Grey Owl Capital Management

Captain's Log, Stardate: July 17, 2015. Our position. Earth, America. Question. Is it? Day by day, we are more convinced the planet is foreign. Central bankers manipulate the price of interest and distortions grow. The bull market is seven years old; the longest since World War II; investors are sanguine. Superficial analysis shows bonds more overvalued than stocks. Uncertain. I've asked Mr. Spock to dig deeper. Either way, there is a dearth of value. Yet, this tool they call "Priceline" seems to hold promise. Hmm… with a click of the mouse, or a tap on the iPhone… to boldly go where no man has gone before.

Figure 1 - Preparing for the first joint World Bank, BIS, IMF, Federal Reserve, ECB, and BOJ intergalactic meet. Set phasers to stun!

Figure 2 - Finding value in a world with little.

"Now Mr. Spock, there's really something about all this that I don't understand, so maybe you could explain it to me, logically of course... Now, when you jettisoned the fuel, and ignited it, you knew that there was virtually no chance of it being seen and yet you did it anyway. Now that seems to me like an act of desperation." -- Kirk

"Quite correct, Captain." -- Spock

"Now we all know, and I'm sure the doctor would agree with me, that desperation is a highly emotional state of mind. So how does your well known logic explain that?" -- Kirk

"Quite simply Captain, I examined the problem from all angles, and it was plainly hopeless. Logic informed me that under the circumstances, the only logical action would have to be one of desperation. Logical decision, logically arrived at." -- Spock

Dear Client,

Captain Kirk's explorations continue below. First, here is the performance table for the Grey Owl Opportunity Strategy as of June 30, 2015[1]:

	Q2	YTD	TTM	Cumulative Since 11/06 Inception
Grey Owl Opportunity Strategy (net fees)	**.06%**	**4.00%**	**5.59%**	**72.96%**
Spider Trust S&P 500 (SPY)	.21%	1.11%	7.24%	79.09%
iShares MSCI World (ACWI and MXWD)	.25%	2.85%	.68%	47.30%

Bond Bubble: The Bigger Short?[2]

The already strong consensus continues to grow: bonds are in a bubble and stocks are the only place to preserve capital. Turn on CNBC and you are sure to hear comments to this end. We have written in recent letters of our belief that central bank intervention has elevated all asset prices and that stocks are particularly vulnerable given their place in the capital structure and historical volatility. We maintain that view today.

At first blush, the consensus idea that stocks present more value (or at least, less downside) than bonds seems to have some merit. At 2090, the S&P 500 trades at just under 18.8x trailing twelve-month operating earnings.[3] This is about 13% above the 10-year average operating price-to-earnings (PE) ratio of 16.6x. A tad expensive, but by no-means a bubble when viewed through this prism. On the other hand, the 30-year United States Treasury bond (UST) ended 2014 with a yield of 3.3%, and as of mid-July yields 3.2%. That is meaningfully lower than the average yield on the 30-year UST over the past 10 years: 4.1%.[4] By this measure, bonds look about 22% overvalued. Still not a bubble, but more expensive than stocks.

---

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

[2] In early 2015, Paul Singer of Elliot Capital Management referred to sovereign bonds in general as a "bigger short" than housing was in 2007. While this may be (or have been at the time he wrote it) the case in Europe, we believe it is less so in the United States. In addition to questioning whether US government debt is in a valuation bubble, we wonder what the catalyst is. While debt levels are problematic in an absolute sense, the US looks good relative to Japan and Europe. And, the Federal Reserve can continue to buy USTs. There is certainly a possibility that continued central bank intervention causes currency instability. This seems more possible after another boom/bust cycle or two, but we own gold as a hedge.

[3] S&P 500 traded around 2090 in mid-July. Through Q1 2015, trailing twelve-month operating earnings were $111.

[4] 10-year average is computed from year-end yields obtained at http://www.federalreserve.gov/releases/H15/data.htm. For 2005, we used the ending yield on the 20-year bond because 30-year data was not available.

As one might expect, this simple view is, in fact, too simple. Examined from a different angle, stocks look more dangerous than bonds. Research Affiliates is a highly respected, quantitative asset management firm with $170 billion in assets under management. They publish 10-year asset class forecasts using a methodology that has historically shown very high correlation to future, actual returns over the 10-year period. Research Affiliates projects a nominal 10-year return for US large capitalization equities (i.e. the S&P 500) of 0.8% annualized with 14.7% volatility.[5] Today, an investor can purchase a 10-year US Treasury with a 2.4% yield. There may be volatility over the next 10-years, but it is pretty much guaranteed that the investor will receive a coupon worth 2.4% of principal every year and get their money back in ten years. Because both the equity and bond returns are nominal, inflation will have the same impact on both. From that perspective bonds appear far less risky than stocks.

