November 7, 2014

"Two roads diverged in a wood, and I—
I took the one less traveled by,
And that has made all the difference."

- Robert Frost, "The Road Not Taken"

Dear Client,

The increasing prevalence of indexing, combined with the Federal Reserve's quantitative easing and a general tendency for market symmetry during bull markets has led to tight correlation among most security categories over the past several years. This is changing. Market capitalization, sector, and single stock divergences that became pronounced during the second quarter of 2014 increased further during the third quarter. October was even more dramatic. Historically, expanding deviations among stock categorizations have coincided with the end of a bull market. This is not a forecast, just a statement about the current environment.

In this quarter's letter we emphasize our primary objective to protect and grow investor capital in an absolute sense. We continue to offer index benchmarks for comparison, but emphasize that they do not play an a priori role in how we structure investor portfolios.

Here is the performance table for the Grey Owl Opportunity Strategy as of September 30, 2014[1]:

	Q3	YTD	TTM	Cumulative Since 10/06 Inception
Grey Owl Opportunity Strategy (net fees)	**-2.15%**	**4.89%**	**10.25%**	**60.31%**
Spider Trust S&P 500 (SPY)	1.14%	8.17%	19.55%	68.88%
iShares MSCI World (ACWI and MXWD)	-2.26%	3.65%	11.66%	43.00%

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

Investment Objectives and Benchmarks

Every quarter in this letter, we compare the after-fee performance of the Grey Owl Opportunity Strategy with the S&P 500 Index ETF (SPY) and the MSCI All-Country World Index ETF (ACWI). Over an almost eight-year period beginning in October of 2006, the Grey Owl strategy has bested the MSCI All-Country World Index by a good margin. It lags slightly the S&P 500.

Comparing the raw return numbers of the Grey Owl Opportunity Strategy with these indices certainly has value. An investor who wants equity exposure to the largest U.S. companies could easily buy SPY and be done. Likewise, an investor looking to expand her equity exposure to include the broader universe of equities outside of the U.S. (in addition to U.S. equities) could purchase ACWI.

Yet, tracking these indices, over even multi-year periods, is not our primary objective. **What we aim to provide is an investment approach that protects capital from permanent loss, retains purchasing power, and smoothly grows that capital over time.** With those objectives in mind, total return is but one analysis criteria.

Protect From Permanent Loss

At first blush, protecting against permanent loss seems like a low hurdle. Sure, putting all of one's money in a single security could lead to permanent loss. It even seems possible if one were to put all of his money into a speculative sector using an index – say, biotechnology or cloud computing. But is it really possible with a diversified portfolio in the form of a broad index?

Over a really long time, it is unlikely one would suffer a permanent loss of capital holding an equity index fund. However, from a practical standpoint, it is very possible. First, a "really long time" is a REALLY long time. This is more than withstanding a one or two year drawdown. Second, many investors require withdrawals, so while not "risk" in the purest Warren Buffett-sense[2], volatility and drawdowns do present risks to most investors.

Imagine an investor who retired in August of 2000, right as the stock market peaked. Further imagine that this investor rolled over his corporate pension plan and decided to invest all of it in the S&P 500. He would have shown a negative return for over six years, including dividends, from August 2000 until September 2006. There would have been a short period of time between October 2006 and May of 2008 (less than a two year window) when his return would have been slightly positive – only 2.3% annualized at its peak in October of 2007! Then in May

[2] Warren Buffett frequently makes the point that volatility is not risk. He claims only to consider the risk of a permanent loss of capital due to significantly overpaying for an asset and/or due to a business' fundamentals deteriorating.

of 2008, the full period return went negative again until October 2011. If that hypothetical investor had almost any withdrawal requirement whatsoever, he would have suffered a permanent loss of capital. Even without a withdrawal requirement, that investor is only up 3.9% annualized today… after 14 years.[3]

