February 7, 2014

*"If something cannot go on forever, it will stop."*

- Herbert Stein, fmr chair of the Council of Economic Advisers

*"Economists are very good at saying that something cannot go on forever, but not so good at saying when it will stop."*

- the same Herbert Stein

Dear Client,

S&P 500 earnings grew approximately 9% for the two-year period from the beginning of 2012 through the end of 2013. Over that same period, the total return for the S&P 500 index was close to 50%. This implies a 35% increase in valuations – i.e. investors were willing to pay 35% more for the same stream of future cash flows.[1]

In that context, we find the market's January "breather" completely rational. Will it continue? We have no idea. However, we do know that long-term (i.e. sustainable) stock market returns are anchored to corporate earnings growth. S&P 500 returns will not exceed earnings growth indefinitely. Additionally, we know that significant government market interventions (both fiscal and monetary) are eventually destabilizing. Like water finding a crack in a dam, market forces eventually overwhelm manipulation. Whether it was fear regarding the Federal Reserve's "taper" that acted as the primary trigger for the January correction, no one can be sure. We *are* sure that a central bank cannot quadruple the size of its balance sheet over a five-year period and completely avoid negative consequences.[2]

At Grey Owl, we focus on building an investment portfolio that can perform well in most environments – not one that is betting on inflation vs. deflation or growth vs. recession. This portfolio provided solid absolute returns in 2013 – a late-stage, roaring bull market. Critically, what was in effect the same portfolio[3] also held up well in January's equity market selloff.

[1] We recognize that the cash flows are very slightly different as two years have passed. Equities are perpetuities after all.
[2] On Sep 10, 2008 assets on the Federal Reserve's balance sheet stood at $925mm. They had grown to $4.1B at last measure on Jan 29, 2014. http://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm
[3] There were several buy and sell transactions that modestly altered the composition over the thirteen month period from the beginning of Jan 2013 to the end of Jan 2014.

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In this letter we aim to put 2013 equity market returns in broader historical context, discuss current market sentiment, and highlight recent portfolio changes. First, here is the standard performance table for the Grey Owl Opportunity Strategy as of December 31, 2013[4]:

| | Q4 | TTM | Cumulative Since 10/06 |
|---|---|---|---|
| **Grey Owl Opportunity Strategy (net fees)** | **5.10%** | **16.41%** | **52.84%** |
| Spider Trust S&P 500 (SPY) | 10.52% | 32.31% | 56.12% |
| iShares MSCI World (ACWI and MXWD) | 7.74% | 22.35% | 37.98% |

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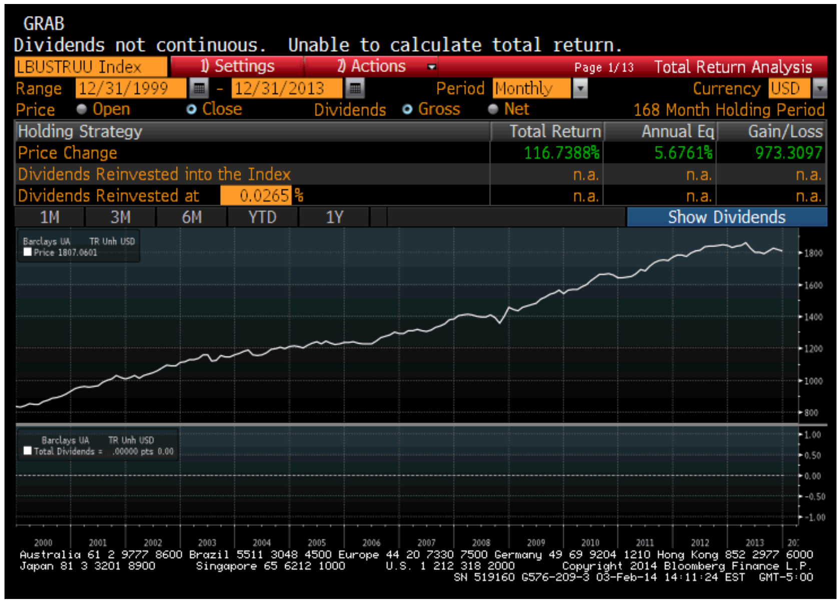
**The S&P 500 – Equity-like Volatility with Fixed Income Returns**

We suspect money management firms will not be rushing to trademark the above "marketing slogan," but it does accurately capture the last decade-plus of long-only equity market investing. Since the beginning of 2000 through the end of 2013 (fully fourteen years), the annualized total return for the S&P 500 index has been just 3.6%. In order to achieve this meager return, investors had to suffer through two 50%+ peak to trough declines.


Over the same period, fixed income (as measured by the Barclays Aggregate US Bond Index) provided a total return of 5.7% annualized with only modest drawdowns: better returns and a smoother ride.