Let's dig just a bit more below the surface. How else might we think about "fair value" for bonds? There are numerous ways to approach the concept of fair value, multiple investment-specific variables to inform the calculation, and macro-economic and demographic considerations to further confuse the matter. Comparing the current yield to historical averages of varying period lengths is one approach as we did above. We can also look at bonds from the perspective of the economic fundamentals that, over the longer-term, influence bond prices (i.e. a bond's version of the earnings, margins, and return on capital analysis we apply to stocks and equity indices).

Taking the fundamental route, we can use a modified version of Knut Wicksell's "natural rate of interest" to assess fair value of government bonds based on fundamentals. In as-close-as-we-can-get-to layman's terms[6], the natural rate of interest on a government bond[7] should equal the return on all capital in an economy. Flawed as it is, nominal gross domestic product (GDP) growth is the proxy most used for return on the economy's capital. Over the past 10 years, real GDP growth has averaged just 1.6% while consumer price inflation (CPI) has averaged 2.1%. Combining the two, we get a nominal growth rate of 3.7%. If 3.7% is "fair value" for a UST, then bonds are, like stocks, about 13% overvalued. Quite a bit less than the overvaluation based only on historical yield averages.

---

[5] Research Affiliates up-to-date forecasts can be found here: http://www.researchaffiliates.com/assetallocation/Pages/Core-Overview.aspx Their equity forecasting methodology is described here: http://www.researchaffiliates.com/Production%20content%20library/AA-Equity.pdf?print=1.

[6] Note that in converting a somewhat obscure academic concept to "near-layman's" terms, we are surely and posthumously putting a few words in Mr. Wicksell's mouth.

[7] The conventional practice is to compare the rate to that of a "medium-term" bond. So, one can further argue about assigning an additional term premium to longer-dated bonds. We recognize this factor, but to simplify an already complex discussion, we will leave it out. For those who want to do the math at home, over the past 30 years, the 30-year bond had a real yield of 30bps above real GDP.

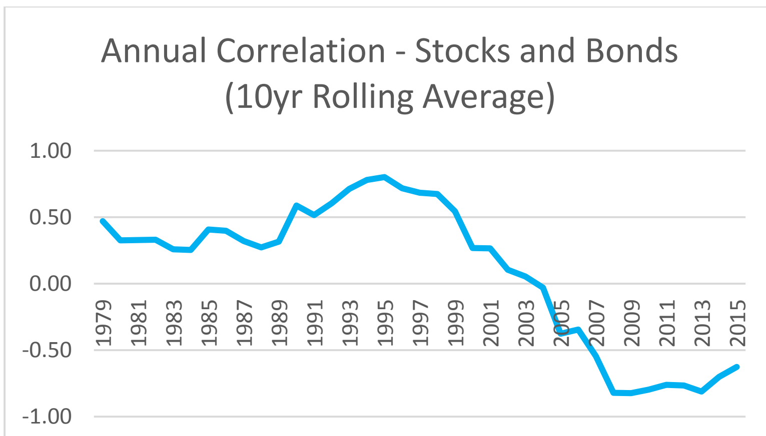
Yes, the Federal Reserve members (and other central banks) have their collective thumbs on the scales of the world's developed economies. However, many investors seem to be missing the fact that developed markets have, at the same time, slowed considerably from their post – World War II average growth rates. AND, the weight of collective societal and government debt levels have (so far) had more of a disinflationary impact despite central banks' extensive efforts to spur inflation. For the fifty years from 1955 through 2004, real GDP in the United States grew at an average rate of 3.4%. As indicated in the above paragraph, the average for the last ten years is 1.6%, less than half the fifty-year number. CPI is a similar story. From 1955 through 2004, CPI averaged 4%. Over the past ten years, it averaged 2.1%. Over the past 5 years, the average is even lower: 1.7%. Last year (2014) CPI was just 0.8%! If we use the 5-year CPI average and the 10-year real GDP average, we get a natural rate of interest of 3.3% - about where the 30-year UST yield is today. The Federal Reserve is meddling for sure, but it is both the tail and the dog.

