April 29, 2011

"Events can move from the impossible to the inevitable without ever stopping at the probable."

- Alexis de Tocqueville

Dear Client,

The second round of the Federal Reserve's "quantitative easing" (QEII) is set to end no later than June 30th. Prominent and successful money managers disagree on the impact. PIMCO's Bill Gross thinks yields are bound to rise as the largest net buyer of Treasuries (the Fed) moves to the sidelines. Gross has sold all of the US Treasury holdings in the flagship Total Return Fund. In fact, the fund now carries a slight, net-short position in US Treasuries. The lesser-known and certainly more controversial, Jeff Gundlach, formerly of Trust Company of the West and now with DoubleLine Capital, believes just the opposite. According to him, yields will fall in the short term because quantitative easing is inflationary. When QEII stops, bond buyers will require lower yields as future inflation expectations recede.

We will not attempt to handicap the outcome of this single event. Frankly, it is a red herring to the far more important big picture. Our broad market thesis still stands:

- 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)

Despite the nearly 100% increase in US equities from their March 2009 low, caution is still the watchword of the day.

We don't spend a lot of time worrying about single events like the end of QEII because our process is not based on forecasting and we very rarely make binary bets. Our objective is to build portfolios that can outperform in myriad possible scenarios. We seek out investments where the price embeds a margin of safety. We maintain dry powder (i.e. cash) to allow us to take advantage of volatility. We look for cheap insurance, often embedded in traditional securities, to protect our portfolios from extreme events.

Rather than our usual quarterly letter format, we thought that it might be a nice change to use a picture-based Q&A to look at the broad investment environment. First, our typical performance table[1] as of March 31, 2011:

	Q1	YTD	TTM	Cumulative Since 10/06
Grey Owl Opportunity Strategy (net fees)	**3.54%**	**3.54%**	**9.98%**	**28.96%**
Spider Trust S&P 500 (SPY)	5.90%	5.90%	15.57%	5.72%
iShares MSCI World (ACWI and MXWD)	3.31%	3.31%	13.24%	8.36%

Q: Are the last 24 months the correct framework for viewing stock market returns?

While the S&P 500 index is up approximately 100% from its 666 low in March of 2009, investors who bought at the 1565 daily peak in October of 2007 are still down approximately 17%. In fact, those who bought at the previous daily peak of 1527 in March of 2000 are down approximately 13% after eleven years! The last two years may feel great to equity investors, but only if taken out of any longer-term context.

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

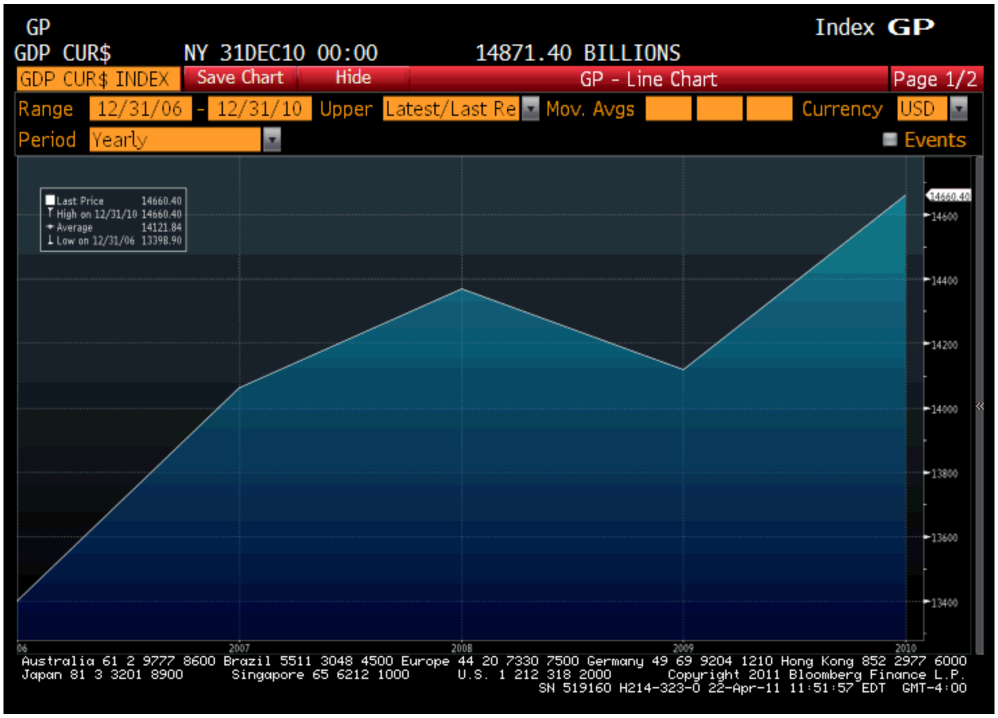
The above calculations are price return only, but dividends don't improve the story by much. Even with dividends included, an investor who bought at the 2000 peak would be up less than 1% per year. For those who bought at the 2007 peak, they are still down over 5% even after accounting for dividends.

