April 29, 2016

"And that's why we keep the hedges… Because the day we take them off, the game is over."

- Prem Watsa, CEO Fairfax Financial Holdings (at the 2016 shareholder's meeting)

Dear Client,

Over the almost nine years we have run the Grey Owl Opportunity Strategy, we have achieved equity-like returns with approximately half the volatility and drawdowns of various equity indices. While the returns have been far smoother than various equity indices, they have not always been smooth in an absolute sense. In addition, our Opportunity Strategy has demonstrated significant "tracking error" compared to just about any index one might choose – i.e. we might go through periods (weeks, months, quarters, years) where the index is up and our strategy is down and vice versa. We are very willing to miss the last leg of a bull market in order to protect capital over the full cycle, and that is what we are doing now – our positioning is the most defensive it has been since 2008. When a market experiences a topping process, perfectly timing an exit is impossible and not our objective. Nonetheless, danger signs that were prevalent in 2000 and 2007 are visible today. The table below summarizes the long-term performance of our "Opportunity Strategy."

	GO Opportunity	**S&P 500 (SPY)**	**MSCI All World (ACWI/MXWD)**
Annualized Return	5.1%	6.6%	3.7%
Largest Monthly Loss	-8.1%	-16.5%	-18.4%
Largest Drawdown[1]	-25.7%	-51.0%	-55.0%
Beta[2]	0.51	1.00	1.11
Sharpe Ratio	0.44	0.41	0.23

Figure 1- Grey Owl Opportunity Strategy Risk Statistics (Nov 1, 2006 - Mar 31, 2016)[3]

[1] On a monthly basis.

[2] To the S&P 500.

[3] All statistics are calculated based on the same representative account(s) used to calculate performance. They are calculated by GOCM using standard formulas.

The first quarter of 2016 and the trailing twelve months were both challenging periods as this performance table for the Grey Owl Opportunity Strategy as of March 31, 2016[4] indicates:

	Q1	TTM	Cumulative Since 11/06 Inception
Grey Owl Opportunity Strategy (net fees)	**-3.31%**	**-7.43%**	**60.01%**
Spider Trust S&P 500 (SPY)	1.32%	1.72%	81.82%
iShares MSCI World (ACWI and MXWD)	0.43%	-4.26%	40.68%

Today, the Grey Owl Opportunity Strategy represents approximately 48% of assets under management (AUM) for Grey Owl Capital Management, LLC. Grey Owl Partners, LP (our hedged partnership) represents 25% of AUM, fixed income 21% of AUM, and third-party managed investments represent 6% of AUM. Despite the challenging quarter for our Opportunity Strategy, our fixed income accounts were up approximately 3.5% from January 1 through March 31, 2016. Grey Owl Partners was down less than one percent. Across all of our different accounts, we performed "OK" in a challenging environment.

The biggest culprit hurting performance during both the quarter and the trailing twelve months was Valeant (VRX). At $36/share the stock is down 86% from its August 2015 peak of $264/share. In our Opportunity Strategy, Valeant represents half of our loss over the past twelve months. Despite this, Valeant has been a successful investment historically and as we wrote in our third quarter 2015 letter and we discuss in further detail below, it will be a positive performer over the entire period of our investment even if our current position goes to zero (i.e. we sold more than our entire cost basis at higher prices).

We manage risk and seek return at the asset allocation level, at the portfolio level within each asset allocation bucket, and at the individual security level within each strategy. Despite our most defensive positioning since 2009 at the asset allocation and strategy levels, an individual position can still cause modest damage – as Valeant proves. Going forward, Valeant is a small position and we see upside from the current level.

At the asset allocation and portfolio level, we are prepared for a storm. Fewer than 50% of our assets are in our equity/risk strategy (i.e. the "Opportunity Strategy") and within that strategy more than 50% of assets are now in cash or cash equivalents. Grey Owl Partners is currently

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

market-neutral and we have very little credit risk in our fixed income portfolios. Which leads us to a brief discussion of philosophy and a parable.

