October 29, 2012

"Hope for the best, but prepare for the worst."

- English Proverb

Dear Client,

As we write this letter on the morning of Monday, October 29, 2012, Hurricane Sandy is bearing down on the mid-Atlantic region. Public transportation has been halted, financial markets closed, coastal areas evacuated, and states of emergency put in place. Scientific models were consulted, preparations have been made. By the time you read this letter, everyone will know the results, but this morning all we have is uncertainty. No one really knows what will happen. Winds may be less than anticipated, trees more resilient, or the storm could turn out to sea. Damage may be averted. However, very few have neglected provisioning for a difficult few days. The potential downside is too much.

Investment markets present a similar scenario. The multiple hurricanes of fiscal deficits and monetary malfeasance are headed our way. Unfortunately, financial market models that seek to assess the magnitude, direction, and timing of economic tempests are far less precise than those of our scientific brethren. So, we prepare for the worst, but we don't immediately evacuate. There are still plenty of opportunities for solid investment returns and we will describe two new investments in the pages that follow. Yet, the risks are real, as we have discussed frequently in these letters, so our overall portfolio structure remains conservative.

Here is the standard performance table for Grey Owl Opportunity Strategy as of September 30, 2012[1]:

	Q3	YTD	TTM	Cumulative Since 10/06
Grey Owl Opportunity Strategy (net fees)	**2.36%**	**8.50%**	**15.34%**	**32.66%**
Spider Trust S&P 500 (SPY)	6.34%	16.43%	29.96%	18.82%
iShares MSCI World (ACWI and MXWD)	6.43%	12.29%	22.35%	8.58%

[1] For more information regarding performance, please refer to the performance disclosure at the end of this letter.

The third quarter of 2012 produced an unprecedented amount of central bank intervention. First, in July, the Bank of England added £50B to its ongoing quantitative easing efforts. Then, on August 2nd, the European Central Bank (ECB) announced that it would undertake "outright monetary transactions" or OMT. Previous ECB interventions were channeled through the European banking system. With OMT, the ECB will be able to directly purchase sovereign debt (with the important caveat that participating countries must agree to specific fiscal policies). Not to be outdone, on September 13th, the Federal Reserve initiated quantitative easing unlimited (QEU) announcing plans to purchase $40B a month of mortgage backed securities (MBS) indefinitely. Finally, a week later, Japan's central bank expanded its ongoing bond buying program by 10 trillion yen (or $126B).

The magnitude of this intervention is hard to comprehend. The Fed ended 2007 with just under $850 billion on its balance sheet yet now holds over $2.6 trillion, a three-fold increase. With the latest policy update, the Fed will be purchasing close to 80% of new MBS issuance, according to Annaly Capital Management, and expand its balance sheet further by almost $500 billion per year. Raise your hand if you think this won't distort markets.

As we pointed out in our last letter, leading economic indicators were slowing across the globe in the second quarter. However, the central bank interventions seem to have slowed the deceleration in some cases or caused a plateau in others. Equity markets and commodities began to rebound at the hint of further monetary intervention but the follow-through has been muted thus far. With each intervention, the bounce in the economy has been to a lower high and the equity market impact has been weaker. Yet the scope and breadth of these most recent interventions may be significant enough to prolong the system's imbalances for quite some time.

In the meantime, another storm brews and we know exactly when it will make landfall: November 6th. The fallout of this election for investors may be significant, or it may just be status quo. Will the current 15% tax on dividends expire leading to a 43.4% tax rate on dividends in 2013 and beyond?[2] And, what will that do to the "blue chip" dividend-paying securities that have been the market's darlings for the last few years? Could a Romney presidency improve business sentiment allowing the economy to pick up steam and with it the coiled spring of inflation the Fed's balance sheet expansion has created? Will Washington avert the fiscal cliff in its entirety? Is there any mix of president and legislature that can fix the $100 trillion plus debt?[3] Or does the dollar's status as the world's reserve currency buy us enough time that we can get by with marginal changes and keep kicking the can down the road for

[2] If the current tax law is allowed to expire, as it is set to at the beginning of 2013 absent affirmative action on the part of Congress, dividends will be taxed at investors' marginal tax rate (39.6% is the highest bracket) plus the new 3.8% tax to help pay for Obamacare.

[3] This figure includes the $16 trillion actual debt plus estimated unfunded liabilities for Social Security, Medicare, and Medicaid.

years to come? We hope for the best, but prepare for the worst. In the midst of this uncertainty, we've found a couple excellent businesses to buy.