This thirteen-year chart is the perfect picture of a range bound market.

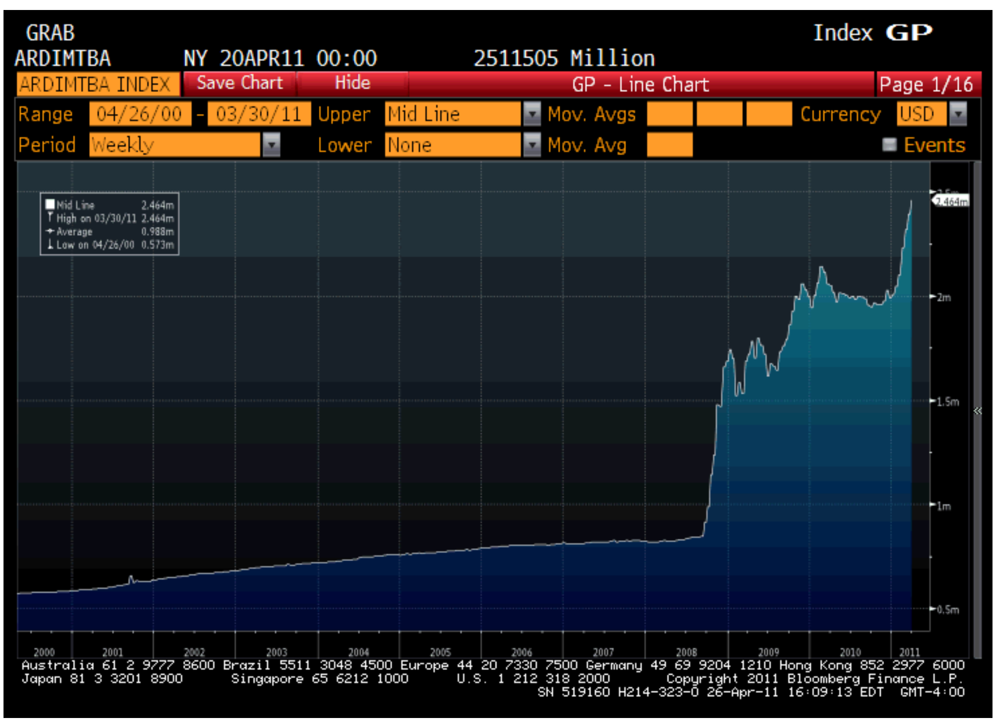
A: From our perspective, the last 24 months are not indicative of a healthy market. After such a run, investors should be growing more, not less, risk-averse. As we have articulated many times before and at length in our investment guide, "[How to Prosper in Volatile and Range-Bound Markets]," we believe we are in an era of increased volatility, slow economic growth, as well as real and inflation led-deleveraging. As the following charts argue, the economy has yet to make much progress.

Q: Has the economy really recovered?

Nominal GDP has grown slightly since 2007 after a mild dip in 2009.