Despite this fourteen year track record, many investors still decide they want equity exposure assuming they will receive higher returns compared to fixed income. After all, they should be compensated for the fact that they have last claim in bankruptcy, as well as much higher historical volatility compared to debt. Unfortunately, this has not been the case since the beginning of 2000. In a section of our fourth quarter 2013 letter titled – "The S&P 500 – Equity-like Volatility with Fixed Income Returns," we pointed out that the Barclays Aggregated U.S. Bond index had provided better annual returns than the S&P 500 over the previous fourteen years. And, during that time, equity investors had to suffer through two drawdowns greater than 50% in order to achieve those weaker returns. To avoid a permanent loss they had to refrain from withdrawals and they needed to hold fast at the bottom. After another three quarters, the fact still stands. From the beginning of 2000 through September 30, 2014, the Barclay's Aggregate U.S. Bond Index has provided an annual return of 5.7%, while the S&P 500's annual return is only 3.9%.

The first step in protecting against a permanent loss of capital is sensitivity to valuation – what Warren Buffett calls a "margin of safety." Even after fourteen years, we believe the broad equity market (and the S&P 500 specifically) is still in a *secular* bear market and it likely will be until valuations bottom below their historical averages. Today, we are five years into a cyclical *bull* market. Price to sales and price to book metrics are near historical highs. Price to earnings looks expensive too if one adjusts for historically wide profit margins. We have structured the Grey Owl Opportunity Strategy to not look like the S&P 500 because if it did, we believe it would be overvalued and exposed to a significant, valuation-driven drawdown.[4]

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[3] These returns were calculated by GOCM using data from Bloomberg.
[4] This does not mean that the Grey Owl Opportunity Strategy is immune from a significant drawdown. It only indicates our belief that the S&P 500 is exposed to the risk of a drawdown due to elevated valuations and we believe we are avoiding that specific risk by constructing a portfolio with distinct constituents compared to the S&P 500. We also recognize that valuation is not a predictor of short-term market behavior and exerts an influence over multi-year periods (often 5-10 years), so this should not be construed as a call for an impending market correction.

Retain Purchasing Power

Purchasing power is a fancy way to describe the inflation-adjusted value of a currency between time periods.[5] Even if your investment shows a positive return in nominal[6] dollars, you can lose money if inflation destroys the value of those dollars at a faster rate.

There are numerous ways to measure inflation. The critics of the current government formula (altered many times over the years, each time resulting in lower measured inflation) for consumer price inflation (CPI) make reasonable points regarding its deficiencies. We share many of those sentiments. Yet, it is the most common metric, so in the interest of brevity, we will reference it here.

From October 2006 through September 2014, CPI has compounded at 1.99%. As the table at the beginning of this letter indicates, the Grey Owl Opportunity Strategy has easily beat this benchmark. The annualized figure for Grey Owl's total return is 6.28%.

Smoothly Grow Capital – Some Additional Performance Metrics

So far, we examined the risk inherent in blindly purchasing an index fund and the threat of permanent capital loss possible from such a conventional and diversified strategy. We also briefly discussed the need to protect capital from purchasing power loss (inflation, currency debasement, etc.). We also know that the Grey Owl Opportunity Strategy has provided a solid absolute return since inception and a decent relative return compared to the S&P 500 and the MSCI All-Country World Index. Now, we will introduce a few new portfolio statistics that highlight the risk-sensitive nature of the Grey Owl Opportunity Strategy and the "smoothness" of historical returns.[7]

	GO Opportunity Strategy	**S&P 500**
Largest Month Gain	7.6%	10.9%
Largest Month Loss	(8.1%)	(16.8%)
Largest Drawdown[8]	(17.7%)	(46.4%)
Beta	0.5	1.0
Sharpe Ratio	0.52	0.42

[5] It is also a framework for comparing two currencies values at a given point in time (e.g. the U.S. Dollar and the Japanese Yen).
[6] From Webster: existing or being something in name or form only. In the case of currency, nominal is distinct from "real" which is inflation adjusted.
[7] All statistics are calculated based on the same representative account(s) used to calculate performance. They are calculated by GOCM using standard formulas. The period is from inception at the end of October 2006 through the end of September 2014.
[8] On a monthly basis.

