April 25, 2014

"Round and round she goes; where she stops nobody knows."

- Carnival Barker

Dear Client,

The broad equity market displayed a fair amount of volatility during the quarter, but essentially went sideways. This pattern continued through April; 2013's losers became 2014's winners and vice versa. In the broadest sense, bonds narrowly beat stocks on the heels of 2013's thorough drubbing. The Barclays Aggregate Bond Index (as measured by the AGG ETF) was up 1.77% for the quarter, while the S&P 500 (as measured by the SPY ETF) was up 1.70%. Gold, gold miners, REITs, and emerging market bonds were all negative in 2013 and are positive in 2014. US small caps, biotech, and social media were 2013's leaders and were all down in the first quarter of 2014.

Despite the market's noise and our defensive posture, Grey Owl's portfolio performed well in the first quarter. Below, we discuss the current environment and provide details behind two investments we initiated during the quarter. First, here is the performance table for the Grey Owl Opportunity Strategy as of March 31, 2014[1]:

	Q1	TTM	Cumulative Since 10/06
Grey Owl Opportunity Strategy (net fees)	**5.55%**	**13.92%**	**61.33%**
Spider Trust S&P 500 (SPY)	1.71%	21.77%	58.78%
iShares MSCI World (ACWI and MXWD)	.90%	16.95%	39.22%

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

Portfolio Adjustments

We made modest portfolio adjustments in the first quarter. At the beginning of the period, the Grey Owl Opportunity Strategy had 74% exposure to equities. After three buys and three sells, we ended the period pretty much where we started at 73% equity exposure. Despite our continued defensive posture, we outperformed the broad equity market (defined by the S&P 500) through security selection. Our top five performers (on a size-weighted basis) for the quarter were World Wrestling Entertainment (WWE), Valeant Pharmaceuticals (VRX), Annaly Capital Management (NLY), Ultra Petroleum (UPL), and Express Scripts (ESRX).

On the buy side, we added to National Oilwell Varco (NOV) and initiated new positions in Post Holdings (POST) and Priceline.com (PCLN). As we write this letter, NOV is our third largest position constituting almost 6.5% of our portfolio. Our investment theses for Post and Priceline are described below.

On the sell side, we trimmed our exposure to Valeant and World Wrestling Entertainment. Both securities experienced rapid gains into the end of January following their substantial appreciation in all of 2013. In the spirit of "bulls make money, bears make money, but pigs get slaughtered," we chose to take some money off the table.

You can find a full description of our VRX thesis in our third quarter 2013 letter. We continue to believe Valeant has a long runway and that CEO Michael Person is an exceptional steward of shareholder capital. He is a true "Outsider" (see POST discussion below for a definition). Even after trimming half of our position at close to $137/share, VRX remains a core holding. It is our seventh largest position at just under 4% of the portfolio. As we were writing this letter, Valeant and Pershing Square (a large "activist" investment firm) revealed a plan to consummate VRX's long sought "merger of equals" with Allergan. We are optimistic about this possibility and believe it will add substantially to Valeant's intrinsic value.

WWE is now our smallest position. As we described in our last quarterly letter, this was a short-term, catalyst driven idea. While the catalyst (a new TV contract) has not yet materialized, the stock price incorporated most possible upside scenarios during the quarter and we trimmed the position twice as the price rose.

Our final sale was one of our oldest positions. After a series of buys and sells dating all the way back to the mid 2000s, we completely exited our Microsoft (MSFT) position booking reasonable, but not spectacular, returns. We still saw upside in many of Microsoft's enterprise offerings. However, at the end of the day, MSFT's leadership appeared disorganized at best. A major corporate realignment was announced, then a somewhat inconsistent hardware acquisition (Nokia), and then the resignation of the CEO who orchestrated both moves. The CEO search appeared sloppy from the outside, though it appears to have ended well. Satya

Nadella (the new CEO) seems to be on the right track, but he still needs to figure out how to deal with MSFT's $84 billion and growing cash hoard. It is an albatross around the neck of return on invested capital.

Post Holdings, Inc.

The idea for our Post Holdings, Inc. (POST) investment originated with a 2012 book *The Outsiders* by William Thorndike, Jr. The book's subtitle sums up its contents well: "Eight Unconventional CEOs and Their Radically Rational Blueprint for Success." Each chapter offers a case study of a public company chief executive who provided shareholder returns significantly better than the S&P 500's performance over his or her leadership period.

