October 20, 2009

> "Alice laughed. `There's no use trying,' she said `one *can't* believe impossible things.'
>
> `I daresay you haven't had much practice,' said the Queen. `When I was your age, I always did it for half-an-hour a day. Why, sometimes I've believed as many as six impossible things before breakfast."
>
> - Through the Looking Glass, Lewis Carol

Dear Client,

Try to imagine a few improbable, if not impossible, things now:

1. We are in the midst of a V-shaped economic recovery.

2. A productive base of $14 Trillion can easily sustain $53 Trillion in total national debt (government, corporate, and consumer).

3. The Federal Reserve can double the size of the monetary base with no inflationary consequences.

4. The S&P500 at 1057 (closing price on September 30) is priced to provide investors the 10% nominal annual return they have come to expect.

That about sums up the market sentiment in mid-October 2009. We will dig into the details underpinning these "improbable things" in the remainder of this letter. Given the precarious nature of the economy combined with the over 50% rally in the stock market, we will also discuss the ever more critical need for a "margin of safety" when making investments. Finally, we will examine the countervailing force of "career risk" that should always be understood by investment managers (who assume it) and investors alike (who are exposed to the lower return consequences it engenders).

First, a review of our performance* compared to investable options for the major market indices:

	Q309	YTD	Since 10/06
Grey Owl Opportunity Strategy	7.70%	14.12%	9.86%
iShares S&P 500 (SPY)	15.38%	19.09%	-18.22%
iShares MSCI World (ACWI)	18.15%	26.69%	-17.49%

The Economic Recovery: V-shaped?

One of the arguments for a V-shaped recovery is that the size of the rebound has frequently been correlated with the size of the decline. This does not appear to us to be a typical recession and at this point unproductive government spending is the major factor giving national income the appearance of stability. Broad leading indicators such as hours worked and business starts continue on a negative path and coincident indicators of sales and consumption do not look any better.

While the unemployment rate is typically a lagging indicator (though it may be a leading indicator this cycle), hours worked is a strong leading indicator. It makes logical sense that a business owner will increase hours for existing employees before incurring the expense and taking the risk of adding net new employees. As of the September 2009 Employment Situation Summary from the Bureau of Labor Statistics, the average workweek was 33 hours. This is a cycle low and down from 33.6 hours a year ago and the 33.9 hours it hovered around during 2006 and 2007.

It is not just that businesses are shedding employees and cutting back on hours. Entrepreneurs are not starting new businesses. According to the Small Business Association (SBA), small businesses employ over half of all private sector employees. Firms with fewer than 500 employees accounted for 64 percent of all private sector jobs created between 1993 and 2008. In other words, small business starts are critical to economic growth. SBA's data on new small business starts has a several year lag, but Paychex, which provides payroll processing to mostly small enterprises, offers some insight into the creation of new businesses. For the quarter ended August 2009, Paychex lost 1% more of their clients due to going out of business and

* This is the performance of our "risk" model, not the performance of your individual consolidated accounts which may or may not include a broader mandate.

added 13% fewer new clients from business starts than in the previous year. These figures are better than the previous quarter but still decidedly negative.

Tax receipts, as well as home and restaurant sales, paint a similar picture. No person or business pays estimated taxes unless they have earned money, so tax receipts are an excellent way to gauge the productivity of the private sector. Here again, the "green shoots" look weak: Federal tax receipts for August 2009 were down over 7% from the prior year. To be fair, new home sales are up significantly from the January low of 329k to an annual rate of 429k as of August. This might look like good news until you compare it to August 2009: 444k and 2007: 776k. Importantly, how much of this is due to the $8,000 first-time-homebuyer government incentive? If Wal-Mart is <u>the</u> gauge for consumer staple shopping, Olive Garden provides a similar barometer for the average family's propensity to eat out: even Olive Garden's same store sales were down 2.9% for the quarter ended August 2009. This is particularly troublesome because Olive Garden's same store sales actually grew in the fiscal year from May 2008 through May 2009 – the heart of the financial meltdown.

The only thing that is keeping measured economic activity (i.e. GDP) at its current level is government transfer payments. As with the cost cutting that is enabling corporations to maintain profitability, this cannot go on forever. Someone has to be doing productive work to make the transfers possible. In fact, Hoisington Investment Management's recent Quarterly Review and Outlook reminds us that the government spending multiplier is zero. "This means there is no long term income benefit from stimulus programs." In addition, the tax multiplier is three. That is, the tax increases that are coming will likely decrease GDP by 3% for every 1% rise in tax rates. With few signs of a true, private-sector driven, economic recovery, a new round of adjustable rate mortgage resets beginning, and underwater commercial real estate loans on the verge of revealing themselves, we are hard pressed to see the green shoots so visible to others.

