GREY OWL
CAPITAL MANAGEMENT

July 23, 2010

> "Uncertainty is the only certainty there is,
> and knowing how to live with insecurity is the only security."
>
> \- John Allen Paulos

Dear Client,

In 1963, business for American Express was booming: half a billion dollars of traveler's checks were in circulation and over one million people had American Express cards. Then, scandal hit. An Amex warehouse subsidiary had issued receipts to Allied Crude Vegetable Oil Refining for bogus tanks of salad oil. The receipts were used to obtain loans on which Allied subsequently defaulted. When the creditors came to seize their collateral, the bogus tanks were exposed. While perhaps not legally bound, American Express assumed moral responsibility and was on the hook for $150 million – more cash than the company had on hand. Following the incident, American Express stock fell from $60/share to $35.

As Amex's share price fell, a little-known (at the time) investment manager named Warren Buffet purchased approximately 5% of the company. After determining that the scandal had no negative impact on cardholders' propensity to use their Amex charge cards, Buffet concluded that the "salad oil scandal" was a one-time event from which the company could easily recover.[1] His conviction was strong – at one point American Express accounted for more than 40% of his portfolio.[2]

Over the past few months we have acquired just under 5% positions in two companies that are experiencing similar headline-grabbing "scandals": 1) Transocean (RIG), the owner/operator of the Deepwater Horizon drilling rig that was destroyed in the Gulf of Mexico and 2) Apollo Group (APOL), the owner of the for-profit, University of Phoenix currently under fire from the media, regulators, and short-sellers alike for their alleged inferior product. Thus, while we typically use these quarterly letters to discuss the broad market and economic climate, as well as to provide

[1] Lowenstein, Roger. Buffet: The Making of an American Capitalist. New York: Random House, 1995, pages 79-82.

[2] Hagstrom, Robert G. The Warren Buffet Portfolio: Mastering the Power of Focus Investment Strategy. New York: John Wiley & Sons, Inc., 1999, page 12.

general insight into our investment process, we are going to spend the bulk of this particular letter reviewing the investment cases for Transocean and Apollo Group. Given the prominence of these two companies in the current media cycle, we thought it would be instructive to present our rationale for these two investments.

A more detailed discussion of Transocean and Apollo follows, but first a review of our performance compared to investable options for the major market indices:

	Q210	YTD	TTM	Since 10/06
Grey Owl Opportunity Strategy (net fees)[3]	**-5.93%**	**-3.35%**	**9.52%**	**11.72%**
Spider Trust S&P 500 (SPY)	-11.36%	-6.55%	14.41%	-18.91%
iShares MSCI World (ACWI and MXWD)	-12.8%	-10.28%	10.74%	-14.73%

Transocean – Overcoming Tragedy in the Gulf of Mexico

We are not new to the Transocean story. In the middle of the last decade, interested by both the increasing use of energy in the modernizing economies of China and India and the increasing difficulty of oil production, we began to look for investments that would benefit from these trends. After examining the full oil production value-chain, we determined the owner/operators of the deep water drilling rigs presented the most compelling investment opportunity. Focused on discovering and extracting oil from the hardest to reach places, their businesses are highly levered to increasing oil demand and prices. The typical deep-water drilling rig costs in excess of $600mm dollars and takes several years to build. In addition, building and operation is a specialized business. These high barriers to entry allow the deep-water drillers to charge premium prices (“day rates” in the industry vernacular) leading to high operating margins (the historical 3-year average is over 42%). They are also able to lock in long term contracts with the large oil and gas companies that use their services (e.g. British Petroleum) leading to very predictable cash flow.

The investment worked well, but in the spring of 2008 with oil approaching its recent peak of over $120/barrel, we sold our stake in Transocean.[4] While we continued to believe that oil demand would increase and supply would be more and more difficult to provide, $120/barrel seemed too high, particularly in the face of an accelerating credit crisis and global recession.

[3] 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.

[4] Performance of past specific recommendations does not indicate future results. Please refer to the additional performance disclosures at the end of this letter.

In late February of this year, we re-engaged with Transocean, initiating a small position. The stock had sold off after the company issued weaker than expected earnings guidance. We were looking to increase our exposure to inflation hedges, but wanted to do it in a way that could still work out well absent significant inflation. Oil is priced globally in dollars, thus US inflation (more dollars; each dollar less valuable) would cause the price of oil to increase. At the time, we thought Transocean was undervalued even if oil remained at $75/barrel, so we were getting the inflation hedge for free.

Then, at just before 10pm on April 20th, gas escaped a well in the Macondo Prospect in the Gulf of Mexico. The gas forced its way up from the wellhead through over 5000ft of water to the Transocean-owned Deepwater Horizon rig. There the gas ignited causing an explosion. The Deepwater Horizon caught fire and eventually sank. The well began to gush oil.