Mr. Thorndike is a private equity investor. His stated purpose for *The Outsiders* was to create a guidebook for the private company executives who lead his portfolio companies. For our purposes, the book also functions quite nicely as a template for identifying public company CEOs to serve as stewards of our capital. In the case of POST, it did not take genius on our part to apply the necessary pattern recognition.

One of *The Outsiders'* eight profiles tells the story of Bill Stiritz and Ralston Purina. For the nineteen years he was CEO at Ralston, the stock compounded at a 20 percent annual rate compared to 14.7 percent for the S&P 500. It is worth emphasizing how dramatic this difference is. A dollar given to Bill Stiritz at the beginning of his tenure became $38, while a dollar placed in an S&P 500 index fund was "only" worth $16!

When Mr. Stiritz assumed the role of Ralston's CEO in 1981, it was an unwieldy conglomerate. The business had high-return consumer goods brands at its core, but also a diverse set of "other" businesses that included a quick serve restaurant chain and a hockey franchise. Mr. Stiritz quickly divested the non-core businesses and then, via two large acquisitions, increased the branded consumer goods business by over 30 percent. Significant acquisitions continued through the late 1980s. Ralston did not just buy brands and leave them alone; following each acquisition, Stiritz streamlined costs, improved product offerings, and enhanced marketing efforts. He bought on the cheap, but he also extracted significant additional value from the assets he acquired. Then in the 1990s, when his business units were operating at peak efficiency and comparable standalone companies were trading at higher multiples, Mr. Stiritz began a series of spinoffs.

While founded in 1895, the current incarnation of Post Holdings, Inc. (POST) began trading in February 2012 with Bill Stiritz as CEO. POST is the final spinoff of Ralcorp Holdings which itself was subsumed by ConAgra in early 2013. POST is the platform on which Mr. Stiritz has begun to build a new consumer packaged goods business focused on branded food offerings in high growth categories.

On February 28, 2014, we established a small position in POST at a purchase price of approximately $57.50. At this share price, we paid slightly more than 10x enterprise value[2] to earnings before interest taxes depreciation and amortization (i.e. 10x EV/EBITDA). This was approximately the same multiple at which larger, ready-to-eat (RTE) cereal consumer packaged goods manufacturers General Mills (GIS) and Kellogg (K) traded at the time. POST was not cheap relative to its peers, but we were not paying a premium for Mr. Stiritz's leadership.

At the time of our purchase, just two years after the spinoff from Ralcorp, Stiritz had already transformed the business. In February 2012, nearly 100% of sales were in the stagnant, RTE cereal category. In February of 2014, RTE cereal was down to 50% of sales. Through a series of five acquisitions (totaling $1.4 billion) that occurred between May 2013 and February 2014, POST added "organic" to its RTE product offering and diversified into active nutrition (25% of sales) and private label (25% of sales). RTE cereal is growing in the very low single digits, but organic, active nutrition, and private label each bring double-digit growth rates. Active nutrition and private label are fragmented industries and we expect that acquisitions in these categories will continue. As they build scale, POST should be able to cut overhead costs at acquired firms while also improving their distribution.

As we prepared this letter, POST announced a deal to acquire Michael Foods for $2.5 billion. If this deal is completed, it would almost double POST's enterprise value. Annual sales would grow to north of $4.1 billion and EBITDA to approximately $590 million. Product concentration would be further diversified: RTE cereal 27%, private label 13%, active nutrition 13%, egg products 35%, and potato and cheese 12%.

With some investments, it is possible to model growth rates, margins, and capital needs within a reasonably sized band of possibilities. As you can probably tell from the preceding paragraphs, this is not remotely possible with POST. What we do know when it comes to POST is that we are paying a fair price for the business as it currently stands. More importantly, we are partners with one of the most creative minds and prudent stewards of capital in business today.

One modest downside to this investment is "key man" risk. Bill Stiritz is 79 years old. However, two factors mitigate this risk. First, Mr. Stiritz brought to POST several executives from his leadership team at Ralston. The bench is deep. Second, the clock might not be ticking quite as quickly as it appears. After all, Charlie Munger (Warren Buffett's sidekick and Berkshire Hathaway's vice chairman) is 90 and hasn't missed a beat.

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[2] Enterprise value is market capitalization plus debt less cash, or the amount of money required to buy the entire enterprise.

Priceline.com Inc.

