



October 25, 2013

"The art of being wise is the art of knowing what to overlook."

- William James

Dear Client,

Despite the recent shenanigans in Washington concerning funding the government and raising the debt ceiling, as well as the constant news coverage of the quantitative easing "taper" that the Federal Reserve may or may not begin, we are going to spare (at least for this quarter) both you and us another long discussion of these very real issues. Refer to [any of our more recent quarterly letters](#) for a longer review of these topics. However, please do not be mistaken. Our position has not changed. The overall national debt level, the ongoing federal deficits, and the extreme monetary intervention will eventually prove disastrous. We remain worried about the consequences for securities markets and thus continue to maintain a conservative investment posture.

Rather than furthering our argument of why it is risky to centrally plan the most important price in an economy (i.e. interest rates), we devote the bulk of this letter to a discussion of our top five investments. We write this type of letter with glee. Over the past year, we have increased the concentration in our top five positions from (an already high by conventional standards) 26% on 9/30/2012 to 32% today.¹ Our objective has been to increase our exposure to what we believe to be the highest quality businesses with proven leadership at navigating dynamic economic conditions and redeploying earned capital at favorable rates. Each of the businesses we discuss stands out on both fronts.

¹ BRK, EBAY, and MKL were top five positions on 9/30/2012. ESRX and VRX are new holdings since 9/30/2012.

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Before we begin a discussion of real businesses, with dynamic leaders and creative employees engaged in mutually beneficial exchange with willing customers, here is the standard performance table for the Grey Owl Opportunity Strategy as of September 30, 2013²:

	<u>Q3</u>	<u>TTM</u>	<u>Cumulative Since 10/06</u>
Grey Owl Opportunity Strategy (net fees)	2.42%	9.63%	45.41%
Spider Trust S&P 500 (SPY)	5.25%	19.26%	41.27%
iShares MSCI World (ACWI and MXWD)	7.84%	18.10%	28.23%

Significant positions in high-quality businesses that we can own for many years comprise the bulk of our investment portfolios. Long-term (i.e. multi-year) investment returns are generated from the per share improvement in underlying business fundamentals such as earnings or book value, as well as how the market chooses to value these fundamentals (i.e. the “multiple” the market assigns) at the starting and ending points.

In the following review of our five largest positions, we discuss valuation at our purchase price, valuation as of September 30, 2013, change in business fundamentals over our holding period, our thoughts regarding future business prospects, and our assessment of “fair” valuation multiples.

Among the five positions, you will see an assortment of outcomes and expectations. In each case, business fundamentals have improved over our holding period. In some cases, valuation multiples have contracted. In others, valuation multiples have expanded. In some cases, we think there is a higher probability that the future will be better than the recent past. In others, we think the future might not be able to match the past, yet will still be very strong. In some cases, we think there is opportunity for multiples to expand. In each case, we think the underlying business will earn far better returns on invested capital than the market as a whole. Finally, we think an exceptional leader runs each of these businesses. Their history of opportunistic acquisitions, prudent balance sheet management, and creative thinking provide us a “free call option” on additional future value creation.

We also describe why we opportunistically added to two of these positions recently. Great businesses with great leadership are rarely available at a discount, but from time-to-time, they

² For more information regarding performance, please refer to the performance disclosure at the end of this letter.

are. We try to buy when the market misinterprets an economic development creating both a margin of safety and an opportunity for higher returns if the market comes around to our way of thinking.

Berkshire Hathaway

Position size on 9/30: 7.7%

2013 has been a good year for Berkshire Hathaway (BRKB). An October 6, 2013 [Wall Street Journal article](#) highlights the success of Warren Buffett's capital allocation efforts during the 2008-9 financial crisis. The Journal estimates that Mr. Buffett has shown a pretax profit of 40% or \$10 billion to date and the returns are still flowing in. For the year through September 30th, Berkshire Hathaway shares provided a total return of 26.54%.