While a review of bond fundamentals paints a more optimistic view of bond prices and yields, the opposite is true for equities. The price-to-earnings ratio comparison used to value the equity market in the introductory paragraph to this section is significantly influenced by corporate profit margins. During expansions, profit margins increase, and they decrease during contractions. Towards the latter part of expansions (where we find ourselves today), wide profit margins overstate earnings relative to their cycle average and thus understate the price-to-earnings ratio. Stocks appear cheaper than they really are. Comparing price-to-sales ratios is one of several ways to correct for this earnings cyclicality. Price-to-sales ratios only look at top-line sales – profit margins are not a factor. Sales are cyclical, but far less so than earnings. At 2090, the S&P 500 trades at 1.8x price to sales. The 10-year average price to sales ratio is 1.4x. Using this metric, stocks appear 22% overvalued.

The above analysis is not meant as the final argument that bonds are undervalued and stocks are overvalued. To make that assessment, more detailed analysis is required. Rather, the intention is to expose the "bond bubble" and "stocks are fairly valued" arguments based on current yield and PE ratios respectively as cursory. When economic and business fundamentals are examined, the story changes. Frankly, the deeper one digs, the worse it looks for equities. From our perspective, central bank intervention seems to have levitated almost every asset class to levels where little or no "margin of safety" exists. Nevertheless, we do see pockets of opportunity in individual equities (see Priceline below). We also believe the combination of economic trends and portfolio hedging attributes (expecting bonds to do well when stocks do poorly) argue for some exposure to long-term US Treasury bonds.

Government Bonds in a Portfolio Context

Pundits who postulate a bond bubble and suggest shorting USTs also ignore the role of long-term government (i.e. default-free) bonds in a portfolio context. Historically, USTs are far less volatile than stocks. Since, 2000, on an annual basis, the S&P 500's worst drawdown was 37% in 2008. USTs worst drawdown was approximately half that – they fell 15% in 2009. Second, as market volatility has increased since 2000, the correlation between stocks and USTs has become increasingly negative (see chart below). When stocks fall significantly, government bonds have absorbed investor capital's "flight-to-safety" and stabilized a portfolio. For example, in 2008 when stocks were down 37%, long-term USTs rallied 26%. Finally, the primary risk to owning government bonds is a significant pickup in inflation. Historically, a small exposure to gold and commodities has largely mitigated this risk. These relationships guide the "all-weather overlay" we apply to our different investment strategies.



Is there anything to be bullish about? Yes, Priceline.

While we are less than enthusiastic about almost every asset class as a whole, there are certainly pockets of opportunity. Many of these opportunities are, axiomatically, hidden: small capitalization stocks, obscure structures, and low-quality entities trading below liquidation value. In contrast, we believe Priceline (PCLN) is an example hiding in plain sight. It has a $60 billion market capitalization, the group booked 100 million room nights in 2015's first quarter, and the Booking.com[8] app has been downloaded 50-100mm times.[9] More importantly, PCLN is a high-quality company, with an excellent capital allocator at the helm, and significant runway ahead of it (online penetration of the travel market is only 38%).

[8] Booking.com is a Priceline Group subsidiary and the primary driver of PCLN's business.
[9] According to Google Play App Installs as of June 2015.

We wrote about Priceline in our first quarter 2014 letter. Around that time, we initiated a small position in PCLN at approximately $1,280. We added to the position once in May of 2014 around $1,132. In June of 2015, at a price of approximately $1,150, we doubled the position size to 6%. PCLN is now our 5th largest equity holding.

The record shows that we have owned PCLN for over a year and the stock has essentially moved sideways. On the other hand, business fundamentals have steadily improved. Priceline continues to make significant progress despite the overhang of a weak Euro (relative to the US dollar). Adjusted earnings grew 25% in 2014 compared to 2013. When we made our first investment, PCLN had 430k hotel properties on its network. At the end of first quarter 2015, there were 635k hotels and other accommodations – up over 40%. In the same quarter, gross bookings grew 12.2% adjusted for currency, but 26% excluding the foreign exchange impact![10] We think PCLN is at least 20% cheaper today than when we first acquired shares.

With online travel penetration at just 38% and Priceline's share of the online business just 12%, the company has a long runway and continues to invest for future growth. The joint venture with China's CTrip continues to grow, allowing Priceline to participate in the rapidly growing Chinese travel market. PCLN recently increased their equity ownership to over 10%. They are in the process of rolling out the Opentable (restaurant reservation) acquisition across their platform. PCLN also continues to ramp up its ad spending to capture mobile users as mobile takes more and more share of online activity and mobile users prove particularly cost effective (no need to generate traffic via Google ads) and sticky (mobile users typically stick to one or two travel apps).