Philosophy

Fairfax Financial Holdings is a $17 billion market capitalization holding company with a record of compounding book value at 20% annualized for 30 years. To achieve this record, the Chairman and CEO, Prem Watsa has demonstrated a willingness to patiently sit out periods of market overvaluation and risk in order to preserve dry-powder for a day with better opportunities. Since 2010, Fairfax has spent $3.6 billion hedging against the risk of an equity correction and global deflation.

At the annual meeting in Toronto on April 14, Mr. Watsa kicked off the event by addressing the elephant in the room. Parable was the rhetorical method: A barber asks one of his customers if he would like to see the stupidest kid in the world. The customer says yes, the barber puts one dollar in one hand and two quarters in another, then calls over a small boy. The barber then shows the boy what is in each hand and tells the boy he can take the money from either hand. The boy chooses the quarters and walks out leaving the barber to say to his customer, “see, isn’t he the stupidest boy in the world?” Later, the customer sees the boy on the street and asks him why he choose the two quarters over the dollar. The boy responded, “because the day I choose the dollar, the game is over!” Mr. Watsa concluded his story, “and that’s why we keep the hedges… because the day we take them off, the game is over.”

Between 2003 and 2006, Fairfax spent approximately $500 million on equity and credit hedges before reaping over $4.5 billion in gains on the hedges in 2007 and 2008.[5] We concur with Mr. Watsa’s outlook concerning equity valuations and systemic stress across the global economic system. We also concur with his willingness to patiently protect capital when necessary.

Volatility Increases, Large-Cap Equity Indices Move Sideways

The first quarter of 2016 was an extreme version of a tale of two periods. From January 1 through February 11, risk assets collapsed. Then, from February 11 through March 31 (and continuing through the end of April as we write) risk assets violently rebounded.

[5] From the 2015 Chairman’s Letter to Shareholders:
http://s1.q4cdn.com/579586326/files/doc_financials/2016/2015-Shareholders'-Letter.pdf

The following table highlights how this volatility manifested across multiple asset classes.

	January 1 – February 11	February 11 – March 31
S&P 500 (SPY)	-10.3%	13.0%
Russel 2000 (IWM)	-15.8%	17.1%
Biotech Index (IBB)	-27.9%	6.9%
Energy Index (XLE)	-10.7%	15.7%
China Index (MCHI)	-20.0%	19.1%
High-yield Bonds (HYG)	-5.7%	8.6%

Figure 2 - Risky Asset Class Moves During Q1 2016; Source: Thomson Reuters

The rapid drop and equally forceful rebound to start 2016 mirrored the experience in the summer of 2015.

Figure 3 - S&P 500 Index January 2015 through March 2016; Source: Bigcharts.com

Sideways movement of indices coupled with bouts of significant volatility is a common feature of a market top.

A similarly volatile, yet sideways pattern developed in late 2006 into mid-2008.

Figure 4 - S&P 500 Index between Oct 2006 and May 2008; Source: Bigcharts.com

Most readers will remember how that story ended, but it is worth revisiting the chart to emphasize the point. From January 2008 through March 2009, the S&P 500 was down 41%.

Figure 5 - S&P 500 Index from June 2008 through March 2009 - Down 41%; Source: Bigcharts.com

Classic Bear Market Rally

"The Markets Have a Message: Don't Believe This Rally" was the headline from a March 28, 2016 Wall Street Journal article arguing this is a classic bear market rally, not an all clear sign:

