July 22, 2011

"Mañana is often the busiest day of the week."
- Spanish Proverb

Dear Client,

Our last quarterly letter began with a discussion of the pending end of QEII and its likely impact on Treasury yields. The best-of-the-best fixed income investors disagreed: Bill Gross[1] positioned for rising yields. A large buyer was exiting the market, after all. Jeff Gundlach[2] was ready to prosper as interest rates fell further. QEII was inflationary, of course, and as it subsided so too would the inflation premium. A mere three months later the above-the-fold story still centers on Treasury yields, but this time from an entirely different angle.

We are quite happy to be situated in modest, class-B office space (we're value investors after all) in Northern Virginia far from the siren song of Wall Street. Unfortunately, we're all too close to what has become the loudest noisemaker in the investing world: Washington, DC. America's best and brightest appear at loggerheads in their attempt to raise the debt ceiling and the August 2nd deadline is fast approaching. The headlines read, "Prepare for Default and Chaos!" The headline, "Don't Panic!" doesn't sell papers, but just as with QEII we submit there are two sides to this coin.

Below, we briefly discuss this issue and then delve into four new investments we made in the second quarter. Despite our pessimistic view of the economy and the fiscal and monetary overhang that exists worldwide, we are finding exciting individual company investment ideas with what we believe to be sufficient margin of safety despite all of the "macro" noise. But first, our typical performance table[3] as of June 30, 2011:

	Q2	YTD	TTM	Cumulative Since 10/06
Grey Owl Opportunity Strategy (net fees)	**0.08%**	**3.62%**	**17.02%**	**29.05%**
Spider Trust S&P 500 (SPY)	0.02%	5.92%	30.41%	5.75%
iShares MSCI World (ACWI and MXWD)	0.97%	4.31%	31.12%	9.33%

[1] Bill Gross is the chief investment officer for PIMCO.
[2] Jeff Gundlach is the chief investment officer at DoubleLine Capital and was formerly with Trust Company of the West.
[3] For more information regarding performance, please refer to the performance disclosure at the end of this letter.

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Debt Ceiling Drama

The article was titled "What If the U.S. Treasury Defaults?" but the subtitle summed up the counter argument to the conventional wisdom. It read, "People aren't going to wonder whether 20 years ago we delayed an interest payment for six days. They're going to wonder whether we got our house in order." The subtitle was a quote from Stanley Druckenmiller, the subject of the May 14, 2011 Wall Street Journal "The Weekend Interview." A logical alternative, we think, to the proposition espoused by editors hungry to sell newspapers, Wall Street chieftains levered to a point where any instability could once again render their firms insolvent, and corporate chieftains addicted to the cheap debt the Fed has provided. Failing to raise the debt ceiling will lead to a default, which will lead to a surge in Treasury yields, which will destabilize the global economy, their argument goes. When pressed, everyone seems to know the current situation (25bps Fed Funds rate and $1.5 trillion dollar annual fiscal deficit) is untenable longer-term, but "mañana" they all seem to cry in unison.

While Druckenmiller may not be a household name, he is as good as they get in the investment business: before closing up shop in 2010 near the top of his game, Mr. Druckenmiller managed $12 billion in assets and averaged annual returns of 30% since 1986.[4] In other words, he has put his money where his mouth is and he has been right more often than he has been wrong. He makes several important points: First, the real issue is not whether the government pays a coupon fifteen days late; it is whether we make budget reforms to deal with our structural deficit. Second, it is highly unlikely that a *technical* default will have the multi-decade implications some are claiming. Russia had a *real* default and three years later their interest rates were at all time lows. Third, Treasuries rallied into the 1995 and 1996 government shutdown. As Druckenmiller further points out, "interest rates never went back up again until the Republicans caved and … supposedly the catastrophic problem was solved."