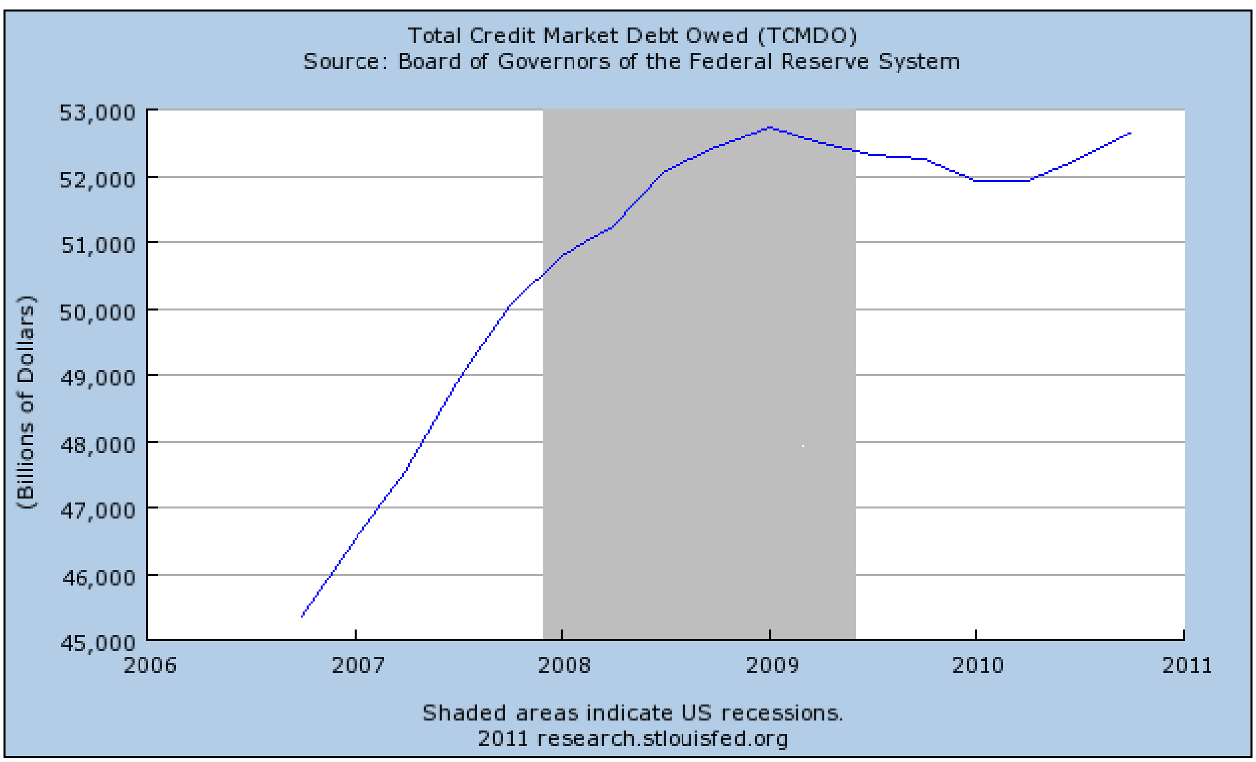


However, much of this was driven by fiscal and monetary policy. The Federal Reserve's balance sheet has almost trippled in size.