> "Traders talk of 'risk on' times, and the past six weeks rank as one of the biggest risk-on rallies since the global financial crisis.
>
> Yet the picture isn't one of wild risk-taking, whatever the headlines appear to suggest. Three of the traditional safe assets to which investors fled in January and early February haven't fallen back as risky assets gained. The yen, gold and the Swiss franc remain elevated compared with the start of the year, and while they have fluctuated, they are almost as strong as on Feb. 11, the day equities and credit hit their trough.
>
> This is unusual, to put it mildly. Safe assets normally move in the opposite direction to risky assets, as investors switch between fear and greed. U.S. Treasury bonds, another safe asset, have sold off, but by much less than risky assets rose.
>
> How do these signs of fear square with the stunning rise in equities and emerging markets? Put simply, this has been a misery bounce driven by stronger commodities. It isn't a rebound to enthuse investors. "

A look at the performance of the most shorted stocks furthers this view. Since the recent low on February 11, 2016 the S&P 500 has rebounded approximately 15%. As the chart below shows, the Goldman Sachs Most Shorted Index has returned almost 34% over the same time. A significant part of the recent rally has been fueled by short covering.

Figure 6 - Performance of Goldman Sachs Most Shorted Index from Feb 11, 2016 - Apr 26, 2016; Source: The Bloomberg

High Valuations Meet Increasing Investor Risk Aversion (Still)

Volatility alone does not portend market corrections. It is more of a coincident indicator. High valuations combined with signs of increasing investor risk aversion are stronger forward-looking signals. The chart below shows an aggregate of four valuation measures for the S&P 500. On the average of these four very reliable measures, the index is 76% above its historical valuation mean. <u>It has only been more expensive two times in the last 115 years: in 1929 and in 2000.</u> It was expensive to the same degree in 2007.

