophistry at its finest.

That introduction should give you a sense of just how “stimulating” we think current federal government actions will prove to be. Over the course of this letter, we will expand on this analysis, examine the inner workings of the recent stock market rally, identify potential economic stumbling blocks, explain the monetary tightrope we currently walk, and then describe how we are approaching this unique economic and market environment from an investment standpoint. In summary, we think the recent rally has been speculative in nature, the government’s efforts are counterproductive, and there are icebergs on the economic horizon. That being said, the speculative rally has left pockets of value where we see opportunity.

Before we begin in earnest, we would like to mention that this is our inaugural quarterly letter as an independent firm. Many of you grew accustomed to enjoying (hopefully) our letters while we were at Merrill Lynch. These letters took a several-quarter hiatus when Merrill Lynch asked (required) us to stop communicating our own views as they might contradict those of the “organization.” One of our many reasons for establishing our own firm was to both continue and

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expand our ability to communicate our specific thinking – the thinking that drives our clients' investments – to our clients, prospective clients, and business associates. We begin that process anew here now.

Anti-stimulus

“Cash for clunkers” is just one of a series of programs, begun under President Bush and greatly expanded under President Obama, sold as penicillin for a bacteria-riddled economy, whose actual result is to merely shift the ownership of resources, as opposed to encouraging the growth of overall economic wealth and enhancing prosperity. “Cash for clunkers” takes from taxpayers and mechanics (in the form of foregone work) and redistributes to government owned auto manufactures, car dealers, and individuals lucky enough to have kept the 1970 Chevy Impala their grandmother left in her will. It is more widely heralded because of its populist conception, but in reality, it is no better than the use of taxpayer dollars to bail out the owners of equity and debt in large financial institutions (not to mention saving the jobs of many a corporate banking executive). Another example of flawed government programs is the effort to subsidize mortgages for underwater homeowners at the expense of the renter who has patiently waited for a three-sigma housing bubble to burst. The arguments for these programs are superficially plausible, but in the end are really no more than voodoo. The wandering, pseudo-intellectuals of ancient Greece would be proud.

Therefore, contrary to President Obama's comments on August 7th in the wake of a less-bad-than-expected loss of 247,000 jobs in July, we aren't convinced that “today we're pointed in the right direction.” From our vantage point, just about everything the government is doing will hinder, as opposed to bolster long-term growth. These actions are the equivalent of pouring sand in our economic gears (or sodium silicate in our collective economic engine if you prefer). The economy will rebound from these low levels (and the process may have already begun) because today we have the same intellectual and physical capital we had a year ago, not because of government intervention. Unfortunately, the government's actions this time around may be just detrimental enough to knock the economy off its long-term real growth rate of 3%. A spectrum of outcomes is always possible, but the highest probability weighting should go to the category labeled “sluggish growth” for at least the medium-term.

The (Junk) Rally Examined

We are well aware that the stock market disagrees with our commentary. The S&P500 made its current bear market bottom on March 9th at the all-too-ironic 666 level and it hasn't looked back since. A significant portion of the rally has been in stocks with leveraged balance sheets and volatile earnings streams, and the market has been driven higher by news unrelated to long-term

corporate earnings trends. In other words, it has been a speculative, “junk” rally. Speculative or not, the result is that the overall stock market is now modestly above fair value (which we estimate to be around 900 on the S&P500).

It is true that a high percentage of companies have beaten analysts’ expectations for second quarter earnings. However, the “beats” are due to aggressive (albeit prudent) cost cutting. Unlike sales growth, growth via cost cutting cannot be repeated indefinitely. More importantly, even with the cost cutting, earnings growth is still negative on a year over year basis. This rally has been driven largely by multiple expansion. Based on fundamentals, we did not expect the rally to be so extensive. As value investors, we will not invest without a margin of safety. Nor will we invest based on the hope of irrational valuation expansion. Even with 20/20 hindsight, we believe that going all-in in mid-March was a bet with a low-probability of a success. In this case, the market rolled eight the hard way. In nine out of ten parallel universes, it probably crapped out.

Our observation of the speculative nature of this rally is not unique. In his most recent missive, Jeremy Grantham of GMO points out that from March 9th through July 15th, stocks priced under \$5/share have outperformed stocks priced over \$50/share by 91%! On August 6th, Reuters Top News ran an article titled “‘Junk’ companies rule U.S. stock market’s rally”. Focusing on the latest stage of the rally, Jennifer Ablan and Rodrigo Campos point out that 81 S&P companies with below investment grade credit ratings (i.e. BB or lower) rallied between 21 and 29.5 percent between July 10 and August 4. One commentator suggested that a “junk” rally is actually a good sign. We assume this thinking is based on the idea that equity investors are assigning lower probabilities to scenarios where these overleveraged companies go bankrupt. Fair enough, but it does not change the fact that these types of investments provide little margin of safety and lead to poor results over longer periods.