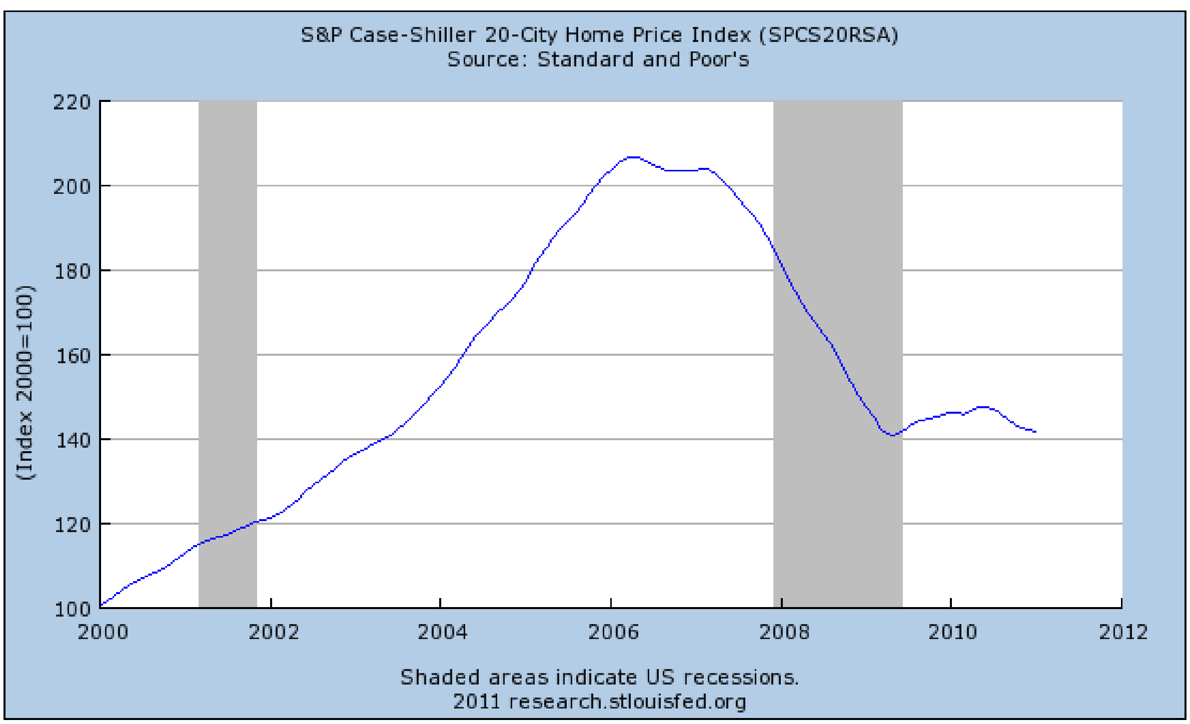
Additionally, the Federal budget deficit has increased significantly. Note the deficit is a negative number, so the graph gets more negative as the deficit grows.

Almost no net deleveraging has occurred.