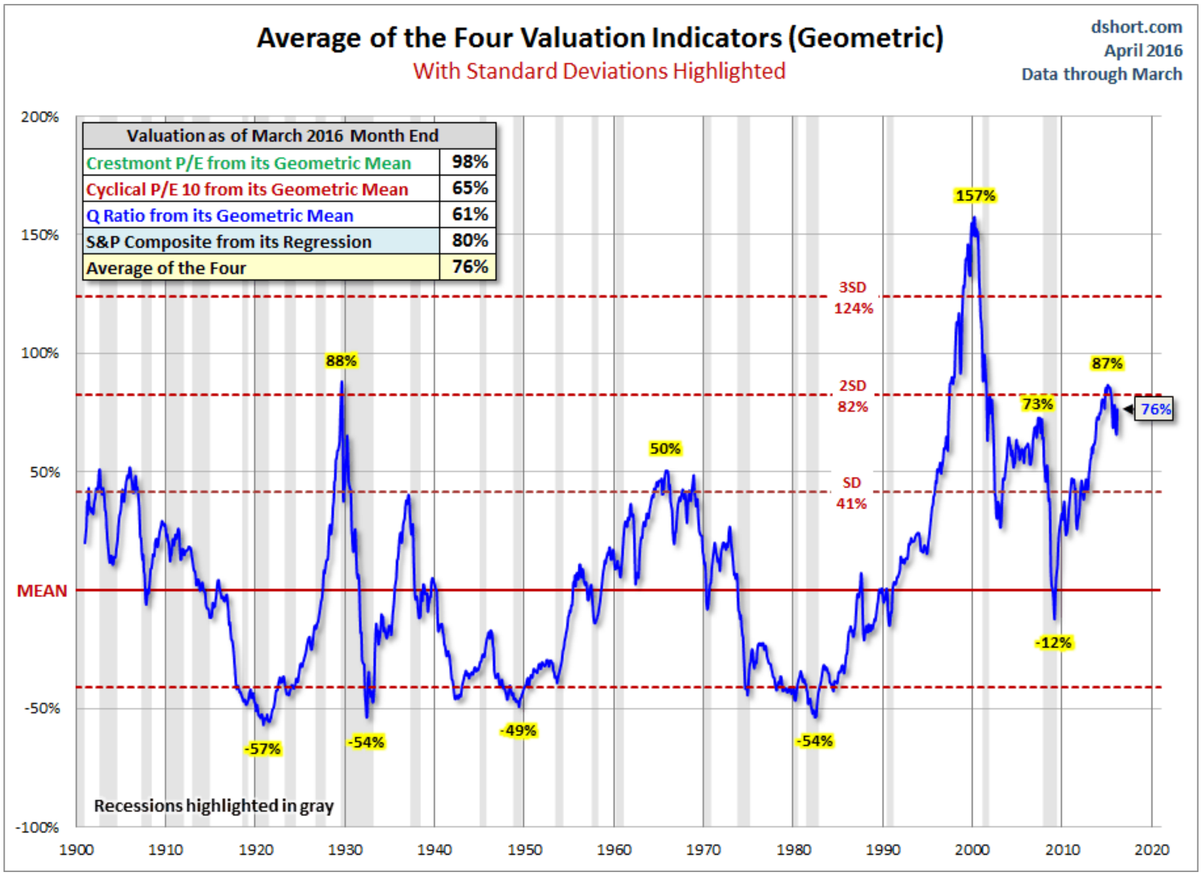


Figure 7 - S&P 500 is 76% above its historical price multiple on four metrics; Source: dshort.com

Signs of investor risk aversion have eased somewhat in the past few months, but remain elevated. Credit spreads are still 24bps wider than they were one year ago.

Figure 8 - BAA vs. AAA credit spread; Source: The Bloomberg

The NYSE advanced/decline line for stocks continues to lag the S&P 500 index. This indicates the average stock is underperforming the market capitalization weighted index (i.e. fewer mega-capitalization stocks are masking poor performance beneath the surface).

Figure 9 - NYSE stocks only advance/decline line (white) compared to S&P 500 index (yellow); Source: The Bloomberg

Comparing the S&P 500 equal weighted index to the S&P 500 capitalization weighted index provides additional evidence of a narrowing market. The S&P 500 equal weighted index tracked the performance of the capitalization-weighted index for 2014 and into the beginning of 2015. Then, the capitalization index began to outperform, again highlighting a narrowing market.

Figure 10 - S&P 500 equal weight index (white) compared to S&P 500 capitalization weighted (green); Source: The Bloomberg

Finally, comparing the S&P 500 to the Russell 2000 makes the point in a more dramatic way. Large capitalization stocks have significantly outperformed small capitalization stocks since the beginning of 2014.

Figure 11 - S&P 500 (white) compared to Russell 2000 (green); Source: The Bloomberg

The Global Economic Backdrop

In [our last quarterly letter](), we discussed the $57 trillion increase in global debt between 2007 and 2014 that raised the ratio of global debt to gross domestic product (GDP) to 290%. Debt has funded mal-investment in Chinese infrastructure, global energy, and corporate share buybacks at higher and higher prices. Global growth (including the U.S.) continues to slow as it takes on greater and greater units of debt to fund one unit of growth.

This quarter, we examine the amount of central bank intervention that has occurred in the past several years – in large part facilitating the global debt increases. Since 2006, the balance sheets of the four largest central banks (the United States, the European Central Bank, the Bank of Japan, and the People's Bank of China) have grown from approximately $5 trillion to over $16 trillion dollars.