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




Our point is not to argue that bonds are better than stocks. Today, valuations for both asset classes portend meager returns going forward. Rather, our point is that 2013 is only one year. Those playing the game with a long-term focus should keep two things in mind:

1) **Starting valuations eventually matter.** Equities began 2000 with a price to earnings (PE) ratio of 30. Equity returns were set up to be poor in 2000 and they have been over the full fourteen-year period since. Unfortunately, at 19 today, the PE on the S&P 500 is still 20% higher compared to the historical average of 15. [5]

2) **Over a full cycle, a balanced portfolio can provide comparable returns to a pure equity portfolio with significantly less volatility.** This is particularly true if gold, which is consistently negatively correlated to both stocks and bonds, is included. For example, Wainwright Economics[6] recently described the returns for a 15% stocks, 70% bonds, and 15% gold portfolio from 1970 through 2013. This portfolio compounded at an average annual rate of 9.29% with just a 6.92% standard deviation. The S&P 500 index compounded at 10.23% with a 15% standard deviation over the same period. Said differently, Wainwright's version of an "all weather" portfolio provided 90% of the

[5] Furthermore, comparing the current trailing twelve month PE on "as reported," GAAP earnings to the historical average does not take into account that earnings may be at a cyclical peak. S&P 500 operating margins averaged 9.6% in 2013. The historical average is 6%. Corporate profit margins are 60% above their historical average. If margins revert to their mean, today's PE ratio is understated (i.e. the broad stock market is far more expensive than it appears). If margins do not revert to their mean, capitalism is broken, as the saying goes.

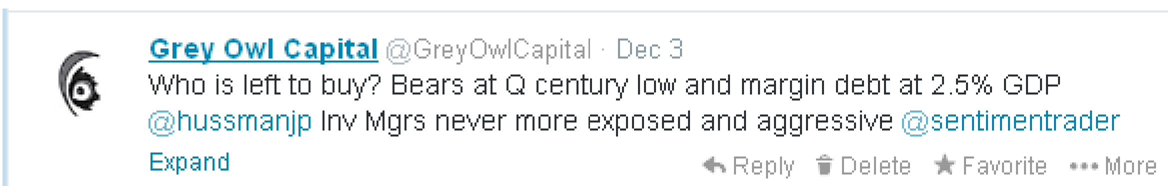
[6] H.C Wainwright & Co. Economics Inc. Tactical Asset Selector January 31, 2014. www.hcwe.com Subscription required.

return with less than half the volatility.[7] Additionally, this portfolio has proven mostly immune to surprise shifts in economic growth and inflation/deflation.

**A Speculative Consensus**

While equities have underperformed bonds for fourteen years, the Federal Reserve's ongoing "financial repression" combined with 2013's exceptional equity market returns have served to create a loud chorus championing equities as the asset class of choice today. The lead story in the January 10, 2014 issue of *Grant's Interest Rate Observer* summarized this well. "As we read the new year consensus of investment sentiment, people love stocks, hate bonds and feel sorry for gold. 'In the many years I've been surveying experts for their predictions for the coming year,' writes New York Times' columnist James B. Stewart, 'I cannot recall another time when optimism about the stock market, the economy and corporate profits was so widespread. As is pessimism about the bond market.'"

Grant then opines, "Perhaps the trader's maxim applies: 'If it's obvious, it's obviously wrong.'" Perhaps the trader's maxim does apply. Investors appear to be crowding onto one side of the boat. We "tweeted" as much on December 3rd.




We went on to discuss in more depth the risks of elevated margin debt levels in a January 31st *Seeking Alpha* post "Why Margin Debt Matters." The article is reprinted in its entirety here.

**Why Margin Debt Matters**

For the past few months, cautious investors, perma-bears, or reasonable skeptics (depending on your point of view) have emphasized the rise of margin debt balances to historic highs as one more sign that "all the passengers are on one side of the boat." In a January 27 post, Zero Hedge's "Tyler Durden" wrote, "margin debt rose by another $21 billion in December to an all time high of $445 billion, and up 29% from a year ago." He goes on to explain how grossly understated this number is given hedge funds' ability to borrow beyond traditional margin limits. Dr. John Hussman of the eponymous Hussman Funds wrote of surging margin debt at

[7] We should reiterate something we have said many times before. Like Warren Buffett, we do not believe volatility equals risk. Real risk is the possibility of permanent capital loss. However, we must recognize that volatility IS uncomfortable for clients and can/does influence behavior at exactly the wrong time. All else equal, less volatility is better.

least as far back as April, 2013. Even the more staid Wall Street Journal has published warnings about the rise in margin debt. For example, the October 24, 2013 Morning MarketBeat was titled *Risky Business of Rising Margin Debt*.