As we wrote last quarter, "We don't spend a lot of time worrying about single events like the end of QEII [today's substitute: resolution of the debt ceiling issue] because our investment process is not based on forecasting and we very rarely make binary bets. Our objective is to build portfolios that can outperform in myriad possible scenarios. We seek out investments where the price embeds a margin of safety." The issue is not the debt ceiling debate or the specific end of one of the Fed's interventions. Rather, the issues are excessive debt in the US and the developed world in general, a US economy artificially propped up by unsustainable fiscal and monetary intervention, and overvalued assets across the board. Capitol Hill is arguing over $1-2 trillion in cuts over 10 years when the Federal government is already $14 trillion dollars in debt, has between $50 and $100 trillion in unfunded liabilities, and is running a current deficit of $1.5 trillion dollars. History shows that no matter the marginal tax rate, the

[4] http://online.wsj.com/article/SB10001424052748703649004575437461858678850.html?mod=WSJ_hps_LEFTWhatsNews

U.S. federal government revenues hover around 20% of GDP, so it is highly unlikely we can tax our way out of this problem. "Public choice" theory says the required spending cuts are equally unlikely. The remaining option is to monetize the debt. When it comes to "macro" issues there are two points worth thinking about regardless of the current headlines. Excessive debt increases volatility and the path of least resistance for the government is to print money.

While we still believe caution is critical given the economic instability that abounds, this outlook is a function of valuations and long-term issues, not the crisis du jour. Thus, despite the headlines, we find ourselves investing in a manufacturer of business printers, an owner of Asian casinos, a real estate development company, and a containership charter company. Our expectations are not that economic growth is set to pick up and with it real estate values and business printing, or that China will avoid a hard landing in its attempt to quell inflation, or even that global trade is immune from a slow down. Rather, in each case we see a business with solid fundamentals and a share-price sufficiently cheap that even should things go wrong in the short-term, we are likely to make money in the long-run. I.e. we have a margin of safety.

21st Century Gutenberg or the Anti-Tablet, Anti-Cloud Investment

With the advent of personal global positioning systems to replace printed directions, "Cloud" applications for sharing photos electronically, and iPads for reading just about anything in your arm chair, consumer printing volume has been in a nose dive. The data is gruesome. According to IDC, page volumes for inkjet printers (a reasonable proxy for the consumer) have decreased from 37 billion pages in 2005 to 10 billion in 2010. That is a 23% decrease per year! So, ever the contrarians, we bought shares in a printer company.

In 2010, Lexmark (LXK) produced $4.2 billion in revenue and $360 million in free cash flow (excluding an acquisition). The company ended the first quarter of 2011 with $1.3 billion in cash and marketable securities and only $650 million in long-term debt for a net cash position of $650 million. At $30/share, the market cap is $2.3 billion or $1.65 billion net of cash. Even if we haircut 2010 free cash flow to $300 million, we get a free cash flow yield of 18%.

We think the market is focused on the deterioration of the consumer printing business and the fact that LXK's top line has been shrinking. What the market seems to be ignoring is the bottom line results LXK has managed through the transition away from consumer printing and the fact that they are six months from being fully transitioned out of that business. Unlike consumer printing, enterprise printing is fairly stable in the US and growing in emerging markets – empirical data shows this was the case during and coming out of the recession. As alarming as the data around consumer page volumes is, the data around enterprise printing is equally reassuring. Page volume for standalone laser printers began to shrink in the low single digits starting in 2008 as the recession took hold. Low single digit shrinkage occurred for multi function inkjet and monochrome laser printers as well. On the other hand, multi function color laser printer page volume has been growing at a robust pace: 37% in 2008, 21% in 2009, and 15% in 2010. Page volume is a critical measure because it not only indicates people and businesses are still buying printers, but more importantly in LXK's case, it measures demand for ink. Their business model is classic razor and blade and 70% of their revenues come from ink. In addition, the move toward color laser has further benefit as these printer cartridges are more expensive and higher margin.

We do not have page volume estimates for emerging markets, but we do know that after growing a modest 2% in 2008 and then shrinking 17% in 2009, laser hardware sales were up 34% in 2010 to a record high 23 million units. To top it off, cash flow is incredibly stable – LXK has generated over $400mm in earnings before interest, taxes, depreciation, and amortization (EBITDA) for each of the last 9 years (including the recession), despite the fact that they have been in a multi-year transition away from the consumer business.