The first two statistics are largely self-explanatory. What they indicate is that we cede some upside for significantly better downside protection. The third statistic expands on this point, but warrants emphasis. The 46.4% drawdown the S&P 500 experienced required an 86.6% return to get back to even. Whereas, the 17.7% drawdown the Grey Owl Opportunity Strategy experienced required a much less onerous 21.5% return to fully recover. Yes, some investors can ignore the extreme volatility, stick with their strategy, and come out whole on the other end of a significant drawdown. Unfortunately, many investors require monthly or quarterly withdrawals to fund lifestyle needs. As such, principal removed at the market bottom significantly increases the return required to break-even. Additionally, investor psychology is such that many investors succumb to the pain and alter their strategy at the exact wrong moment.

The final statistics emphasize shorter-term portfolio volatility. Our beta of 0.5 indicates that the Grey Owl Opportunity Strategy is about half as volatile as the S&P 500. Perhaps most importantly, the Sharpe Ratio comparison indicates that for each unit of volatility we experienced, we earned a higher return than the S&P 500.

Tracking Error

At this point, we can see that over an eight year period the Grey Owl Opportunity Strategy has accomplished what we set out to do. We have protected against permanent loss during significant drawdowns and more than offset the cost of inflation while smoothly growing investor capital. Throughout this entire period, what we have *not* done is look like the S&P 500 (or any other index for that matter) or perform like the S&P 500 over short periods of time. Institutional investors and their consultants give low scores to portfolio managers with high "tracking error" – i.e. when the portfolio diverges from the indices used to benchmark performance. Contrarian to the end, "tracking error" is not a factor in our thinking.

Portfolio Composition

The Grey Owl Opportunity Strategy currently holds twenty equity securities. In addition, the portfolio has a small gold position (via an exchange traded fund – ETF) and cash of approximately 25% of the portfolio. Only eleven of the twenty equity securities are in the S&P 500. After accounting for weights there is only a 5.25% overlap with the S&P 500 index, yet these eleven securities make up 43% of our portfolio. Of the eleven securities held in both the Grey Owl Opportunity Strategy and the S&P 500 the weight of ten is significantly higher in the Grey Owl portfolio. Both the Grey Owl portfolio and the S&P 500 index hold Apple. It is the largest holding in the S&P 500 with a weight of approximately 3.6%. The Grey Owl strategy is underweight Apple. There are 489 securities in the index that we do NOT own. In other words, the Grey Owl Opportunity Strategy looks *nothing* like the S&P 500.

The Grey Owl Opportunity Strategy looks dramatically different than the S&P 500 by design. Many institutional equity portfolios are constructed with the S&P 500 as a starting point and thus look only slightly different after incorporating decisions to emphasize (or de-emphasize) a particular sector or security. Performance relative to the S&P 500 is a function of the portfolio manager's ability to properly tune these modest deviations in anticipation of economic developments or shifts in investor sentiment. The overall valuation level of the index is never considered and therefore significant drawdowns are only slightly mitigated, if at all.

In contrast, every single holding in the Grey Owl Opportunity Strategy is selected on a stand-alone basis with no regard to index inclusion. We believe there is a strong likelihood of absolute returns over a 1-3 year period. Today, we believe there is a strong likelihood the S&P 500 provides very low single digit to negative returns over a 5-10 year period. (Though this may not play out for several more years.) We have commented many times before that the S&P 500 only looks inexpensive when discounting earnings assuming a permanently low Treasury rate and permanently high corporate profit margins. Normalize either of these variables, or both, and the S&P 500 looks expensive.

Short-term Performance

As we pointed out in our last quarterly letter, divergences between individual securities, sectors, and market capitalizations have become more extreme this year. This has typically been a sign that a bull market run is nearing its conclusion. In addition, it means that short-term divergence between a specific portfolio and a broad market index, such as the S&P 500, will increase.

The following table highlights the significant divergence between different indices and market sectors.