Berkshire Hathaway has been a core holding since the inception of our Grey Owl Opportunity Strategy on November 1, 2006. From this date through September 30, 2013, Berkshire has provided a total return of 61.47% compared to 41.24% for SPY, the S&P 500 index ETF. This performance is not a function of "multiple expansion." Rather, the returns of the underlying Berkshire businesses and investments have provided the results. For the seven years between the second quarter in 2006 and the second quarter in 2013, book value has compounded at an annual rate of 10%. Over the same time, Berkshire's price to book value multiple shrank from almost 1.7x to approximately 1.4x today. Despite providing investment returns that were 1.5x better than the S&P 500 for the period, the stock is almost 18% cheaper today.

While the 10% compounded return in book value cited above includes the "financial crisis" period, it is still well short of Berkshire's 19.7% historical compounded book value. On top of that, Mr. Buffett is 83 years old. So, why does Berkshire deserve to be such a large position today?

At 1.4x book value, there is no "Buffett premium" in the stock, nor is the stock priced for anything close to 20% growth in book value. Operationally, the subsidiary businesses are decentralized and essentially run themselves with little input from Omaha. Buffett's investment lieutenants have successfully managed significantly increasing allocations of firm capital and have played critical roles in private deal transactions. It is unlikely they would ever have the caché of Mr. Buffett, but it is likely they will be successful by any other standard. Given Berkshire's underlying business strength, we think it could easily trade upwards of 1.75x book value. Finally, we believe risk is mitigated given a buyback program that would commence if the stock traded down to 1.2x book value or lower.

Valeant

Position size on 9/30: 6.3%

We first purchased shares in Valeant (VRX) at the beginning of 2013. VRX has been our best performing security in 2013. Year to date through 9/30, the stock was up 75%.³ Yet, even after an incredibly strong run, we added to the position when Valeant announced in May [that it would acquire Bausch and Lomb](#) for \$8.8 billion.

Today's Valeant is the brainchild of J. Michael Pearson who became CEO in 2008 after running McKinsey's pharmaceutical group for many years. Since becoming CEO, Mr. Pearson has made 18 large acquisitions (and a greater number of smaller purchases). 16 of the 17 large acquisitions prior to Bausch and Lomb are on track or ahead of the initial deal model according to VRX's internal score card.⁴ In 2012, Morningstar reviewed the 11 deals that occurred prior to the start of 2012 with an investment value greater than \$75 million. They estimated that the average cash on cash return for these deals was 26%. This is a spectacular record of accomplishment indicating that Mr. Pearson is judicious in the type of acquisitions he makes and the price he pays (he has walked away from several large deals rather than engage in a bidding war). It also demonstrates Valeant's operational expertise and ability to integrate new acquisitions successfully. The first 17 acquisitions created scale across dermatology and emerging markets. With Bausch and Lomb, VRX is acquiring a platform to build out an ophthalmology business.

Valeant's success under Mr. Pearson is a function of a four-pronged strategy:

1. Focus on markets (clinical indications and geographies) that can be meaningful to Valeant, but too small to warrant significant competition from big-Pharma (e.g dermatology and Latin America);
2. Rapidly and aggressively integrate acquisitions leading to operational cost savings and leveraging VRX's tax efficiency;
3. Minimize risk by drastically cutting the research and development function and using acquisitions to feed the pipeline; and
4. Opportunistically allocate capital – VRX has repurchased shares when they were undervalued, but also issued shares and used leverage when compelling acquisition opportunities were available.

In 2012, VRX earned \$4.51 per share. Today, Valeant trades at approximately 18x analyst estimates for next year's earnings of \$8.67 per share. (If achieved, this will represent per share

³ Our return through 9/30/13 was slightly less as we made our initial purchase in January when the stock was a few dollars higher than its 12/31/2012 close.

