November 2, 2015

“It seems to be a law of nature, inflexible and inexorable, that those who will not risk cannot win.”

- John Paul Jones

“Wise men say, and not without reason, that whoever wished to foresee the future might consult the past.”

- Machiavelli

“You’ve got to know when to hold ‘em…”

- Kenny Rogers

“Never tell me the odds.”

- Han Solo

Dear Client,

The Grey Owl investment process starts and ends with robust risk management. Our goal with the Grey Owl Opportunity Strategy is to provide equity-like returns, but with lower drawdowns and volatility than the major equity indices. As such, we worry about the downside first. We do not want clients to fear opening their monthly statements, and we certainly do not want to put regular withdrawals at risk, regardless of what the indices are doing. Over the almost nine years we have run the Grey Owl Opportunity Strategy, we have achieved our goals as the table below illustrates.

	GO Opportunity	**S&P 500 (SPY)**	**MSCI All World (ACWI/MXWD)**
Annualized Return	5.65%	5.97%	3.31%
Largest Monthly Loss	-8.10%	-16.52%	-18.41%
Largest Drawdown[1]	-25.78%	-50.78%	-54.93%
Beta[2]	0.52	1.00	1.12
Sharpe Ratio	0.49	0.38	0.21

Table 1 – Grey Owl Opportunity Strategy Risk Statistics (Nov 1, 2006 – Sep 30, 2015)[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.

In 2008, most investors were driving a fast car down a country road at night with no headlights. They ignored widening credit spreads and kept their allocation to risk assets too high. Value investors bought financial securities because they seemed cheap relative to book value, and neglected to size the position with any consideration to the idea that these entities had so much financial leverage, a bad quarter could entirely wipe out equity value. When cracks in housing finance became obvious, most investors neglected to do robust scenario analysis to determine their true exposure to the situation.

Our approach is different. We think about risk-management at the asset allocation level. Do we want to have more or less exposure to risky assets? When we size individual positions, upside potential matters, but risk factors like business variability and financial leverage have a larger impact. When a portfolio holding experiences a business shock or controversy, we use scenario analysis to assess and size the spectrum of possible outcomes. How much risk does the event really introduce? The current environment presents the opportunity to discuss all of these components of risk management in the following letter. First, here is the performance table for the Grey Owl Opportunity Strategy as of September 30, 2015[4]:

	Q3	YTD	TTM	Cumulative Since 11/06 Inception
Grey Owl Opportunity Strategy (net fees)	**-5.65%**	**-1.87%**	**1.80%**	**63.18%**
Spider Trust S&P 500 (SPY)	-6.42%	-5.40%	-0.77%	67.64%
iShares MSCI World (ACWI and MXWD)	-9.27%	-6.71%	-6.56%	33.65%

Market Environment – Risk Management via Asset Allocation

Widening credit spreads are one of the strongest signals that investors are becoming increasingly risk averse. From September 30, 2014 through September 30, 2015 credit spreads (BAA – AAA yields) widened 59bps from 76bps to 135bps. Market internals, as articulated by Lowry's and other data sources, corroborate the credit spread outlook.

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

Figure 1 - BAA - AAA Credit Spread - One Year (source: the Bloomberg)

During periods of rising investor risk aversion, risky assets like US equities perform poorly. Haven assets like US Treasury bonds and gold perform well. HCWE, an economic consulting firm, recently published a table of US equity returns since 1975. The table is sorted into three categories: widening credit spreads, stable credit spreads, and narrowing credit spreads. In periods where credit spreads were widening as they are today, equities returned only 10% over two years on average.

Year-to-year change in BAA-AAA spread	**Cumulative two-year US equity performance**
Widened by more than 25bps	10%
Changed less than 25bps	24%
Narrowed by more than 25bps	42%

Table 2 – Credit Spreads and Equity Performance

Periods of widening credit spreads are also ripe for significant drawdowns. For these reasons, we now hold approximately 30% cash in our separate account strategy. This backdrop is also why we added to Annaly Capital Management (NLY) during the quarter. NLY owns governmentbacked mortgage debt and has performed well historically in weak market environments. Part of the appeal today is its 12% yield. In addition, we have lowered our net equity exposure in Grey Owl Partners. Depending on week-to-week movement in our market hedges, our equity exposure varies between market neutral and mid-teens net long exposure. We also increased our exposure to long-dated US Treasury bonds in Grey Owl Partners. In our fixed income accounts, we have lowered our exposure to credit risk, both domestic and foreign, and increased our US Treasury exposure. Across all of our strategies, we are moving toward a capital preservation mode.

The October Rally

The S&P 500 rallied 8.4% in October. Despite this move, credit spreads remained elevated – moving from 135bps on September 30, 2015 to 137bps on October 30, 2015. In addition, the move was concentrated in mega-capitalization securities. A significant portion of the overall US equity market remains in the early stages of bear market territory. This signals a poor outlook for large capitalization indices (such as the S&P 500) as well.

