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:

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>YTD</th>
<th>TTM</th>
<th>Cumulative Since 10/06</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grey Owl Opportunity Strategy (net fees)</td>
<td>3.54%</td>
<td>3.54%</td>
<td>9.98%</td>
<td>28.96%</td>
</tr>
<tr>
<td>Spider Trust S&amp;P 500 (SPY)</td>
<td>5.90%</td>
<td>5.90%</td>
<td>15.57%</td>
<td>5.72%</td>
</tr>
<tr>
<td>iShares MSCI World (ACWI and MXWD)</td>
<td>3.31%</td>
<td>3.31%</td>
<td>13.24%</td>
<td>8.36%</td>
</tr>
</tbody>
</table>

**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.

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\(^1\) 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.

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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.
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.

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 very 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