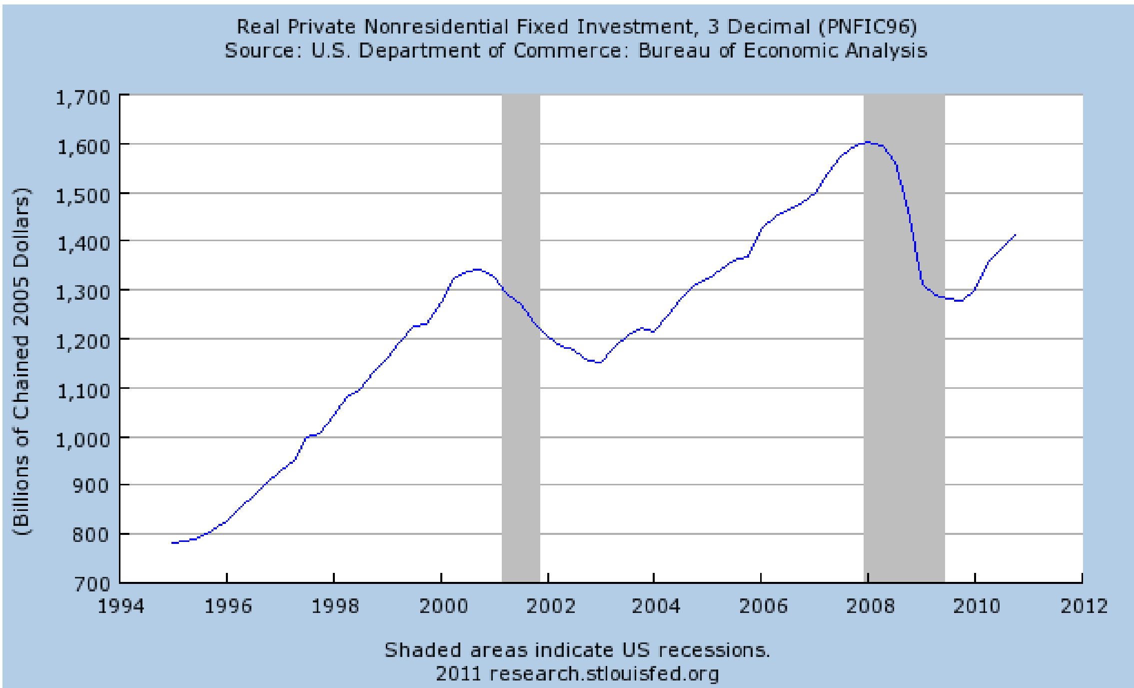


Yet, despite all of this intervention, the labor participation rate has continued to worsen. (The unemployment rate has only improved because workers have left the workforce and are no longer counted as unemployed.)

Housing prices have made no improvement.



While real private nonresidential fixed investment (i.e. business capital investment) has bounced off of its lows, it still has a long way to go. This is critical. Business capital investment measures the creation of goods and service producing assets. In other words, it is a true measure of wealth creation. Distinct from money printing and government stimulus, business capital investment is the only sustainable way to grow the economy and add jobs.



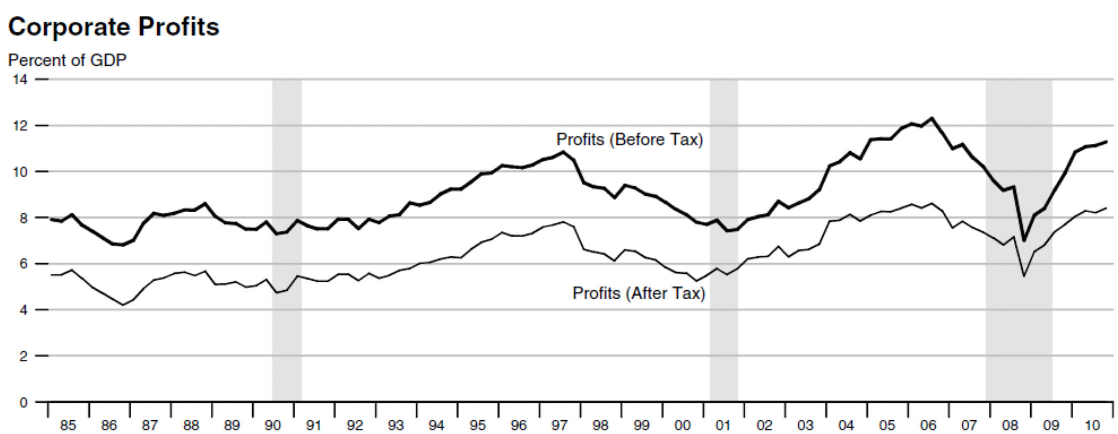
A: The private sector economy has not fully recovered and it is unclear what will happen when government fiscal and monetary stimulus is eventually withdrawn.

Q: Do underlying corporate and economic fundamentals warrant current valuations?

Now that the stock market is up nearly 100% from its 2009 low, the cyclically adjusted price earnings ratio (CAPE) has also returned to very high levels. Historically, 7-10 year returns from peak CAPE valuations have been zero plus or minus a few percent. This is because investors have embedded extremely high expectations into these valuations.

Source: http://www.econ.yale.edu/~shiller/data.htm

Most importantly, these high valuation levels are built on very high corporate profit margins. Profit margins have been a very mean reverting series. High profit margins attract competition. While the graph below shows profit margins at or near a 25-year peak, longer-term data is even more dramatic. From the mid-50s through the mid-90s, corporate profits were rarely above 6% of GDP. 6% is the long-term average.