Pending Stumbling Blocks

While the market has rallied to a point where a significant economic improvement appears necessary to sustain current levels, there are plenty of potential large, negative shocks waiting in the wings. The two most important are related. First, whereas in a typical economic cycle, the unemployment rate is a lagging indicator, it may function as a leading indicator in this cycle. In a typical cycle, overinvestment in a particular area of the economy leads to bloated inventory as demand does not keep up with supply. Inventory is then liquidated (e.g. telecom bandwidth in 2000) which leads to lower sales levels due to price cuts, which leads to business cutting staff to maintain profit margins. By the time the last step happens, businesses are profitable again, the excess inventory is worked off, and a fresh growth cycle begins. Typically, individuals who lose their jobs tap into savings or borrow against their home equity line to get through a short period of unemployment. This time may be different.

In this cycle, consumers are far more leveraged than in the past. Therefore, unemployment has the potential to cause additional defaults (on mortgages, credit cards, etc.) causing a negative spiral. This is important because while job losses have slowed, they are nevertheless still losses.

Second, we are just now entering a new peak in adjustable rate mortgage resets. This comes at a time when just under 25% of mortgage holders are underwater – that is, they owe more on their mortgage than their house is worth. This combination of negative equity and interest rate resets will likely send defaults soaring past their current high levels. This could easily lead to another round of asset write-downs for banks, lower housing prices, and a further decrease in consumer spending.

The Monetary Tightrope

As the credit crises took hold, both individuals and financial institutions began to stuff currency under their respective mattresses. The fear of asset deflation and counterparty default was so great that individuals began to hold on to cash (higher checking balances, lower credit card balances, and more cash in the wallet) and banks refused to lend. With demand for currency high, the price of all other goods in the aggregate would have to fall. To combat this deflation, the Federal Reserve began to implement the electronic-age equivalent of printing money. The increase in money supply provided by the Federal Reserve has, to-date, roughly matched the increase in demand for currency (i.e. prices are relatively stable).

Now, the economy is walking a tightrope. If the Fed is not aggressive enough and we get another round of mortgage defaults that further impair bank balance sheets, deflation could pick up. On the other hand, if China slows its purchase of US debt, or consumers decide to rebuild their nest egg a little more slowly, or businesses decide to invest and banks agree to provide the necessary capital, the Fed will be forced to sell assets and destroy dollars – but will they be able to do it quickly enough?

The inflation/deflation debate will likely have a significant impact on investment returns going forward if history is any guide. For a thorough discussion of why, see Ed Easterling's research at www.crestmontresearch.com. Briefly, anything other than low (i.e. 1-2%) inflation has historically caused investors to increase the risk premium required to hold equities, driving down valuation multiples (i.e. PE ratios). Logic validates the empirical evidence: inflation devalues the stream of future cash flows an asset provides and deflation means you could buy the same asset tomorrow at a lower price.

Investing After the Crash

We now find ourselves in an environment where equity markets are slightly overvalued, downside surprises for economic data are likely, government “stimulus” programs appear to be following the very un-stimulating Japanese playbook, and the value of our unit of account is poised on a tightrope. At first blush, navigating an investment path appears daunting and perhaps impossible. However, upon further reflection and faithfulness to the only process that we believe has and can produce sustainable investment outperformance (i.e. value investing), perhaps the way forward is not so unclear.

The most important rule of value investing is to make sure that you have a significant margin of safety before committing capital. Luckily, the “junk” rally has left plenty of steady-Eddie businesses trading well below intrinsic value. While the government’s anti-growth policies are bad for individual prosperity because they limit creative destruction, they do enhance the value of existing franchises by limiting competition. While both deflation, and above 2% inflation, has historically led to valuation compression (i.e. lower P/E multiples), assets with lower duration (i.e. assets that pay a high coupon or dividend and return capital to investors more quickly), outperform in environments that see multiple compression. Fortunately, many of the steady-Eddie businesses that have not participated fully in the current rally pay high single digit coupons. Real estate investment trusts (REITs), telecommunication firms, and tobacco companies equities appear favorably priced on a sector basis and we are actively researching these areas for individual investment opportunities. Based on what we see as a modestly overvalued broad market, we will increase overall equity exposure on market dips and decrease overall equity exposure should the rally persist much higher as we look to add exposure in the areas described above.

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 1-800-GREY-OWL.

Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC

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