October 28, 2016

"Nobody but cattle know why they stampede,
and they ain't talking."

- Cowboy Saying

Dear Client,

Overall market, economic, and investor sentiment conditions are similar to where they were in late July when we wrote our second quarter letter. We will not spend much time repeating those details or offering new proof. It suffices to say, historically accurate indicators continue to show that asset values in general and US equities in particular are overvalued. The median US stock trades at the highest price to sales ratio in the history of the S&P 500 index; and it is not even close. Research Affiliates projects an annualized real return for a domestic 60/40 stock/bond portfolio of just 86bps[1] (!) annualized over the next 10 years.[2]

The economic situation is no better. Global debt levels relative to global gross domestic product are well beyond the point where they have historically led to stagnant growth and we are seeing it in GDP growth rates – the Conference Board now expects US real GDP to grow at just 1.5% in 2016. Central Bank intervention has pushed over $10 trillion dollars of sovereign debt into negative yield territory. Large European banks such as Deutsche Bank are levered over 25-1 and could easily prove insolvent absent a government intervention. (Remember Lehman, etc. were levered over 25-1.)

Despite this backdrop, we continue to operate in a non-binary fashion. We do not want to bet on a stock market collapse or massive inflation or deflation. We try and tilt the portfolio (and/or client asset allocation) with a mind toward magnitude, probability, and likely timeliness of potential outcome based on fundamental, technical, and sentiment indicators. This year, our fixed income strategy has been the star. It has benefited most from exposure to long-dated US Treasury bonds that performed very well in the first half of the year. Our equity (or risk) strategy has plodded along (up slightly). Our limited partnership, which is far more hedged than our separate account strategies, is down a few percentage points for the year. Any form of

---

[1] Bps is basis points. 100 basis points = 1.00%.
[2] https://www.researchaffiliates.com/en_us/asset-allocation.html

"insurance" has been wasted money for the past few years, but we refuse to believe the business and market cycles have been tamed. Hedge funds (and all forms of active management) are as out of favor right now, as they have ever been. This is another cyclical phenomenon. The pendulum always swings back the other way. Thus, this is a terrific contrarian sign for the patient.

We spend most of our efforts trying to identify individual, mispriced securities where we think we have the opportunity to earn high-single-digit to 20%+ IRRs depending on the riskiness and range of possible outcomes. Here are a few ideas that excite us most right now.

A Few Ideas We Are Most Excited About

Leucadia National Corporation (LUK)

Leucadia National Corporation consummated its merger with Jefferies Group, an investment bank in March of 2013. As a part of the transaction, the executive team at Jefferies took over the management of Leucadia. Despite spectacular multi-decade shareholder value creation at both LUK and Jefferies, the last few years have been a struggle.

The two largest components of Leucadia are Jefferies and National Beef, the fourth largest U.S. beef processing company. For the last few years, both businesses have been under significant pressure. At Jefferies, the Bache commodities group and the fixed income unit have been a drag. Jefferies has now divested Bache and the fixed income business has been significantly realigned and right-sized. At the current run rate of the last two quarters, Jefferies would earn $368mm on $3.5B in tangible common equity or approximately 10% return. Jefferies appears back on track. Likewise, National Beef has gone from its worst year in a decade to peak performance. In 2015, National Beef lost $14mm in EBITDA. In the third quarter of 2016 alone, the company made $130mm. National Beef is on track to surpass its peak EBITDA earnings of $336mm in 2011.

Leucadia has tangible equity of approximately $7.5B. If Jefferies can earn $370mm and National Beef can earn $340mm, those two businesses alone (combined just slightly more than 40% of LUK tangible capital) could drive close to 10% growth in overall firm tangible book value. With the rest of the Leucadia businesses either earning high 20% return on equity or building significant value as earlier stage investments/businesses, value creation should be evident for the first time in several years. The stock trades today at just under its $20 tangible book value. Growth in book value for the first time in several years should itself provide a reasonable return, as well as act as a catalyst for shares to trade at a higher multiple.

Express Scripts (ESRX)

Express Scripts is the largest Pharmacy Benefits Manager (PBM) in the country and is one of three PBMs that control over 75% of the market. From the American Pharmacists Association via Wikipedia: “PBMs are primarily responsible for developing and maintaining the formulary, contracting with pharmacies, negotiating discounts and rebates with drug manufacturers, and processing and paying prescription drug claims.” Despite the fact that pharmaceutical spending should grow at a robust pace given an aging population and the prospective addition of new covered lives through the Affordable Care Act, ESRX trades at just 10x 2017 consensus earnings with a free cash flow yield of approximately 10%.

Express Scripts’ stock price has come under pressure as ESRX and Anthem publicly renegotiate their contract. Anthem represents 14% of ESRX’s revenue. A proposed merger between Anthem and Cigna further complicates this situation. While Anthem has leverage to extract better terms from ESRX, we think it is unlikely that they completely sever ties. Even if ESRX does lose the Anthem contract, we think the shares are undervalued at today’s price around $70/share. With Anthem, we think ESRX is worth upwards of $100/share. Without Anthem, we think ESRX is still worth in the mid-$80s.

Small Capitalization REITs

Last December Grey Owl was interviewed by Value Investor Insight about New Senior Investment Group (SNR), a senior housing properties REIT. That piece was published at year end and as of October 19 the stock has returned 25.8% YTD. SNR is currently trading at $10.60 and we continue to hold a position. We did cut back our position size at $11.78 when the stock surged last summer. Our thesis was that the stock traded at too big a discount to net asset value (NAV) because of technical issues the firm was correcting; and we would be paid a large dividend while we waited. We are currently following a similar playbook with three other REIT holdings: Independence Realty Trust (IRT), Northstar Asset Management (NSAM), and Wheeler REIT (WHLR). All trade at a significant discount (20-30%) to conservatively calculated Net Asset Values (NAV), and are paying us a weighted average dividend yield of 10.5%. Over time, we will collect our dividends and expect them to trade close to NAV.

Gold and Gold Miners

Over the past several months we have increased our exposure to gold and gold mining stocks. This has mildly hurt us recently as these positions, especially the miners, are very volatile. In the next several quarters we expect our position to benefit from three factors: currency devaluation, increasing inflation pressures, and trend following. Gold tends to rise with increasing inflation, and inflation pressures have risen recently. As global economic growth has slowed, countries have increasingly resorted to currency devaluation to boost their economy (e.g. China). As trading partners retaliate, all currencies are debased and gold benefits as a store-of-value. Once this trend becomes established it tends to last for several years, and the current uptrend in gold started at the beginning of 2016.

Gold is also a haven asset in times of market uncertainty. If we ever see market volatility again our gold position should hold its value and may even appreciate as money flows to haven assets.

Conclusion

This environment warrants a balanced, hedged portfolio. Despite the difficult setup (i.e. Research Affiliates 86bps annual return expectation for a classic stock/bond portfolio over the next ten years), we are very optimistic on a number of individual ideas, especially the ones we described above. We also maintain faith and patience that given the current backdrop an alternative, hedged approach to investing will prove the most advantageous over the next several years. We expect this to become clearer and clearer as the unprecedented global Central Banking experiment progresses toward its inevitable conclusion. Nobody knows why cattle stampede at the exact moment they do, but there sure are some circumstances that encourage it more than others.

*****

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