If Priceline continues to grow its bookings at a mid-teens rate (down from 28% in 2014) for the next ten years it would likely end 2024 with only a high-teens share of the online travel market. In the context of online travel's oligopolistic structure (PCLN and Expedia dwarf all competitors) and PCLN's network and scale advantages, this seems like a modest expectation. Add in a bit of advertising leverage once the mobile market reaches maturation and PCLN is worth between $1800-2000 share today. Unlike broad assets classes, we think PCLN offers a significant margin of safety.

What is holding back the stock today? It could be the exposure to Europe and investors' fears in the wake of Greece's debt issues. It could be the legacy "name your own price" business (that today makes up less than 5% of PCLN's operating income) and the goofy William Shatner commercials. Irrational as it would be, perhaps the $1000+ price tag keeps some investors away. Most likely, the stock price stagnation is due to the overhang of a weak Euro. This will likely continue to be a drag on PCLN's currency-translated metrics for the next quarter or two.

---

[10] Data from Priceline Group's press releases and the Bloomberg.

We are happy to take advantage of the “time arbitrage” opportunity and wait out the cycle.

Conclusion

We continue to position all of our strategies in a balanced and conservative manner. As central banks and governments across the globe behave similarly to Mr. Spock in the dialog that introduced this letter, the distortions increase, as does the potential for volatility down the road. Despite a world awash in debt, central bankers and legislatures continue to see more debt and debt-monetization as the remedy. Like Mr. Spock, they must be thinking: *"Quite simply Captain, I examined the problem from all angles, and it was plainly hopeless. Logic informed me that under the circumstances, the only logical action would have to be one of desperation. Logical decision, logically arrived at."*

Seven years into an equity bull market we are increasingly aware of rising investor risk sentiment, particularly expressed via the increase in credit spreads (see chart below).

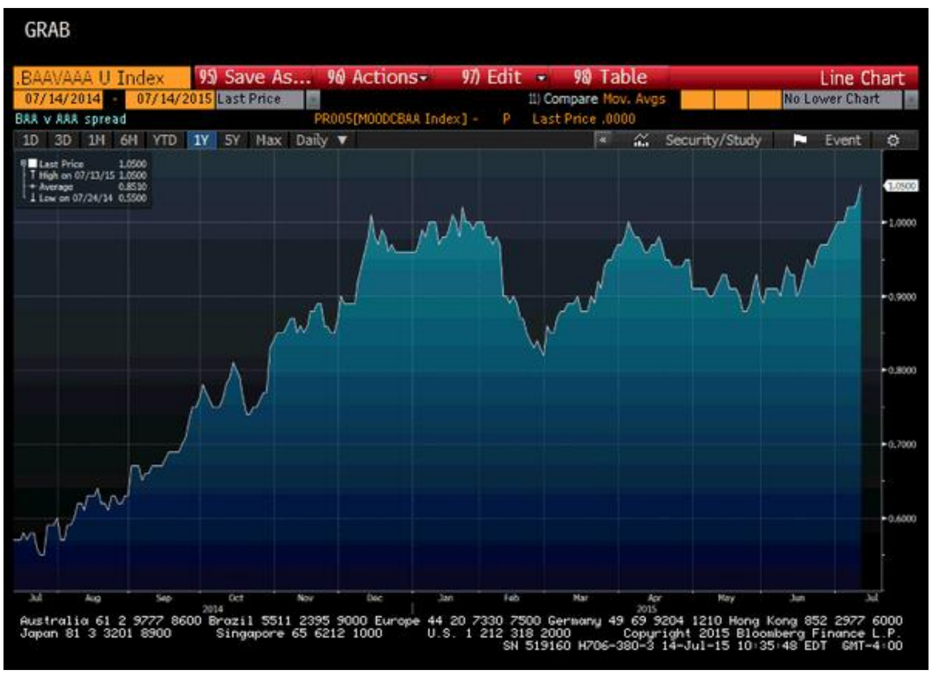


Figure 3 - BAA - AAA Credit Spread - One Year (source: the Bloomberg)

Should this continue we will increasingly (though at a measured pace) move more and more into capital preservation mode. At the same time, we constantly search for investment ideas that offer upside potential with downside protection. Priceline is a terrific example of an investment we believe meets these criteria.

If you know of an investor who cannot afford to sit in cash and 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.

*****

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. 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.

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.

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 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.