The National Debt

Four times a year, the Federal Reserve publishes a compendium of data tables titled the *Flow of Funds Accounts of the United States*. The release covering data through June 2009 tells us the following: total United States domestic debt outstanding was $53 Trillion. If we assume a 5% interest rate and Gross Domestic Product (GDP) of $14 Trillion per year, just making interest payments will cost domestic debtors (individuals, corporations, and governments) 19% of GDP (think of it as our collective income) to finance the debt. This does not include any principal payment. Unfortunately, the $14 Trillion may prove unsustainable, as additional borrowing is all that is keeping it at this level. With the federal government's deficit projected to be $1.5 Trillion for the next few years, the $53 Trillion number keeps getting bigger. Additionally, the 5% interest rate is just a round number – it is lower now, but it is unclear for how long. This provides a nice segue to a discussion of the Federal Reserve's actions.

The Fed and the Money Supply

Over the past year or so, the Federal Reserve has doubled the size of the monetary base. Some of this has gone to purchase a portion of the government and consumer debt discussed above. Some is just sitting on banks' balance sheets because banks are afraid to lend and consumers afraid to borrow (for now). The key question is this: when the time comes, will the Federal Reserve have the political will to shrink the monetary base back to its previous level in order to avoid a significant decrease in the dollar's value, a significant increase in the price level, or some combination of the two? We are watching this carefully.

The Stock Market

The trailing PE ratio on reported earnings for the S&P500 has a historic average of 15. As we write, the S&P500 is around 1090. This would imply annual earnings of $72.66 (1090 / 15 = 72.66). Analysts' bottom up estimates for third quarter 2009 *operating* earnings are $14.91. Annualized, this is $59.64 or 18% below the $72.66 that would justify 1090 on the S&P500. "As reported" earnings are expected to be $9.83, a much bleaker picture. Either way, the market appears modestly overvalued for even a normal environment. Add in the above-described issues and there does not appear to be a margin of safety for owners of the broad market.

Margin of Safety and Career Risk

When calculating the intrinsic value of a business (or a security that represents a claim on the profits of a business) one must estimate the future cash flows that business will generate. This is by definition an imprecise art even during times of stability. During times of great instability and potential change, it is even more imprecise. Successful investors recognize the imprecision and thus only invest when they have a margin of safety – that is, when they can buy an asset at a price lower than their assessment of the asset's value. This mitigates the risk of the errors they surely made in their valuation. Today, we demand even greater margins of safety than normal when we make an investment because the range of possible outcomes is greater than at any time since at least the early 1980s.

Although demanding a margin of safety is a sure way to mitigate investor risk, it can introduce career risk for the investment manager. This is the risk of being fired for lagging the market and it is particularly the case when the investment manager's stance varies greatly from the collective. While long-term investment risk can be thoughtfully mitigated, career risk is an entirely different beast altogether. The only way to avoid career risk is to not stray too far from the heard. Given our analysis of the economic factors underpinning the recovery and current stock market valuation levels, the only way Grey Owl, as investment manager, can avoid career risk, today, is to lower our margin of safety requirements and increase our equity exposure to match the consensus. We want our clients to understand that our approach is focused on protecting capital and is long-term oriented. We will not chase short-term phenomenon in order to avoid career risk.

Jeremy Grantham, the eponymous founder of GMO who we often cite in these letters, was the subject of an October 2008 piece in *The Economist* on career risk. The article, which we have attached for your review, states, "Mr. Grantham's skepticism cost him plenty of business during the bullish years, as foolish investors preferred to share Gatsby's belief in 'the green light, the orgiastic future'."

It is often easiest to believe convenient, yet likely impossible, things. The problem with impossible things is that the mirage only radiates until it doesn't. We continue to be underweight equities and specifically the riskier levered businesses that have rallied the most in the past six months. Where we do own equities, we are looking for terrific businesses we can buy cheap, businesses particularly tuned to do well in the current environment, or stories with a specific catalyst not tied to the economy. On the fixed income side, we have owned, for some time, exposure to non-dollar bonds and continue to do so as a means to mitigate the negative effects of the Federal Reserve's actions.

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