⁴ A review of the prior 17 acquisitions is on page 7 and 8 of VRX's latest earnings presentation: http://www.slideshare.net/Valeant_Pharmaceuticals/q2-2013-financial-results-conference-call

earnings growth of 39% annually over that two-year period!) Consensus earnings estimates for 2015 now sit at \$10 per share, but Jefferies estimates that \$11.64 is likely. Sell side analysts have a deserved reputation for overestimating potential upside. However, VRX has developed a reputation of under-promising and over-delivering. This is despite what seem like aggressive operational cost and tax saving objectives going into most of their acquisitions. At the announcement of the Bausch and Lomb deal, Valeant targeted \$800 million in operational cost savings. This was for a company doing \$640 million in earnings before interest, taxes, depreciation, and amortization (EBITDA). In their [second quarter earnings release](#), the company indicated they were already on track to achieve a run rate of \$500 million in savings by the end of 2013 and well over the initial \$800 million estimate by the end of 2014.

The existing business has terrific characteristics. Mr. Pearson has a number of levers to pull with Bausch and Lomb that should turn more revenue into earnings. We are excited about VRX's next few years.

Express Scripts

Position size on 9/30: 5.9%

Like Valeant, Express Scripts (ESRX) is a newer holding. We first purchased shares in November 2012. More recently, we added to the position after shares sold off when several large corporations announced that they were moving portions of their insured base to the Affordable Care Act (ACA) "private insurance exchanges." The fear is that this will take business from the pharmacy benefit management (PBM) companies such as Express Scripts. We felt the reaction was overdone for two primary reasons. First, many of the firms offering insurance on the exchanges are already customers of the PBMs. Second, those that have not partnered with PBMs will have difficulty competing with the PBMs to provide drug benefits to members effectively and thus will likely partner with a PBM in the future.

Express Scripts today is the result of a [multiyear roll-up](#) of eight pharmacy benefit management companies culminating in the 2012 acquisition of Medco Health Solutions, which doubled claim volume and created the industry's largest PBM. Today, Express Scripts processes upwards of 1.3 billion claims on an annual basis and commands a 30% market share. This massive scale allows ESRX to extract discounts on the purchase of pharmaceuticals of up to 30% from the drug companies. ESRX then passes on a significant portion of the savings to their customers (large corporations, associations, and insurance companies) while maintaining a healthy profit for themselves. Until recently, ESRX traded at a premium to the market driven by expectations of continued market share gains via organic growth and acquisitions. After the Medco acquisition, antitrust regulations would likely prohibit further acquisitions. Today, ESRX trades at a below-market price/earnings multiple of 15x forward estimates.

While the days of accretive acquisitions are likely behind it, we think ESRX can continue to grow its revenues in the mid-single-digits and earn high returns on invested capital well into the future. Returns could be enhanced as ESRX digests the Medco acquisition and works to rationalize its selling, general, and administrative cost structure closer to pre-Medco levels (as a percentage of sales). Given its minimal capital needs, we expect the company to quickly pay down debt and then aggressively buy back shares. This could easily lead to mid-to-high teens earnings per share growth over the next few years.

Markel

Position size on 9/30: 5.6% (increased to 7.5% subsequent to the quarter's end)

Like Berkshire Hathaway, Markel (MKL) has been a core holding since the inception of the Grey Owl Opportunity Strategy. Unlike Berkshire, Markel underperformed the market over that same period. This is despite better underlying business performance. For the seven years between the second quarter of 2006 and the second quarter of 2013, Markel compounded book value at an annual rate of 14% (compared to 10% at BRK).

Many consider Markel a “mini-Berkshire.” As time goes on, this characterization becomes more accurate. The Markel Ventures operating segment includes wholly owned non-insurance businesses. It has grown from \$167 million in revenue in 2010 to \$489 million in revenue in 2012, 16% of 2012’s total revenues. At the end of 2012, Markel announced the transformative acquisition of Altera, a reinsurance business. This acquisition doubles Markel’s size across a number of attributes. It will also provide significant additional “float” that Markel can use to grow the Markel Ventures business segment to an even larger percentage of the overall business.