Our first priority was to determine the impact to our existing Transocean position. We began to research the details of the contract between Transocean and BP, as well as the complex ecosystem of distinct companies involved in the drilling process. What we quickly learned was twofold: 1) as is standard industry practice, BP indemnified Transocean from risks associated with blowouts in their contract with the exception of gross negligence; 2) an emerging fact pattern showed that BP had directed Transocean and other contractors to follow legal but less than "best practice" approaches to numerous drilling activities (e.g. the number of pipes used, the mud-circulation process, and the well cementing process) – gross negligence on Transocean's part seemed unlikely. That being said, we recognize that in large-scale tragedies such as this, politicians and even the public want to find a villain to both blame and punish. British Petroleum continues to take the brunt of this, but Transocean has been included in numerous lawsuits and will likely face some monetary repercussions. We have reviewed historical oil spill examples and the current environmental regulations to draw a box (albeit a very fuzzy one) around the cleanup costs and regulatory fines. We believe Transocean has the financial means to cover their pro-rata share ($1B of which would be covered by additional insurance). Which leads us to Transocean's underlying business.

Transocean has a contracted revenue backlog of almost $30B resulting in a free cash flow backlog estimated to be just under $15B. Insurance covered the vast majority of the value of the Deepwater Horizon. Additionally, the Gulf of Mexico (GOM) drilling moratorium should have only modest impact on their revenues – over 75% of their contracted backlog is non-GOM. Within the GOM, it is likely companies will continue to either honor their leases or pay a breakage fee close to the full value of the contract. Should the moratorium be extended it takes about one month to move a rig to the coast of Brazil and two months to the coast of Africa where there is pent up demand for deep water drilling capability. We believe Transocean's business is very much intact.

After reviewing the situation, we not only felt comfortable with our existing position, we believed this presented an opportunity to buy more at an incredibly cheap price. We made two more purchases – one at the end of April shortly after the incident and then again in early June as the stock continued to sell off. At $50/share, the stock trades at just under 6.5x 2010 consensus earnings per share (EPS) estimates. Its total market capitalization is only slightly more than its free cash flow backlog.

Until the well is capped and the cleanup has shown significant progress, we expect the stock price to remain both undervalued and volatile. However, a year from now we expect the stock market to have returned its focus to Transocean's underlying business fundamentals and away from the Deepwater Horizon tragedy

The University of Phoenix – Regulatory Uncertainty in For-Profit Education

"I feel reborn. I'm like a Phoenix rising from Arizona."

- Frank Costanza (*Seinfeld*)

While also the product of uncertainty, our investment in the University of Phoenix's parent Apollo Group (APOL) is slightly different from Warren Buffet's Amex investment or our own investment in Transocean described above. In the cases of both Amex and Transocean, the company experienced a dramatic one-time negative event that did not seem to impinge on long-run business prospects. Apollo, on the other hand, suffers from regulatory uncertainty that could affect the business long-term.

The overall for-profit education industry has been the subject of significant headline risk. There have been a number of recent stories in Barron's, Bloomberg.com, and the New York Times that (from our perspective) make broad generalizations from anecdotes. These articles tell of situations where graduates were unsatisfied with their career options after receiving a degree, individual enrollment counselors (recruiters) demonstrated bad behavior, and even where whole (albeit small) schools used unsavory recruitment practices. (The New York Times has also written about graduates of prestigious private schools shouldered with large debts and unmarketable liberal arts degrees.)

When it comes to assessing the educational viability of secondary schools (private, public, and for-profit), the most telling metric from our perspective is the cohort default rate (CDR). This tells us how many students from a particular year (cohort) default on their student loans. Broadly speaking, if the education received provided sufficient value it will allow a graduate to get a job earning enough income to pay interest and principal on their student loans (in addition to funding their other living expenses). Reviewing the 2007 cohort, across all secondary education institutions 11.8% of students had defaulted on their student loans after 3 years (i.e. through 2010). As one might expect given the ongoing recession, this number is elevated compared to 2005 where the total default rate after 3 years was 8.4%. For the 2007 cohort, for-profit schools averaged 21.2%, whereas Apollo's University of Phoenix was 15.9%. The public university average was 9.7% and the non-profit, private average was 6.5%. Interestingly, the average for both 2-year public and non-profit, private schools (essentially community colleges) was 16.2%.

Clearly, non-profit private school defaults are better than public schools, which are better than for-profit private schools. If you think about the distinct demographics that each of these education systems serve, this makes perfect sense. For example, a significant number of students attending the University of Phoenix and other for-profit schools are single parents, work full time in addition to attending school, and are the first in their family to attend a secondary school. Their situation is far different from the average 18 year old at Harvard whose parents are paying her tuition, room, and board. What we find particularly interesting is that the University of Phoenix actually has a lower default rate than the average community college. This was the case for 2005 and 2006 cohorts as well. Are the community colleges "churning and burning" students at the students' and the tax payers' expense as many of the news stories suggest of the for-profit schools?

