January 15, 2010

"Anyone who isn't really confused doesn't understand the situation."

- Edward R. Murrow

Dear Client,

Reports concerning unemployment and housing show economic conditions continued to worsen in the fourth quarter. While corporate profits (as measured by the S&P 500) have improved from the significant losses of -$23.25/share reported in the fourth quarter of 2008, they are nowhere near their peak annual rate of $85/share experienced between the third quarter of 2006 and the second quarter of 2007. Importantly, much of this improvement can be attributed to financial firms which, while repaying TARP funds, are at the same time receiving another (lightly-disguised) subsidy as they borrow from the government at a Fed Funds rate under 25bps and lend that money right back to the government at close to 4%. Yet, "the market" (the S&P 500 is at 1140 as we write) is up over 70% from its 666 March low.

The cover of last week's Economist read "Bubble warning" and we could not agree more. By our estimation, the S&P 500 is now 20-30% overvalued. <u>However, with a no-end-in-sight loose monetary policy this rally could continue for quite some time.</u> We will spend the rest of this letter discussing our process for investing in this climate. First, a review of our performance[1] compared to investable options for the major market indices:

	Q409	YTD	Since 10/06
Grey Owl Opportunity Strategy (net fees)	**5.22%**	**20.08%**	**15.60%**
SPDR Trust Series 1 (SPY)	6.11%	26.37%	-13.23%
iShares MSCI World (ACWI)	4.47%	32.35%	-7.00%

[1] 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.

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Our overall investment process is quite simple[2]. We spend most of our time looking at individual investment ideas trying to find five to seven ideas each year that meet very specific criteria. For us to invest your capital (and ours), we need to believe that the idea has a very low probability of losing money and multiple ways (depending on how the uncertain future evolves) of providing a better-than-market return over a several-year time period. Given our generalist approach (we do not focus on a single sector or market cap), we are able to be very meticulous and look at lots and lots of ideas before committing to one. In other words, we can wait for the “fat pitch” Warren Buffet so frequently discusses. We then try to build a portfolio that diversifies factor risks. That is, we try to build a portfolio that diversifies exposure to changes in inflation or consumer behavior or global trade, etc.

In a “normal” environment, our approach works fine. Today, there are two (somewhat related) forces, exogenous to the above process, that create complications. The first concerns the structure of the overall economy. It is unclear how the significant national debt, increased government involvement in the economy, and unorthodox monetary policy will broadly affect corporate profits and real (after subtracting inflation) returns. Second, most valuation approaches conclude that equities are overvalued. Additionally, we have yet to experience a real “revulsion” bottom in the current market cycle - investors have yet to "give up" on equities, a behavior that typically marks market troughs. Therefore, we are concerned that even if we make investments that we believe are undervalued, they may be subject to a broad re-pricing lower along with the rest of the market. While their intrinsic value may remain sound (or even grow), these investments could get cheaper during a broad market correction. Our last two letters addressed point one – the economic issues – in depth. Please refer to these letters for more on that topic[3]. In this letter, we will briefly touch on valuation and then describe a thought exercise that helps us frame the key issue we now face: how much capital do we invest in opportunities we believe are cheap today and how much dry powder do we keep available for potentially cheaper opportunities that the market may afford us in the future?

Current Market Valuation

Valuing a broad market index like the S&P 500 is actually straightforward. One way to approach the process is to work backwards from the return investors expect. The return from

[2] This refers to our process for equity or “risk” investments. Our fixed income process is geared toward choosing what type of fixed income risk to take (e.g. interest rate, reinvestment, credit, currency, etc.) as opposed to individual security analysis and selection.

[3] An archive of our quarterly letters can be found here: http://www.greyowlcapital.com/index.php?page=news-ins

owning equities can only come from three places: 1) earnings growth, 2) dividends, and 3) re-pricing (i.e. a change in the earnings multiple – price-to-earnings or PE ratio)[4].

Since 1900, earnings growth has averaged 6% nominal (i.e. including inflation). If we expect a return greater than 6%, we will need either a dividend yield that makes up the difference or a re-pricing higher. Over this same period from 1900, the forward PE ratio on the S&P 500 has averaged 14. With a 50% dividend payout[5], this has allowed for the close-to-10% average returns most investors equate with equities. The return from 1982 through the end of 2009 was higher than 10% because the market started from a PE ratio of 8[6]. The return since 1999 was well worse than 10% (actually negative) because the market started from a PE ratio of 30.5[6].

As of this writing, Standard & Poor's lists expected "as reported" (i.e. GAAP) earnings for 2010 at $58.71. This equates to a forward PE ratio of 19.4. The dividend yield on the S&P 500 is currently just under 2%. We believe "fair value" is closer to the historic average PE ratio of 14 and a dividend yield closer to 4% as this is the only way a broad market index can provide investors with the return they have consistently required for holding risky equities.

There are only two strong arguments for higher valuations. The first argument is that we are experiencing an economic shift to sustainably higher corporate profit margins and/or profit growth. Profit margins have been mean reverting over long periods. Basic economics provides the rationale. Excessively high profit margins engender competition, which eventually drives profit margins down. The second argument for higher valuations is that investors have permanently changed their expected return for holding risky equities. Like the mean reverting profit margins, the mean reverting earnings multiple over very long periods tells us this is unlikely. Those two arguments notwithstanding, we believe the stock market is 20-30% overvalued.