While not likely able to grow at the same rate, from a capital structure standpoint, the company looks a lot like Microsoft (MSFT), only amplified. If we were running the show, we would issue an additional $550 million in debt and buy back $1.2 billion in stock. A stable business like this can easily withstand 3x debt to EBITDA. With a new market capitalization of $1.1 billion, we would put in place a $110 million dividend; around a 35% payout ratio. We suspect the stock would trade to a 4-5% yield or $60/share. Distinct from MSFT, this business is the perfect size for a leveraged buyout. If management will not fix the capital structure, maybe someone else will. "Hello, Carlyle, KKR, and Blackstone. Are you listening?"

Rolling the Dice in the People's Republic

Prior to 1988, a gambler in the United States had two choices if she wanted to play table games or slot machines: Las Vegas or Atlantic City. However, in that year, the Indian Gaming Regulatory Act kicked off a wave of casino expansion throughout the United States. Today, thirty-eight states have some form of casino gaming.[5] Casino-specific gaming revenues increased from $7 billion in 1988 to $35 billion in 2010.[6] For much of this period, the demand for gaming product outstripped the legally controlled supply of gaming options. This supply/demand imbalance allowed just about anyone with a gaming license to generate a nice profit. The best operators were able to do extraordinarily well. A savvy investor was able to take advantage of this growth industry and supply/demand imbalance without needing to learn casino operations or acquire the lobbying expertise necessary to gain state gaming licenses. For

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[5] http://www.americangaming.org/files/aga/uploads/docs/sos/aga-sos-2011.pdf
[6] Vogel, Harold. Entertainment Industry Economics. p. 387.

example, if you had purchased shares in the Penn National Gaming (PENN) IPO on May 26, 1994 you would have compounded your money at a 25% annual rate through December 31, 2010. This is extraordinary and we challenge you to find another single security that was able to provide that level of return over that long a period.

The US market is becoming saturated. Profits, while still quite strong, are not what they used to be. We cannot go back in time, but we can apply Mark Twain's famous aphorism: "history doesn't repeat itself, but it does rhyme." We think it's 1994 for gaming in Asia (and more specifically China). Las Vegas Sands (LVS) is smack-dab in the middle of it.

At $44/share, LVS trades at a free cash flow yield of 5.6% even after we haircut current EBITDA margins to slightly above 2009 trough levels. The back of the envelope math works like this: $8 billion in run-rate revenue and an average EBITDA margin of 34% yields $2.7 billion in EBITDA; subtracting $300 million for interest payments, $215 million for maintenance capital expense, $185 million for taxes leaves $2 billion in free cash flow to equity. Divide by 811 million shares and you get free cash flow per share of $2.47 or a 5.6% yield. This is an impressive yield for a company that has grown revenue at 31% annually for the last five years and is very profitable.

As mentioned above, we think gaming is set to continue its explosion in Asia. The only new supply coming online in Macau over the next few years will come from LVS. A large, 6,000-room project will open in early 2012 on Parcels 5 & 6 of the Cotai Strip. A smaller project on Parcel 3 could open as early as 2013. Just the Parcel 5 & 6 project could easily add another percent or two to LVS' free cash flow yield at $44/share. Equally important, revenue at existing properties is likely to continue to rise given how underserved Asia is. There are plenty of statistics to illustrate this, but one that sticks out is the fact that only 2% of the total population of China and Southeast Asia visit Macau or Singapore in a year whereas 10% of the U.S. population visits Las Vegas. We're ready to roll the dice on LVS; the odds appear in our favor.

The Aviator

Martin Scorsese titled his 2004 biopic of Howard Hughes *The Aviator* after the main character's love of flying machines. *The Real Estate Mogul* would have been more descriptive, though probably would not have sold as many tickets. The Howard Hughes Corporation (HHC) was spun out of General Growth Properties (GGP) on November 9, 2010 as part of the latter company's emergence from bankruptcy. HHC gets its name from the Summerlin property in Las Vegas, Nevada originally acquired by Hughes in the 1950s. Today, HHC is a collection of master planned communities, operating properties, and strategic development opportunities.