After looking at a multiyear chart of Priceline.com's (PCLN) stock price, it would be reasonable to challenge our assertion that we are "value investors." The chart goes from the lower left to the upper right at a steep angle. Over the ten years through 2013, PCLN's stock price has compounded at an average annual rate of 52%. Over the past five years, the number jumped to 74%. Is PCLN Grey Owl's attempt at "momentum investing?"

Despite the historical gains, PCLN still offers the potential to deliver multiple years of high teen shareholder returns going forward. While PCLN is on the verge of becoming the world's largest travel agent, it only commands a 4% market share. It has a long runway for growth as online travel booking continues to take share from offline. We purchased shares during the first quarter at approximately $1,280.

PCLN is an excellent, high-return business with a 35% return on equity in 2013. The firm is able to achieve this very high return because it has built a sustainable competitive advantage (i.e. a "moat") based on the network of hotel properties the firm has aggregated over many years (430k total and 200k in Europe alone) and the many traveler bookings it is able to bring to its current and future hotel partners. PCLN's websites have more than 30 million unique visitors per month. PCLN's business is concentrated in Europe where boutique hotel properties are more common and where cross border travel is more frequent. PCLN is able to showcase properties in multiple languages and transact in multiple currencies – a prohibitive effort for a single property hotel company and a barrier to entry for potential competitors.

It might be too early to consider PCLN's CEO, Jeffery Boyd, an "Outsider" in the Bill Stiritz mold. We need to see how he reacts if the price is not right – will he stop share buybacks if his stock becomes overvalued; will he walk away from an acquisition if the price becomes too high? Nevertheless, Mr. Boyd presided over one of the most lucrative acquisitions in corporate history with the 2004 purchase of Booking.com for 110 million Euros (or approximately $135 million). In 2013, international business (primarily Booking.com) provided 94% of PCLN's operating income. 94% of PCLN's current market cap is approximately $60 billion. If we assign this value to Booking.com, it represents a 444x return on investment or 84% annualized return for ten years.

At 23x forward earnings, PCLN does not appear cheap on the surface. Yet, it is the best-positioned online travel agency and online travel bookings continue to experience significant growth. In a world of 2-3% GDP growth, PCLN increased revenue over 30% annually for the last three years. Over the same period, earnings per share (EPS) expanded at a 55% annual pace. This rate will certainly moderate. Even so, 20%+ EPS growth for many more years is a reasonable expectation. This would still leave PCLN with only single digit market share. If those expectations are met, PCLN seems like a good deal at today's price.

Conclusion

We continue to position the portfolio defensively while opportunistically trimming exposure to ideas that have appreciated beyond our probability-weighted estimate of fair value and adding to ideas that we believe are below fair value. In addition, even in a market hitting all-time highs, we have been able to ferret out an idea or two as Post and Priceline demonstrate.

As we discussed in our last letter, the stock market has appreciated far more than underlying fundamentals warrant. As we wrote then, "S&P 500 earnings grew approximately 9% for the two-year period from the beginning of 2012 through the end of 2013. Over that same period, the total return for the S&P 500 index was close to 50%. … In that context, we find the market's January [now January through April] 'breather' completely rational. Will it continue? We have no idea. However, we do know that long-term (i.e. sustainable) stock market returns are anchored to corporate earnings growth. S&P 500 returns will not exceed earnings growth indefinitely."

In addition to our portfolio of selective equities, we hold cash and gold (and longer dated Treasury bonds in our fixed income accounts and partnership) in an effort to create an "all-weather" portfolio. As we have repeatedly written, the current level of government intervention, both fiscal and monetary, has served to smooth volatility in the short-term, but this is at the expense of significantly increasing long-run volatility. We continue to structure portfolios in a way that will enable them to perform well whether the economy grows or shrinks and whether we experience inflation or deflation.

The Fed's "taper" continues, but the degree of market intervention remains at a historical high. The wheel is spinning, the carnival barker is crying out. Where does this end? Nobody knows.

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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.

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Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC

The securities discussed above were holdings during the last quarter. The stocks we elect to highlight each quarter will not always be the highest performing stocks in the portfolio, but rather will have had some reported news or event of significance or are either new purchases or significant holdings (relative to position size) for which we choose to discuss our investment tactics. They do not necessarily represent all of the securities purchased, sold or recommended by the adviser, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. A complete list of recommendations by Grey Owl Capital Management, LLC may be obtained by contacting the adviser at 1-888-473-9695.

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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 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.