Yet, in a December 20, 2013 commentary, technical analysis service Lowry Research Corporation points out that “since market tops are always a reflection of excessive risk-taking, it is reasonable to expect margin debt to be at high levels near major market tops. But, that does not mean it is an effective or accurate tool for anticipating major market tops. History shows that margin debt was at record levels for each of 19 years, from 1950 to 1969 and for each of 25 years, from 1976 to 2000.”

So, does margin debt matter? We believe the answer is yes. While it may not be a useful tool for market timing, it does help to describe the general stability of the financial system – particularly when viewing margin debt expressed as a percentage of a normalizing variable such as gross domestic product (GDP). The greater the margin debt as a percentage of the system, the less stable the system is.

Why is margin debt destabilizing? There are several reasons:

1. **Margin debt is a loan that can be called at any time.** Imagine how precarious the housing market would be if your bank could call you on Monday morning and tell you to pay off your mortgage by the middle of the week or they would start selling the windows and doors on your home.

2. **The higher margin debt becomes as a percentage of financial assets, the smaller the selloff in financial assets needed to cause the margin clerk to make the above-described call.** Traditional margin loans are governed by Regulation T. This allows investors to borrow up to 50% of their initial investment amount. Therefore, an investor with $100 could make a $200 investment. Importantly, the investor must maintain at least a 25% capital ratio. So, if that $200 investment went down more than 33%, the margin clerk is calling. Unfortunately, this oversimplifies the issue. Institutional investors can use far more leverage and the margin call is governed by more than just Regulation T’s maintenance requirement. If a large brokerage firm gets nervous and wants to take down their loan balance, they can make a margin call. If they don’t like the type of collateral being held (maybe momentum stocks like AMZN, or NFLX, or YELP) they can make a margin call. To use the home analogy again, it would be as if your bank could require you to repay your mortgage if they were worried a hurricane was headed toward your neighborhood.

3. **When margin debt is high enough, selling begets selling.** It could work like this. a) Some broker-dealer(s) get over-extended by lending against a class of securities that proves to

have much more downside volatile than they originally expected. As these assets selloff, the firm(s) begin to call in margin loans. b) The portfolio managers getting the margin call sell securities into a falling market in order to pay off their loans. c) The additional selling causes the market to go down more. d) Go back to a) until such time as the system is unlevered and securities are primarily owned without debt.

Thus, while neither absolute margin debt levels nor margin debt as a percent of GDP may be good market timing indicators, significant margin debt IS emphatically a sign that the system is unstable. We submit the following chart of the two most recent margin debt peaks as evidence.


This graph, created using Bloomberg Financial, shows the absolute dollar amount of margin debt from the end of 1999 through the end of 2013. At the margin debt trough in September 2002, the S&P 500 had fallen 45% from its August 2000 level. At the margin debt trough in February 2009, the S&P 500 had fallen 51% from its October 2007 level.

**At the End of the Day, Increasing Intrinsic Value is All that Matters**

Rather than focus on either anticipating macroeconomic swings (i.e. inflation vs. deflation or expansion vs. recession) or forecasting short-term stock market moves, both largely fools errands, we concentrate on two areas. First, as discussed above, we aim to construct an "all weather" portfolio that can do well in most macroeconomic environments. We want to be aware of speculative excess, broad asset class valuations, and macroeconomic trends, but we will not typically do more than tilt a portfolio based on this assessment. As Herbert Stein reminds us, something that is unsustainable can persist for much longer than one would expect. Second, we look to purchase equity positions in businesses that we believe exhibit competitive advantages that will help them increase their intrinsic value at an attractive rate. When all is said and done, this is the primary driver of value creation.

Comparing our largest holding today to the S&P 500 highlights this point. We have discussed Markel Corporation (MKL) before. For a review of our investment thesis, see our third quarter 2013 letter and our third quarter 2011 letter. The following table compares MKL and the S&P 500 for the two years from Q3 2011 through Q3 2013.[8]

| | MKL | S&P 500 |
|---|---|---|
| Two-year Total Return | 45% | 55% |
| Two-year Fundamental Growth | 38% book value growth | 15% total<br>9% earnings growth<br>6% dividends |
| Percent of Two-year Return from Fundamentals | 84% | 27% |

There are multiple ways to gauge short-term investment success. One can look solely at returns compared to an index. Alternatively, one can focus on changes in the intrinsic value of the businesses owned in their portfolio. Over the most recent two years, MKL has increased in intrinsic value by 38% (increase in book value) compared to 9% (increase in earnings per share) for the S&P 500. MKL increased intrinsic value over 4x as much as the S&P 500. While MKL underperformed the S&P 500 on a return basis over this two-year period, the returns it generated are far more sustainable. It feels good when the price goes up, but that feeling may be fleeting if the intrinsic value of the business does not catch up with the price. Otherwise, the price will eventually decline to meet the intrinsic value.