Weight Watchers International, Inc. (WTW)

At the beginning of August, we acquired shares in Weight Watchers International. At just over $43/share and with 2012 EPS expectations between $4.00 and $4.20/share, WTW traded at approximately 10x earnings and a 10% free cash flow yield. This was incredibly cheap for a company that consistently generates EBITDA margins in the high 20s, return on invested capital in the mid to high-30s, and has grown sales an average of 8% per year for the last five years (which includes the 2007-2009 recession).

When we made our purchase, the stock was 48% off its 2012 peak of $82.91. The primary culprit for the sell-off seemed to be a management misstep in their business-to-business segment. In an effort to scale this segment more effectively, the company initiated a new payment plan and an online signup. The transition was smooth for large corporate accounts, but backfired, due to lack of attention, with the small businesses that currently make up the majority of this segment. Compounding the problem, this occurred during the first three weeks of the year when new signups peak. Thus, investors were concerned with the amount of time it would take to see an improvement. Despite these operational difficulties, the company chose to complete a self-tender offer for $720mm (12%) of its common stock at $82/share. When the company reported first quarter results on May 2nd, missing guidance, the stock plunged. Mr. Market assumed the company's poor execution significantly lowered intrinsic value and the company overpaid for the buyback, further lowering intrinsic value by wasting some portion of the $720mm used in the tender. [4]

While we recognize the operational and capital allocation errors, we think the market's reaction was overdone. The company is an incredible business franchise (refer back to the financial fundamentals in the first paragraph of this section) addressing a significant and growing need. Nearly one-third of US adults and 15% of the world's population are obese. 70% of the US population is overweight or obese. While the US leads the pack, this is a consistent trend across most wealthy, developed nations. Japan is the exception.

Not only is the problem widespread, it is expensive. The US spends $2.5T on health care costs, 75% of which are for chronic diseases. The Centers for Disease Control estimate that lifestyle choices drive 50-80% of chronic diseases. Further, studies suggest that obese patients spend an additional $1,100 - $3,600 / year above the cost of the average healthy-weight individual.

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[4] Share repurchases are a way for corporations to return excess capital to shareholders (similar to dividends). In the case of WTW, remaining shareholders will now earn approximately 13.6% more per share (all else equal, including sales and margins). Buying shares below intrinsic value extracts value from selling shareholders. Buying shares above intrinsic value extracts value from the remaining shareholders.

In an industry filled with fads and schemes, Weight Watchers' "points" program works. The program's efficacy has been clinically proven through 70 trials over the past 15 years. Most recently, *The Lancet* published a study indicating Weight Watchers members lost twice as much weight as individuals receiving standard care.

As the company corrects its modest operational issues, refreshes marketing with new spokespeople (e.g. Jessica Simpson), completes store facelifts, and expands the online program, we expect the market to value more appropriately the Weight Watchers' franchise as the excellent and growing business it is.

Laboratory Corporation of America (LH)

In mid-September, we purchased shares in Laboratory Corporation of America for approximately $91.25/share. Like Weight Watchers, LabCorp is a high-return business with secular tailwinds. In addition, we think the stock is cheap, trading at an 8% free cash flow yield.

LabCorp is half of a duopoly at the top of a still fragmented clinical laboratory market. Quest Diagnostics is the other less-well-run half. Blood (and related) tests have become a critical component of medical care and are used for over 80% of diagnostics, yet they only account for 3-4% of total medical costs. Given its scale and efficiency, LabCorp is able to provide these tests at a third the costs of hospitals and doctors' offices. Both of these factors afford LabCorp a significant price umbrella that should allow the company to continue to maintain its margins. In addition, the cost advantage relative to hospitals allows LabCorp to acquire hospitals' business as the hospitals work to streamline their own operations.

As society grows wealthier, people live longer, and medical innovation continues to advance, healthcare will likely grow at a faster rate than the overall economy. As a low-cost, high-value component of medical care, clinical diagnostics should thrive.

Unlike Weight Watchers, LabCorp's execution has been superb. They have been very disciplined acquirers – a critical factor when investing in a serial acquirer. Their share buybacks have been accretive and they continually make progress on each element of their "five pillars of success." We are excited to be in partnership with LabCorp's management team.

With the addition of these two high-quality businesses, we continue the portfolio "high-grading" process we described in our fourth quarter 2011 letter. We are slightly more invested on the back of QEU, but maintain our overall cautious posture. The threats from fiscal imbalances and monetary distortion are real. We own gold as a hedge against inflation and in fixed income accounts maintain a very short portfolio duration. Our equities are largely focused on excellent businesses, particularly those in areas such as health care (e.g. LH, WTW, and our pharmaceutical basket) that should be less economically sensitive than the broader market. We continue to believe the imbalances will create volatility and hold cash in an effort to both mute the impact and as dry powder for when opportunities present themselves. See the attached article that describes Warren Buffett's thinking regarding cash as a "call option."

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

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.