The demographic difference provides an explanation for the differing CDR rates between for-profit, public, and private schools, but does that mean the for-profit rate is ok? We think so for a number of reasons – particularly the University of Phoenix's rate which is quite a bit lower than the for-profit average. First, Phoenix's 2007 rate of 15.9% measures students trying to get jobs during 2008 and 2009 – a significant recession. The rate has been much lower for non-recession cohorts. Second, 84% of students with loans from the University of Phoenix are paying. Third, any college experience at all has a significant benefit from an employment perspective. Just look at the May 2010 Bureau of Labor Statistics Employment Situation report and you will see that the unemployment rate for high school graduates with no college degree is 10%, whereas the unemployment rate is 7.8% for those with some college or an associate's degree. Finally, even given the higher default rates, an argument can be made that for-profit schools are cheaper for the taxpayer given their lack of other public funding and the significant corporate taxes they pay. Private lenders would charge different interest rates to account for the for-profit students' higher average default rate. Absent that, the government should look at the all in cost for education. The for-profit schools appear to have an edge when you include direct government support and taxes paid.

There is no doubt that the entire education spectrum needs to improve. However, the negative focus by regulators, journalists, and prominent investment managers (talking their short book[5]) on the for-profit space in general strikes us as the result of a narrow worldview – many of these

[5] A "short book" is the collection of stocks an investment manager has sold (without owning) with the hopes of buying them back at a cheaper price. "Talking one's book" is when an investment manager makes an investment and then publicly argues for their investment. In the case of APOL, prominent investment manager Steve Eisman has testified before Congress for increased regulation of for-profit education companies. Increased regulation would hurt these businesses, likely driving their stock price down, and making money for Mr. Eisman.

individuals have degrees from elite private colleges and come from privileged backgrounds. Rather than trying to protect the proletariat from the “education predators,” the critics should consider that in a survey of alumni (albeit conducted by the University of Phoenix), on a scale of 1 to 5 with 5 being “strongly agree” graduates responded with a 4.14 average to the statement “UPX education is useful in career.”

The biggest negative overhang for the for-profit space is the anticipation of new regulations designed to limit student debt burdens. Preliminary language from the Department of Education that updates existing regulations called for in the Higher Education Act of 1965 proposes to limit student debt burdens to 8% of the average salary for the typical job that a degree recipient could obtain assuming a 10-year payback period. Here is an example for context: if the typical job in a particular industry pays $60k/year and student loan interest rates are at 5% then the maximum debt a student could take on would be $37k. Interestingly, the Act explicitly exempts degrees designated as “liberal arts.” We are not lawyers, but this seems to violate the 14th Amendments “equal protection clause;” if not technically, at least from a common sense perspective. It is ok to get an anthropology degree from Harvard with federal student loans, but not a nursing degree from the University of Phoenix?

If implemented, this would clearly affect some of the degree programs at most for-profit universities. However, even if implemented as is, we think Apollo trades at right around fair value. Many of their degree programs would survive as is and they could modify others to meet the threshold. More importantly, we do not think the proposed regulations are realistic and are unlikely to be implemented as is. One reason is that it will hurt bachelor degree programs more than associate degree programs – they cost more. In addition, there is no clear method for implementing – what is the average job for a business degree? Finally, based on US Secretary of Education Arne Duncan’s positive recent comments on the for-profit space, we think cooler heads will prevail as the proposal goes through the review process.

As with Transocean, this uncertainty has made Apollo very cheap. APOL trades at a free cash flow yield of 11% and a P/E of 12.5 on trailing twelve-month (TTM) earnings. This is for a business that has 28% operating margins, has grown revenue an average of 17% over the last three years with very little marginal capital required, and has zero debt. In this case, the extreme uncertainty around the regulatory changes has caused the market to over-discount. [6] It appears to us that the stock has priced in a 100% likelihood that the Department of Education implements the proposed “gainful employment” regulations resulting in no revenue growth for the next five years. We think our downside is protected and we like the upside. When the regulation changes are finalized (likely in November), we think there is a good chance that APOL “rises like a Phoenix from Arizona.”

[6] When investors “discount” a particular event, they assign it both a probability and a cost and then reflect this belief in their assessment of the stock’s fair value.

Market Climate

We continue to find both the broad equity and fixed income markets modestly overvalued. In addition, we are concerned that the economic recovery was only a mirage that the slowly dwindling government stimulus will reveal. We remain defensively positioned and are looking for very specific situations like those described above that can work well even in the face of overall valuations contracting and economic stagnation. The majority of our equity portfolio is made up of "high quality" companies – those with consistent earnings growth and low financial leverage. On the fixed income side, we have built portfolios that we believe can survive both Japanese-style deflation and 1970s-style stagflation – both possible given the slow private sector growth, increasing government regulations, growing government debt loads, and expansive monetary policy. As this letter's opening quote implies, investing (like life) is filled with uncertainty. In extreme examples, the market over-discounts possible, but unlikely, scenarios. This creates buying opportunities for opportunistic investors. We think Transocean and Apollo Group are just such opportunities. We also believe the economic uncertainty will lead to further volatility and dislocations that we can exploit to our advantage.

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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