In their October 30, 2015 weekly report, Lowry's described the overall market situation at the new recovery high on October 28th: 55% of small-cap, 28% of mid-cap, and 20% of large-cap stocks in the Lowry's "operating company only" universe were still down 20% or more from their bull market highs. In other words, investors are still showing signs of risk aversion. Until that changes, we will continue to shift our portfolios away from risky assets and toward haven assets.

Valeant (VRX) – Past, Present, and Future

The Past – Managing Risk through Prudent Position Sizing

If you are not familiar with the Valeant story, you have not been reading the business news over the past month. For background on our Valeant Pharmaceuticals investment thesis, see our third quarter letter from 2013. Despite recently losing over half of its market value from late August through late October, we still show an almost 100% gain over the lifetime of our investment in VRX.

From the beginning, we recognized that Valeant is employing a unique and aggressive business model – from an operational standpoint, as well as through the use of significant financial leverage to finance acquisitions. Given the higher risk profile, we twice trimmed the position so that it did not grow to be too large a percentage of our overall portfolio. This is despite the fact that the stock never exceeded our fair value target by much and continued to perform incredibly well from an operational standpoint. The history of our buys and sells illustrates this point.

We first purchased shares in Valeant Pharmaceuticals (VRX) in January 2013 at an average price of $64. We added to the position in June 2013 at an average price of $84. We sold approximately half of our shares in January 2014 at $138. More recently, we sold approximately one-third of our remaining position in August 2015 at $231. After the recent sell-off, we added fifty percent more to our position on October 26, 2015 at an average price of $110. <u>At $110 per share, our total return on VRX has been 97%. More importantly, if our current position (including the shares we just bought) went to zero, we would still show a modest positive return on our entire VRX investment of 16%.</u>

The Present – Are we crazy to be buying VRX again?
(Or, risk management via scenario analysis.)

On September 21, 2015, a story broke that a small, private pharmaceutical company, Turing Pharmaceuticals AG, acquired and then subsequently raised the price of a toxoplasmosis drug 5000%. VRX closed at $229 on that same day. Then, news articles began accumulating about drug price increases across the pharmaceutical industry in general. Politicians began to talk about capping drug prices. Critics cited Valeant as one of the more aggressive price raisers. VRX's share price dropped precipitously. After a few days, it settled in a range between $160-180.

With uncertainty and pressure already surrounding the company, several short sellers published innuendo-filled reports regarding Philidor, a specialty pharmacy Valeant used to distribute several of its dermatology products. The reports suggested that Valeant was using Philidor to "stuff the channel" with inventory and record sales that never really existed in an effort to inflate Valeant's financial performance. On this news, VRX shares dropped below $100 and have now settled into a range between $95-120. While the "channel stuffing" allegations were quickly rebuked, Valeant cut ties with Philidor on October 30, 2015. It became clear that Philidor had used aggressive (potentially illegal) actions to collect from insurance companies and Express Scripts and Caremark took Philidor off their platforms.

From a risk-management standpoint, we re-examined Valeant's business in an attempt to determine the potential extent of damage these issues could do to Valeant's business (aside from short-term movements in stock price). First, we identified the segments of the business exposed to these two issues: significant price increases and aggressive practices at specialty pharmacy distribution channels. Then, we attempted to estimate the magnitude of the issues within these segments.

- Price increases. The majority of the significant price increases were within Valeant's neurology segment. This segment makes up a modest 10% of their overall sales and 15% of earnings. Moreover, Valeant's recent financial performance demonstrates that the overall business does not rely on significant price increases. The company grew organic same store sales 16% year over year during the first three quarters of 2015. Half of this was via price and half via volume. Current business growth is not reliant on significant price increases.

- Philidor; specialty pharmacies; "channel stuffing." Just 7% of both sales and earnings come from the specialty pharmacy channel. More importantly, the insinuations of "channel stuffing" and accounting fraud appear baseless – to the point that the shorts have altered their narrative regarding Philidor to accusations of aggressive insurance collection. The later allegations appear to hold merit as Express Scripts and Caremark cut relationships with Philidor, forcing Valeant to do the same.

At $110 and 6.9x 2016 consensus earnings, VRX is undervalued even if we haircut earnings for the 22% that make up the product segment and distribution channel that have come under scrutiny. Further, a brief examination of health care legal settlement history provided by Pershing Square (the second largest holder of VRX stock) on their October 30, 2015 call with investors helped to baseline the potential legal risk to Valeant:

- There were 303 health care industry settlements with the government from 1991 through July 2012 for a total settlement value of $29.35 billion. The average settlement was $96 million. The largest settlement was $3 billion. GlaxoSmithKline, Pfizer, Johnson & Johnson, Merck, and Abbott were responsible for a combined $16.53 billion or 56% of the total settlement amount. Violations included: unlawful promotion, kickbacks, concealing study findings, overcharging government health programs, poor manufacturing processes, and monopoly practices.