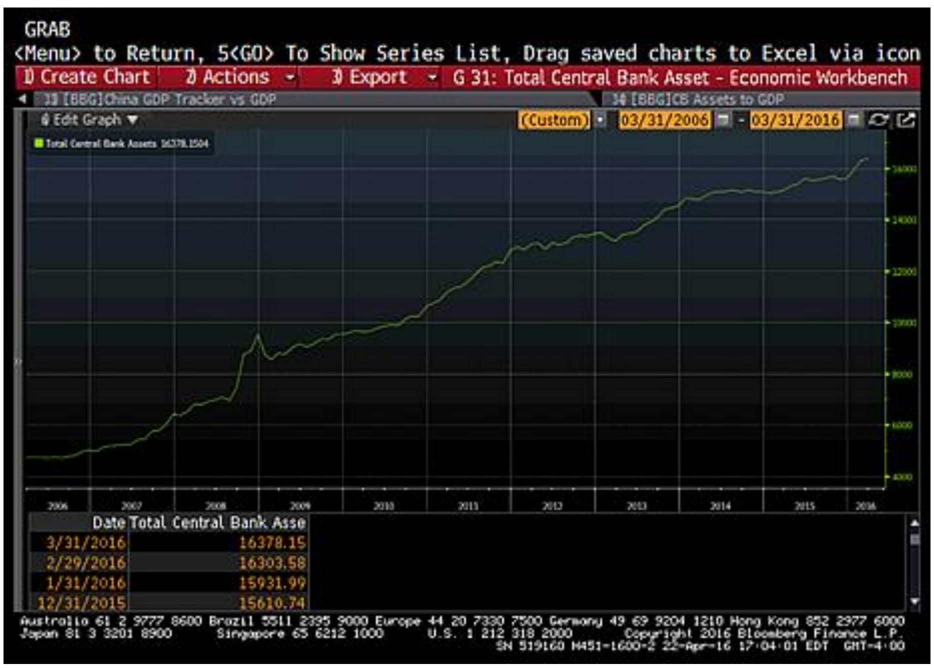
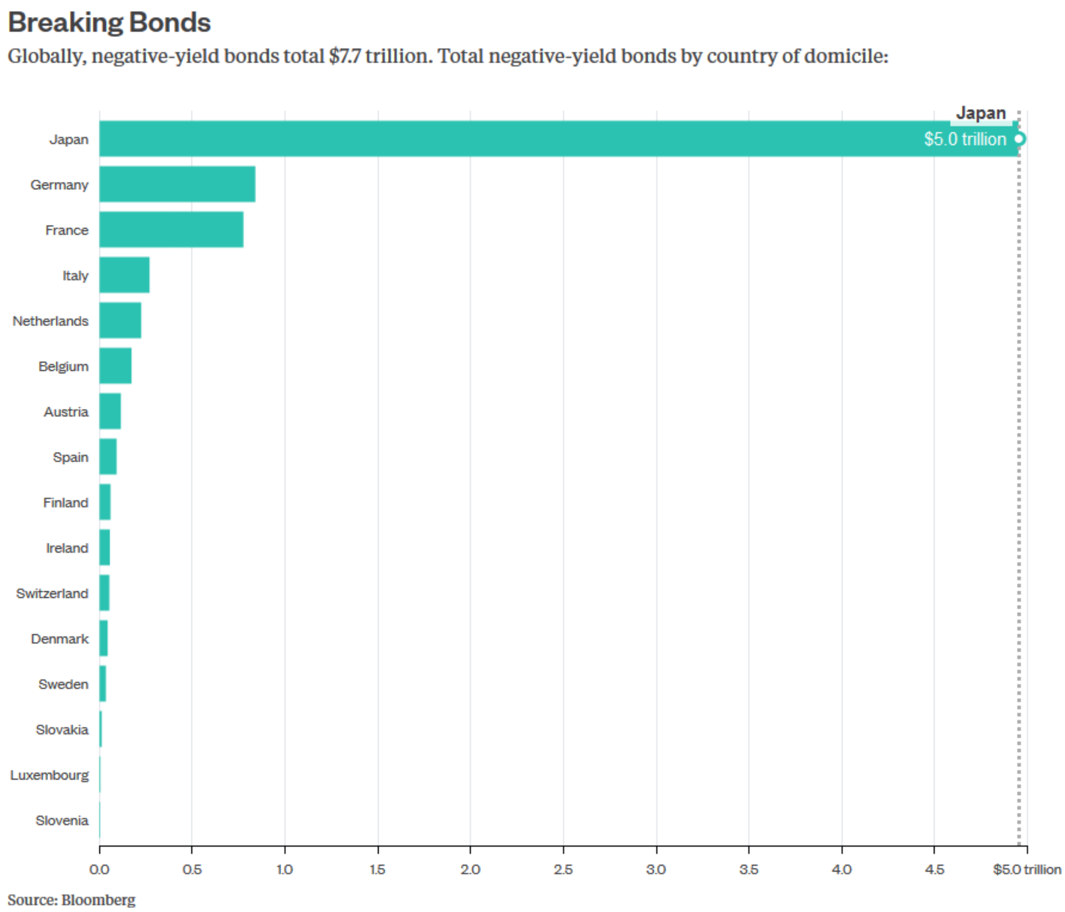