Index or Portfolio	**Q3 2014 Return**
S&P 500	1.14
Grey Owl Opportunity Strategy	(2.2)
Wilshire 5000 (total market index)	(0.5)
S&P MidCap 400 (mid cap index)	(4.1)
Russell 2000 (small cap index)	(7.4)
Energy ETF (S&P 500 energy sector)	(9.0)
Emerging Markets (EM index)	(2.3)

In addition to restating the quarter's performance for the S&P 500 and the Grey Owl Opportunity Strategy, the above table highlights the distinct performance of stocks based on market capitalization. While many consider the S&P 500 to represent "the stock market," it is actually a large and mega cap index. (See the appendix for a more detailed description of the S&P 500 and its use as the primary benchmark for equity investors.) While the Grey Owl Opportunity Strategy underperformed the S&P 500 and Wilshire 5000 for the quarter, it outperformed the many other market segments, including mid and small cap companies. The table also highlights the energy sector which was the worst performing sector during the quarter and emerging markets which lost ground to the broad U.S. equity market.

Conclusion

We continue to structure the Grey Owl Opportunity Strategy, as well as our tactical fixed income portfolios and Grey Owl Partners, LP in a balanced manner.[9] We are cautious about the world and U.S. economy. Despite being the cleanest dirty shirt, the U.S. remains in the weakest economic recovery in the history of the country. The unemployment rate has improved, but the actual number of employed people is still lower today than it was in 2007 before the recession. The U.S. stock market is equally problematic. For example, corporate profit margins remain near record levels. Even so, EBITDA[10] per S&P 500 share is lower today than in 2007. We have yet to experience the conclusion of the unprecedented Federal Reserve (and the Japanese and European central banks) monetary policy experiments.

Our approach diverges from the conventional. Over the past eight years it has behaved generally as designed. Taking the less traveled path does make all the difference.

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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

[9] Our typical client has a mix of these different strategies offering a balanced portfolio tailored to their individual needs and preferences.

[10] EBITDA is earnings before interest, taxes, depreciation, and amortization.

Appendix – Comparing the S&P 500 and the MSCI All-Country World Index to the Grey Owl Opportunity Strategy

The S&P 500 is a typical benchmark for equity portfolios. When U.S. investors, business people, or media ask "how is the market doing?" the answer usually involves a reference to the S&P 500. Rightly so. After all, the index includes "500 of the top companies in leading industries of the U.S. economy. Focusing on the large-cap segment of the market, the S&P 500 covers approximately 80% of the available U.S. market cap."[11] So, for a predominantly equity-oriented strategy (such as the Grey Owl Opportunity Strategy), it makes some sense to offer a comparison to the S&P 500.

While the S&P 500 does provide a reasonable proxy for the overall U.S. equity market, as the description points out, it has a significant large-cap bias. Like most modern indices, it is market cap weighted. The top ten holdings account for 18% of the index (despite being only 2% of the securities.) The weighted average market cap is $131 billion.[12] (For comparison, the weighted average market cap of the Grey Owl Opportunity Strategy is $48 billion.) In addition, the S&P 500 leaves out 3,198 publicly-traded U.S. operating companies, not to mention non-U.S. companies.[13] For an opportunistic strategy (such as the Grey Owl Opportunity Strategy) that is not limited to U.S. large cap equities, it omits a significant portion of the investable equity universe. It also excludes the much larger universe of publicly traded debt.

As a complement to the S&P 500, some investors like to use a global benchmark. In an age of frequent international travel, integrated world economies, and electronic trading, investors might prefer a broader picture. Thus, the MSCI All-Country World index (ACWI) makes sense as a benchmark. The ACWI "captures large and mid cap representation across 23 Developed Markets (DM) and 23 Emerging Markets (EM) countries. With 2,449 constituents, the index covers approximately 85% of the global investable equity opportunity set."[14] Yet, like the S&P 500, the ACWI excludes small cap companies and leaves out a significant number of publicly traded operating companies. It offers a broader picture, but is still far from complete.

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[11] SPDR S&P 500 ETF Fund Overview. As of 0/28/2014. https://www.spdrs.com/product/fund.seam?ticker=SPY
[12] S&P Dow Jones Indices S&P 500 fact sheet. http://us.spindices.com/idsenhancedfactsheet/file.pdf?indexId=340
[13] Wikipedia's Wilshire 5000 entry indicates that as of September 30, 2014 the index contained only 3,698 components. http://en.wikipedia.org/wiki/Wilshire_5000
[14] MSCI ACWI fact sheet. http://www.msci.com/resources/factsheets/index_fact_sheet/msci-acwi.pdf

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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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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.