Spinouts often present compelling opportunities for value investors. As investors in the parent company receive shares in the spinout, selling is often a rote and indiscriminate exercise. The new holders do not know anything about the new company they own and they did not "buy" it on purpose. Thus, as initial investors sell, spinout shares can offer very favorable valuations. In addition, released from the shackles of the parent company, new management is able to focus 100% on their operations so attempts to unlock value typically increase. We think this is the case with HHC.

At $60/share the company trades at a slight premium to the very marked down book value on the de novo balance sheet. In fact, prior to the spinout, book value was over $30/share higher. Today, we estimate that even a fire-sale liquidation of all properties would be within 10% of current book. However, a rapid liquidation is not why we invested in HHC.

While subject to a far wider range of potential values than our typical investment, we see significant upside in HHC. Equities and fixed income have seen incredible rallies over the past two years. Real estate, on the other hand, even commercial real estate, has not. In HHC, we have a highly experienced and incentivized real estate development team at the helm. CEO David Weinreb has over twenty-five years of real estate development experience along with the prescience to have sold most of his assets prior to the recent downturn. Mr. Weinreb, along with the company's president and chief financial officer has invested over $19 million of their own capital in the enterprise. Their incentives are aligned with ours. In addition, HHC's assets reside in terrific locations including Manhattan, Chicago, Honolulu, the Las Vegas strip, and even Alexandria, VA (right in our back yard) to name several. If we assign valuations based on reasonable development expectations for the strategic development properties and assume modest increases in residential land values and sales dribbled out over many years for the master planned communities, it is easy to come up with values 25% higher than today's share price. There is a lot of room between lip and cup, but we are backing a solid team. To top it off, we have an excellent inflation hedge should the government continue its profligate ways.

No Ship of Fools

We initially began researching Diana Containerships, Inc. (DCIX) subsequent to its January 2011 initial public offering at $15/share. The company is a spinout from the well-run Diana Shipping Inc. (DSX). Shipping is a capital intensive, cyclical business with the typical company employing significant leverage. The business is volatile, as are the stocks. Employing lower leverage, the folks at Diana chart a somewhat smoother course. At $15/share we thought DCIX was close to fair value, so we passed. However, the spinout phenomenon was in effect. The share price proceeded to drop as holders of the much larger DSX began to sell the DCIX shares they had received automatically. In addition, after using a credit line to buy additional ships and given its dislike of debt, DCIX announced a secondary stock offering to pay down the credit line. Short sellers then drove the stock down further in anticipation of covering their shares via the secondary. When the secondary broke its offer price, the stock fell further as anyone who participated for a flip quickly dumped his shares. After the smoke had cleared, DCIX traded around $7/share and presented what we think is a compelling opportunity.

We estimate DCIX's net asset value (NAV) at $9.30 based on recently delivered ship value (in other words the going rate for these ships, not some value based on cost at the peak of the market). In addition, due diligence indicates that market rates are approximately 25% below new build prices or "replacement cost." At $7/share we can in essence buy these ships at 75% of NAV. Further, the current EBITDA yield is just over 20% unlevered. A slowdown in global trade would hurt both the business (if the timing of the slowdown coincided with their charter renewal schedule) and the stock, but the strong balance sheet will allow DCIX to weather such a storm. Over the long run, we believe global trade will only expand. Jefferies' estimates DCIX will be able to pay out a $0.85 dividend in 2012, which at $7/share is over a 12% yield. Even if the stock were to trade to just an 8% yield (still quite high in a world of the 3% 10-year Treasury), the price would be over $10.50/share.

Conclusion

We remain concerned about the global economy and suspect of broad asset class valuations. However, in a world of literally tens of thousands of securities there are always opportunities. Absent a significant market correction, we are likely to continue to hold cash or "dry powder." We also continue to look to hold assets that can perform well in an inflationary environment, as dollar debasement seems to be the political path of least resistance out of our current spending and debt problems. The politicians appear happy to solve the problems "mañana." When presented with opportunity, we, on the other hand, are happy to make hay when the sun shines.

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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The securities discussed above were holdings during the quarter ended June 30, 2011. 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 new purchases 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 presented in the table on page 2 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.