Figure 12 - Combined balances sheets of Fed, ECB, BOJ, and PBOC; Source: The Bloomberg

One of the many shocking results of these activities is the almost $8 trillion in sovereign debt now trading with NEGATIVE interest rates. That is correct – borrowers are **paying** to hold securities issued by Japan and fifteen European countries.



The negative rates are a reaction to central bank intervention, but also a reflection of slowing growth and disinflationary trends throughout the world. We believe this degree of central bank market interference can only end poorly. The pictures really speak for themselves.

More on Valeant (VRX)

We wrote in detail about the issues surrounding Valeant (VRX) in our third quarter 2015 letter. Unfortunately, the situation warrants we discuss the position again.

When the controversy began in mid-2015 we focused our analysis on the two issues raised by politicians, short-sellers, and the media: a) were any of the drug price increases illegal; and b) was there fraud within Valeant's distribution system? Our assessment was that nothing appeared illegal, and frankly, any moral question regarding drug prices was subjective. On the distribution side, we found no evidence of fraud at Valeant's captive specialty pharmacy

(Philidor). We did recognize Valeant was being aggressive on both fronts, but the actions were already discounted in the share price.

Where we erred was in not recognizing Valeant's vulnerability given the concentrated nature of payers in the pharmaceutical value chain. A few insurance companies and pharmacy benefits management companies make up the bulk of pharmaceutical distribution. Just as Valeant (i.e. Mike Pearson) had historically used its knowledge of the complicated system to extract as much value as possible, the payers used Valeant's newfound vulnerability to renegotiate pricing on a meaningful portion of Valeant's product portfolio. This led to a significant earnings revision, which given Valeant's debt load and the overall uncertainty with the situation, led to another round of panic selling in mid-March. Further, the controversy has led them to restate old financial statements moving $58mm of earnings from one quarter to another and subsequently hold up the filing of their 2015 10-K report causing further uncertainty.

While our overall investment posture is the most defensive it has been since 2008, we nonetheless cannot escape all volatility. We run a concentrated equity strategy and individual securities are subject to significant, sometimes violent, price movements. Valeant may go down as one of the most extreme examples of that reality in history.

Today, at $36/share, Valeant trades at 3.6x newly revised cash earnings guidance of $10/share for 2016. Cash flow covers interest payments 3.5x. This week Joe Papa, a respected industry veteran with an excellent record of accomplishment as the CEO of Perrigo (PRGO), accepted the CEO position at Valeant. We read this as an endorsement of Valeant's collection of assets, its ability to file required financial statements in a timely manner, and its ability to cover its debt load. Given the current financial dynamics and this endorsement, we are optimistic the worst is behind us.

Conclusion

Valuations across all risk assets are high, global debt levels have exploded, central bank market intervention is at a historically unprecedented level, and market internals signal increased investor risk aversion. *"And that's why we keep the hedges… Because the day we take them off, the game is over."*

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If you know of an investor who cannot afford to sit indefinitely in cash, but recognizes the systemic risk in the current global financial system, please ask him or her to give us a call. We believe our approach has the potential to allow investors to earn reasonable and consistent absolute returns while protecting against the time when the “stable disequilibrium” will eventually destabilize.

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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

Valeant was a holding during the last quarter in both Grey Owl Partners (1.4%) and the Opportunity Strategy (0.9%). We did not hold Fairfax Financial Holdings in any accounts 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.