Markel’s success has come despite significant headwinds. Since 2005, the insurance market has been “soft.” This term indicates that it has been very difficult for insurance companies to raise premium prices and in some cases premiums have declined. 2011 finally saw pricing stabilize and 2012 saw mid-single-digit rate increases across the Markel portfolio. In addition, interest rates are at exceedingly low levels putting downward pressure on Markel’s investment income (a critical component of all insurance company earnings). Markel’s chief investment officer has refused to invest in longer maturity fixed income investments to improve yield in order to protect the company’s book value from future rate increases; a wise decision from our perspective. Both of these issues have likely weighed on MKL’s valuation.

Today, Markel trades at under 1.2x book value. While Markel is less diversified than Berkshire (insurance generates only about one third of earnings at BRK) and there is certainly risk in an acquisition that doubles the company’s size, we think longer-term MKL could compound book

value at a faster rate than BRK and trade at a higher multiple. We recently had the opportunity to chat informally with Markel's president and chief investment officer, Tom Gayner. Mr. Gayner indicated the insurance climate was "not too hot, nor too cold." Perhaps we are not yet in a "hard" insurance market, but a "soft" market seems to be behind us. He also expressed excitement and confidence in the Altera integration, as well as a consistent, measured approach to the investment portfolio. We were pleased.

Ebay

Position size on 9/30: 4.5%

We initially purchased eBay (EBAY) shares in December 2011. At the time, eBay was unloved trading at 18x 2011 earnings per share and just 12x 2012's prospective earnings. Since then, eBay's shares have returned over 75%, but that return was all in 2012. Shares have been flat throughout 2013.

When we first purchased eBay shares, their Marketplaces business was thought a second rate player to Amazon.com and PayPal was not yet on investors' radar. Today, CEO John Donahoe's "turnaround" is largely recognized as complete. The thorough "[eBay is back!](#)" piece from February 2013's Fortune magazine describes this success in detail.

It is worth highlighting a few metrics to demonstrate both the existing scale and continuing growth of eBay's core businesses. Active users on eBay's Marketplace have grown from 94.5 million at 2010's year-end to 123.6 million in the third quarter of 2013; a 10% annualized growth rate. Active registered accounts on PayPal have grown over that same period from 94.4 million to 137.4 million; a 15% annualized growth rate. This growth in business fundamentals has been magnified in per share earnings which have grown at a 20% annualized rate from the third quarter of 2011 to the third quarter of 2013.

Today, shares trade at 19x next year's earnings. We suspect that most of the return from multiple expansion is in the past. Yet, we remain excited about the underlying growth in business value going forward. PayPal's offline partnership with Discover Financial Services, new innovations such as [PayPal Beacon](#) to help physical retailers use mobile technology to engage customers, and the recent [Braintree](#) acquisition (the payment technology behind the wildly popular Uber black car app) are all in their early days. The shift to ecommerce and mobile-enabled commerce has a long way to go. We look forward to participating in this growth through eBay shares for some time to come.

Conclusion

The current investment environment is fraught with risk. Interest rates are near generational lows. Broad market equity indices are rich after adjusting earnings for normalized profit margins. Government intervention is distorting the economy in an unsustainable way. We by no means deem these risks inconsequential. Yet, in any environment, opportunities exist. We are willing to deal with (“overlook”) these risks in the context of owning the businesses described above. We believe the quality of the businesses and their leadership is strong enough to overcome many headwinds.

Wayne Gretzky liked to say, “I skate to where the puck is going to be, not where it has been.” The bulk of our portfolio constitutes high quality businesses with leadership that has demonstrated an exceptional ability to allocate capital and to move the business to where the market *is going to be*.

When irrational fear (e.g. the ACA exchange risk surrounding ESRX) or a transformational event (e.g. VRX’s Bausch and Lomb acquisition) causes the price of an existing holding to trade at a significant discount to intrinsic value, we will jump at the opportunity to buy more. In the meantime, we are looking for more ideas that fit our parameters.

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

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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.