- On October 27, 2015 Novartis reached a settlement in principle with the Department of Justice for alleged bribery of pharmacists (at specialty pharmacies similar to Philidor) for converting patients to Novartis drugs. The settlement in principle is for $390 million. Per Pershing Square, "at least one of the products in question was alleged to cause 'serious, potentially life-threatening' side-effects and has a 'black-box' warning." <u>There is no indication that any of Valeant's patients were at risk because of Philidor's behavior.</u>

From our perspective, the legal risk to Valeant is minimized, as Philidor was a separate legal entity not owned by Valeant (though Valeant does have an option to buy Philidor). In addition, should Valeant be legally implicated in any Philidor improprieties, the historical record would indicate total exposure is likely in the several hundred million dollar range and very unlikely to exceed a few billion. From its August peak near $260 to approximately $100 today, VRX lost $55 billion in market capitalization.

The Future – Uncertain for Sure
(But, the risk has been quantified.)

No one knows exactly what the future holds for Valeant. Yet, analyzing the accusations against the company and the potential impact on the business, we believe the risk of permanent capital loss to the current share price is modest. At 7x earnings, the upside far outweighs the risk. Even in an overall environment where risk aversion is increasing, there are opportunities to prudently take risk.

eBay (EBAY)

We purchased shares in eBay (EBAY) during December 2011 and January 2012 at an average price of $30. At the time, eBay traded at 18x 2011 earnings per share (EPS) and 12x 2012's prospective earnings. When we made the eBay investment, most investors considered eBay a second rate player to Amazon (AMZN). The PayPal digital payments business (then contained within eBay) was equally ignored. Yet both had active user bases over 100mm growing at a rapid pace. Given the price we paid, if eBay's businesses continued along their established path – and the network-effect-based business moats of both eBay and PayPal were a sign they should – we were set up to do well with the investment.

Contrast eBay to Amazon. On December 30, 2011, AMZN closed at $173 or 127x 2011 EPS. While we believed (and still believe) in the continuing secular shift from brick-and-mortar to online retail and found Jeff Bezos a visionary and Amazon a compelling business (particularly from the consumer standpoint), we felt the premium price left little room for error. Amazon would need to continue to grow at a double digit pace for a long time and they would eventually need to improve their margins (i.e. actually make money).

On July 20, 2015, EBAY spun off PayPal (PYPL) as a separate company. Shortly after that, on August 17, 2015, we sold our entire position in the eBay stub for $28. At $28 eBay traded at approximately 15x 2016 EPS estimates - a fair price for the slower growth marketplace business. We continue to hold the PYPL spinoff shares.

On July 20, 2015, the date eBay spun-off PayPal (PYPL), our EBAY investment had returned 141% or 28% annualized. This compares to an 18% annual return for the S&P 500 and 8% for the traditional retail behemoth Wal-Mart over the same period. As it turns out, despite the greater valuation risk, AMZN had better performance over that period. It provided an annualized return of 34%. While AMZN did manage to maintain its torrid growth through those years, it has not managed to improve margins. For the three years 2012-14 combined, AMZN actually lost $0.02 in adjusted earnings. At $488 (the price on 7/20/15), AMZN traded at 265x analysts' average estimate for 2015 earnings and 96x 2016. Despite the modestly better performance of AMZN, we believe the EBAY results were achieved with lower risk. Moreover, we continue to hold the PYPL position, so the jury is still out.

Other Transactions during the Quarter

In August, we trimmed our Express Scripts (ESRX) exposure. The position had grown to 9.5% of our portfolio and closer to fair value. It remains our third largest position. We sold the remainder of our Apple position at $115, booking a nice gain. Apple's business remains strong and it is not particularly expensive. However, it is currently in the midst of a weak product upgrade cycle. In addition, the key risk to Apple remains – it is a one-product <u>hardware</u> and software company, with software margins. Our final sale was National Oilwell Varco. We think the risk of a prolonged low oil price is real given the slowdown in China and the continued technological advances in fracking.

It was not all sales during the quarter. As mentioned above, we added to NLY. We also increased our position in Priceline.[5] Finally, we initiated a position in Elekta, a Swedish-based and Stockholm-traded health care firm that manufactures radiotherapy machines, software, and services for cancer treatment.

Conclusion

Risk management is not simply a step in the investment process. It is an all-encompassing, ongoing activity, and a frame of mind. Every action we take when structuring our portfolios starts with the questions: "How can this go wrong? What is the downside? What don't we know that could hurt us?" John Paul Jones was correct – risk is a necessary component of progress, but we can use all the tools at our disposal (including history) to quantify it. Unlike Han Solo, we want to assess the odds to the best of our ability. And, after the analysis is done, as with the Valeant situation described above, you gotta know when to hold 'em…

With credit spreads wide and continuing to widen, accompanied by performance dispersion across equity market capitalizations and sectors, investors are expressing increasing risk

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[5] We wrote extensively on Priceline in our last quarterly letter: http://www.greyowlcapital.com/uploads/letters/GOLetterQ22015.pdf

aversion. If these conditions accelerate, our positioning will become more conservative. If they reverse, we will increase our exposure to riskier assets.

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If you know of an investor who cannot afford to sit 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. With credit spreads widening, who wants to drive a fast car down a country road at night with no headlights?

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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

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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.