April 20, 2010

"It's not the return on my money I'm worried about. It's the return *of* my money."

- Will Rogers

Dear Client,

While the stock market paused briefly to catch its breath in January, risk taking was broadly rewarded beginning in mid-February. As we entered March and passed the one-year anniversary of the 2009 market lows, the market took off again. As if it was scripted, the most highly indebted and economically sensitive companies have performed the best during this rally. Financials, in particular banks, have roared. The market has been fueled by consistent marginal improvements in the economy, which have led to expectations of much bigger improvements in coming quarters. Whether the markets can live up to these lofty expectations is the sixty-four thousand dollar question. We remain alert to potential potholes in the road, but are finding pockets of opportunity.

Our thoughts on the current investment climate follow, but first a review of our performance compared to investable options for the major market indices:

	Q110	YTD	Since 10/06
Grey Owl Opportunity Strategy (net fees [1])	**2.74%**	**2.74%**	**18.77%**
Spider Trust S&P 500 (SPY)	5.42%	5.42%	-8.52%
iShares MSCI World (ACWI and MXWD)	2.88%	2.88%	-3.21%

[1] This is the performance of our "risk" model or opportunity strategy, not the performance of your individual consolidated accounts, which may or may not include a broader mandate. Please refer to performance disclosures found at the end of this letter for additional information.

Sovereign Risk

Despite the recent market ebullience there are several potentially destabilizing economic factors brewing. There has been significant discussion of Greece's debt woes. Not only is Greece in danger of default on her sovereign debt, and seeking help, her private sector banks are experiencing significant liquidity shortages. Markets have been calmed by assurances that the European Union (EU) will find some solution, but if Greece does not experience some harsh repercussions, the bailout will serve to encourage bad behavior in the future by Greece or other struggling countries.

We draw the analogy with a family and how the parents (European Union) react to bad behavior from one of their children (member countries). If the offending child does not experience appropriate punishment, what will deter the other children from behaving in the same fashion? Nothing. Greece is one of the EU PIIGS, the acronym for Portugal, Italy, Ireland, Greece, and Spain. The other PIIGS are not in great shape either. We will monitor this situation carefully as further PIIGS turmoil could impact liquidity or risk perceptions in the US markets.

Japan is struggling as well. Japan's sovereign debt is enormous, amounting to roughly 5.3x gross domestic product (GDP). Japan has spent the past 20 years supporting zombie banks and piling on public debt in an attempt to revive a stagnant economy. If that playbook sounds familiar, it should; the US is pursuing a strikingly similar strategy. Japan has little to show for the effort and is in an increasingly precarious position. While public sector debt has grown from 3.9x GDP to the previously mentioned 5.3X, nominal GDP has not changed a stitch. With a cost of capital of only 1.4%, Japan currently spends roughly 28% of her tax receipts on interest expense, before any reduction of principal. With principal retirement, it gets up toward 50%. The country continues to run huge deficits, so only a modest increase in the cost of capital will be unsustainable. With a very old society, Japan cannot grow her way out of this. Over 24% of the population is older than age 65. It has been said Japan will soon use more adult diapers than infant diapers. It will be interesting to see how they attempt to navigate their mess and how widespread the ramifications are.

Not to be overly gloomy, but there are other issues, most notably China. The general belief is that China is chugging along smoothly, but underlying problems are beginning to reveal themselves. The amazingly strong GDP growth, frequently touted in the media, has been largely supported by a boom in property construction. However, there is disturbing evidence that a lot of property is unoccupied. A recent Time magazine pictorial titled "Ghost City" showed the Kangbashi district of Ordos City in Inner Mongolia. Kangbashi was built in the past five years. It is filled with office towers, administrative centers, government buildings, museums, theaters, sports fields, and acres of subdivisions. Kangbashi was designed to house, support, and entertain one million people, but hardly a soul lives there. This is a dramatic

example of how China is creating growth out of thin air. A blow up in China would have significant repercussions. Recently, Edward Chancellor of GMO, LLC wrote an insightful white paper titled "China's Red Flags." If you are interested to learn more about China's precarious economic situation, the white paper can be obtained by visiting www.gmo.com and registering as a user. Registration is free.

The US is not without problems. We have discussed the federal government's spending problems at length in past letters. In addition, state governments and municipalities are increasingly stretched, unemployment remains stubbornly high, and we are at the beginning of a new batch of Adjustable Rate Mortgage (ARM) resets. However, with all the turmoil throughout the world, the problems facing the US may take some time to come to the forefront. We do not doubt that there will eventually be consequences for the excessive buildup of debt and mis-allocation of precious resources. The questions are when and how the consequences manifest themselves.