Three well-regarded investors, who (like us) warned of pending doom well before the recent credit crisis and market correction, agree with us again. John Hussman of the Hussman Funds says the S&P 500 is currently priced to deliver total returns averaging just 6.1% over the coming decade. Jeremy Grantham of GMO believes fair value on the S&P 500 is 860. David Rosenberg of Gluskin Sheff says the market is 25% overvalued. So what is a value investor to do?

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[4] A Barclays Global Investors InvestmentInsights piece from 2002 titled "The Equity Risk Premium" by Richard Grinold and Kenneth Kroner does an excellent job of describing this framework in detail and showing the short-term variations and long-term stability in each component over long periods.

[5] A 50% dividend payout on $1 of earnings would lead to $0.50 dividend. If we paid $14 ($1 x 14 PE) for this stock (or index) we would have a 3.6% yield ($0.50 ÷ $14 = 3.6%). A 3.6% dividend yield plus 6% earnings growth would provide us with a 9.6% total return.

[6] These are actually trailing twelve month PE multiples.

Buy 80-cent dollars or wait for 50-cent dollars?

In investor parlance, we refer to a security that we believe trades at 80% of fair value as an "80-cent dollar." Likewise, an investment that trades at 50% of fair value is a "50-cent dollar." With the market 20-30% overvalued, through our research process we are able to identify a sufficient number of 80-cent dollars but few 50-cent dollars. This leads us to the question: do we buy the 80-cent dollars or wait for 50-cent dollars?

If we assume that an 80-cent dollar will accrete to fair value over a three-year period, we can expect an 80-cent dollar to provide us with a 7.7% annualized return[7]. A 50-cent dollar that accretes to fair value over a three-year period would provide a 26% annualized return. The question then becomes, how long can we wait for the 50-cent dollar so that our average return over a longer period improves from waiting. It turns out that in this simple construct, we can wait six years making no investments, then buy 50-cent dollars that take three years to accrete to fair value and still achieve an annualized return over the full nine-year period of 8%. This modestly beats the alternative, which is three consecutive rounds of buying 80-cent dollars and allowing them to accrete to fair value over three years.

Unfortunately, the real world is more complicated than the above scenario. If we remove the simplifying assumption and include increases in intrinsic value, the 80-cent dollars look a lot better. After all, not only do we have two extra rounds of 80-cent dollars accreting to fair value, we also have six extra years of increases in intrinsic value. Additionally, we have no way to gauge if or when the overall market will correct and present us with 50-cent dollars.

Fortunately, we can again look to history for guidance.

Range-bound Markets

Two hundred years of US stock market history paints a remarkably consistent picture of (approximately) twenty-year bull markets followed by (approximately) twenty-year sideways or "range-bound" markets. We would contend that we are ten years into a sideways market.

Investment manager and author, Viataliy Katsenelson, describes range-bound markets this way, "range-bound markets are the bear markets of price-earnings (P/E) ratios (they decline), whereas bear markets are the bear markets of P/Es *and* earnings (they both decline). Range-bound markets are so-called payback markets – investors are paying back in declining P/Es for

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[7] We would also expect that the investment would grow in intrinsic value during this period so the total return would be higher, but we will ignore that component to keep this thought exercise simple.

the excess returns of the preceding bull market."[8] Importantly for our above analysis, he demonstrates that range-bound markets have shown significant volatility and approximately as much downside volatility as upside volatility.[9]

Thus, if history were any guide, we would expect the next several years to provide sufficient (downside) market volatility, which will allow us to increase our exposure to equities when more 50-cent dollars are available. As these securities recover to fair value, we will again tune our equity exposure based on the overall market's level and the availability of new 50-cent dollars. Ideally, we will repeat this process until PEs decrease to well below their historic average of 14.

There is one caveat to the range-bound market theory. In past letters, we have discussed the potential for inflation (or at least a very unstable monetary unit of account) given the dramatic recent Federal Reserve actions, as well as the significant (and ongoing) increase(s) in the federal debt. We also described the historic correlation between inflation (documented by Crestmont Research) and inflation volatility (documented by William Hester of Hussman Funds) and shrinking earnings multiples (PEs). They show that multiples have expanded during periods of low and stable inflation and multiples have contracted during periods of high and volatile inflation. If inflation and/or inflation volatility is a necessary requirement for multiple contraction, we must consider the possibility that the Federal Reserve will be able to keep the value of the dollar stable, thus managing inflation and allowing the stock market to keep its elevated multiple for another cycle.

Katsenelson's analysis makes a broader argument for multiple contraction based on human psychology: "They [range-bound markets] follow [bull markets] because excess optimism feeds on itself and drives stock market valuation to one extreme, and then unmet expectations turn into disappointment, driving stock valuations to the opposite extreme. Long excesses require lengthy corrections."[10] There just are not enough data points to provide us conviction that Katsenelson's broader explanation is sufficient nor to show that inflation is necessary to create a range-bound market. Both explanations are possible.

Therefore, we choose to make decisions based on a range of outcomes. In other words, in today's market we will buy some 80-cent dollars, but also leave some dry powder for the 50-cent dollars we expect (but are not certain) will appear. This will allow us to protect capital and provide the opportunity for satisfactory gains if we (and history) are wrong. It will also provide the opportunity for substantial gains if we (and history) are right. As the opening quote from

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[8] Katsenelson, Vitaliy N. Active Value Investing: Making Money in Range-Bound Markets. New Jersey: Wiley, 2007. p.6
[9] Ibid. p.31-34
[10] Ibid. p.61

Edward R. Murrow warns, there are no clear paths, only probabilities and ranges of outcomes. We aim to be prepared whatever future unfolds.

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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