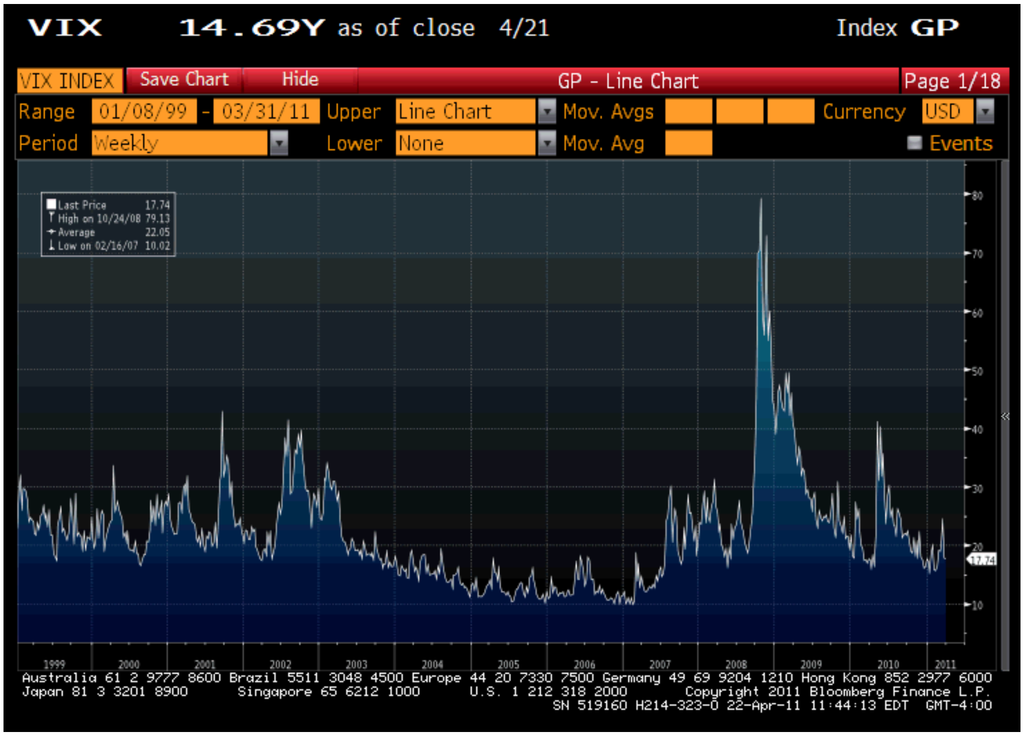


Source: http://research.stlouisfed.org/publications/net/page21.pdf

A: Unless corporate profit margins stay at historically high levels, stocks, in general, are overvalued.

Q: So, why are markets so complacent?

The stock market volatility index (VIX) or "fear index" has returned to very low levels.



A: The significant and rapid rise in equity values has made investors complacent. From our perspective, we are not on stable footing. In addition, investors are not being compensated for the risks that abound with high valuations and low expectations for volatility; quite the opposite. These conditions can certainly continue for some time. However we don't think they can continue indefinitely.

Q: What is an investor to do?

A: We are positioned to deal with this environment as follows:

- A large portion of our portfolios are built on very stable long-term businesses, with little balance sheet risk, and modest valuations. While these securities would certainly sell off in a broad market correction, it is likely they would sell off less than the market. In addition, we believe that the underlying businesses would continue to compound intrinsic value in most economic environments and through either deflation or inflation.

- We own a few companies of lower quality, but with near-term catalysts to value creation. Most of these names are <u>very</u> cheap by our estimation.

- We own operating businesses in energy, gold mining, and commercial real estate that should perform very well in an inflationary environment (i.e. where the purchasing power of the dollar decreases).

- A significant portion of our portfolios are in cash. We will put this to work when risk aversion and volatility eventually return.

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

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. A complete list of recommendations by Grey Owl Capital Management, LLC may be obtained by contacting the adviser at 1-888-473-9695. 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.

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 presented in the table on page 2 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.