Uncertainty, Volatility, and Time: The Value Investors Friends

"The advantage of a bad memory is that one enjoys several times
the same good things for the first time."

- Friedrich Nietzsche

The market's memory is amazingly short. So short in fact, that the financial media has recently been touting the Dow Jones Industrial Average's move over the 11,000 mark. Not mentioned is that this first occurred in 1999, and the Dow has gone above and back below this level eleven times. Whether the market breaches a particular level is not important. Understanding what the current level of valuation offers investors looking forward *is* important.

Investing capital today presents the challenge that current valuations seem to have already baked into the cake a significant economic recovery. No question, the economy has been showing some life recently, and along with that investors have displayed a significant willingness to take on risk. When risk taking unwinds, volatility rises because the time frame many investors use to make decisions becomes much shorter.

As the herd's time frame shortens, this can create great opportunities for investors willing to take a longer-term view – a concept sometimes described as "time arbitrage." For example,

when markets decline, the stocks of asset management companies are often hard hit. Asset management revenues are typically a percentage of the assets under management. When markets decline, so do asset managers' revenues. Declining markets also tend to precipitate withdrawals. So, declining markets are doubly challenging for asset management companies. Expecting that dynamic to go on forever, some investors liquidate their holdings without taking a longer-term view. This happened in dramatic fashion following the collapse of Lehman Brothers in September 2009, and we were able to acquire a basket of these stocks at spectacular valuations. One key to the success of this investment was our belief that the capital markets would endure and eventually adapt to the "new reality."

The Survival of the Equity

Companies have a remarkable ability to find ways to make money. Even under the most difficult circumstances, when company management and directors have meaningful ownership incentives, they explore creative options for utilizing resources in the most profitable manner. For many years, we have been shareholders of Markel Corporation, a specialty property-casualty insurance company. Markel's outstanding Chief Investment Officer, Tom Gayner, recently pointed out that Darwin is often misquoted regarding survival of the fittest. What Darwin actually said was "it is not the strongest of the species that survives, but the one most adaptable to change." Tom went on to say that equities (stocks) and the businesses they represent give the best odds of surviving calamity. We agree.

This reminds us of a story about a Japanese man stranded at sea for many months on a raft. Early in this ordeal, the man discovered that fish followed the sun's reflection off the crystal face of his watch. So, he began directing the fish into the raft, and discovered he could grab the momentarily stunned fish with his free hand. He dried the fish in the sun for food, and pierced their eyes to get water. This abbreviated version does not really do the story justice, but you get the point. Like the stranded man, companies find a way to make the most of a difficult situation. They undertake asset sales or spin-offs, refinance debt, raise additional capital, restructure contracts, or explore joint ventures and business combinations, and even outright sales of their entire business, along with countless other actions that create value.

Despite the adaptable nature of equity, stocks are invariably more volatile than bonds or cash. To be a successful equity investor, you must have a sufficiently long time horizon and be willing to endure wide swings in the market price of your holdings. And, with those swings comes opportunity; opportunity to acquire assets and earning power at lower valuations. When you are able to buy at lower valuations, you have a chance to benefit in two ways: you benefit from the increase in intrinsic value of the business over time, and you may also be able to sell at a

higher valuation at a later date. In addition, paying a lower price provides a margin of safety to protect against business deterioration or other unexpected circumstances that can lead to losses.

Consider a business growing earnings at 12%. If you buy the business when it is earning $5.00 per share, at 10x earnings, you pay $50 per share. Over the next three years earnings grow 12% per year ending at $7. If market sentiment changes and the stock then sells at 14x earnings, your stock is at $98. This would be a 25% annual rate of return. Not bad for owning a boring company growing at 12%. The key is finding a business with reasonably steady growth prospects that has the potential to trade at a higher earnings multiple.

Our job is to identify the great investment opportunity that presents itself in any environment. Turmoil in the financial markets is a double-edged sword. It dampens the value of what you own, but it also creates opportunities to expand your holdings at better prices. Sometimes it is easy to find ideas, other times it is not. Recently value has been more difficult to find, but not impossible. The run-up has left the S&P 500 with an expected return over the next 7-10 years in the 3-4% range. With that expectation, coupled with the issues discussed at the outset of this letter, we are being very discerning about when and how we add risk exposure. Regardless of the market level, when we find ideas that present a significant margin of safety, and reasonable return prospects, we will not hesitate to pull the trigger. Please send along any investment ideas that might meet this description.

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 presented 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 represents 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.

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.