**Portfolio Changes[9]**

The fourth quarter of 2013 saw only four changes to our investment portfolios: two sales and two purchases.[10] We sold Western Alliance Bancorp bonds realizing a modest positive return over a short time frame. We also sold Accor (AC-FR) for a reasonable gain after holding for just a few months. We had hoped to compound our money for several years as the company transitioned from an owner of hotels to a pure franchisor. However, when the new CEO announced a strategy shift, we exited the position.

[8] We use earnings growth for the S&P 500, but book value growth for MKL because a significant portion of the change in MKL's intrinsic value from period to period does not flow through the income statement and only shows up on the balance sheet.
[9] We are referring to our, largely equity-based, "risk" portfolios. There were additional portfolio changes in our tactical fixed income portfolios and Grey Owl Partners, LP .
[10] There were several other changes in taxable accounts for tax-loss-selling purposes. We swapped one ETF for another with identical economic characteristics. We ignore these changes for the purposes of this letter, because they do not alter the portfolio's composition from a future performance standpoint.

Our first purchase was an increase in our exposure to MKL, which we noted in our last quarterly letter. The second change was the addition of World Wrestling Entertainment (WWE). We described our investment thesis in another recent *Seeking Alpha* piece that we reprint here.

**Will World Wrestling Entertainment Pin NBC?**

At this week's Consumer Electronics Show, World Wrestling Entertainment (WWE) announced the launch of WWE Network. Covering the event, The Wall Street Journal wrote, "World Wrestling Entertainment Inc. is sidestepping the cable world that long has been its bread and butter to launch the WWE Network, a subscription-only, online video channel that will air round-the-clock programming."

While a terrific opportunity for significant value creation, it is unlikely this is a complete "sidestep" of cable. Rather, WWE is flexing its collective muscle as it continues to renegotiate its two largest broadcast rights agreements with NBC Universal. The contracts for "Raw" and "Smackdown" expire this year and NBC Universal's exclusive negotiation period concludes at the end of this month. The timing of the network announcement seems aimed at pushing NBC Universal toward action. It was as if they said, in the words of the late Randy "Macho Man" Savage, "Hey NBC, snap into a Slim Jim!"

We typically invest in high-return businesses, with strong competitive advantages, and executives with a record of excellent capital allocation and balance sheet management. We aim to hold these types of investments for at least 3-5 years and in the best case, forever. We discussed our five largest positions, all of which meet these criteria, in our third quarter 2013 letter.

WWE does not exactly fit these parameters. Yet, we are owners of WWE equity. It is our belief that the current "Raw" and "Smackdown" distribution agreements are so far below market that there is a high probability they will renew at 2, 3, or even 4x the current rate. The majority of this new revenue should flow to the bottom line. Thus, we were willing to overlook their shareholder-unfriendly dual share class structure, an operating history that includes questionable capital allocation decisions, and a dividend that is not covered by current cash flow. The immediacy and magnitude of the event present an incredible risk reward dynamic.

We have followed the evolution of the media business for some time, compelled by the increasing value of content in general and "DVR-proof" content (typically live sports) specifically. Additionally, we find the ongoing shift in media consumption patterns brought on by the proliferation of broadband Internet access intriguing. We watched from the sidelines for several years. Then, we came across a Forbes video and story highlighting the pending WWE broadcasting deal negotiations. We immediately recognized the investment opportunity.

The analysis is relatively straightforward:

1. **WWE content is approximately as valuable as "live sports" content.** While WWE events are not "live sports" they have attributes that make them equally "DVR-proof." Nielson estimates that 95% of the TV audience for sports watches live. Live viewership for WWE events is in the low 90%s.

2. **Given current market rates, WWE should be able to increase their rights fees by 2-4x.** WWE's current deals are both several years old and were below market from the beginning. If WWE is able to renegotiate their cost per viewer hour to match the low-end of current sports rights deals (Fox's NASCAR deal) their rights fees would more than double. At the high-end (NBC's NHL deal), their rights fees would increase more than 13x. 2-4x is a conservative estimate.

3. **A market-rate rights deal for "RAW" and "Smackdown" would translate to significantly higher EBITDA and a much more valuable business franchise.** A doubling of the rights fees would add close to $85mm to EBITDA. A quadrupling would add close to $255mm. At three times the current contract, we get a back-of-the-envelope fair value around $25 / share. This is almost 50% upside from today's price of $17.

4. **The catalyst is imminent.** With NBC Universal's exclusive period about to expire, we believe a new deal could be announced in the next few months.

Oh, by the way, the WWE Network could have some value too.

Subsequent to writing the above article, WWE stock price increased to the mid 20s. At that point, the risk/reward equation shifted and we trimmed our position. With no contract announced yet, we feel there is still potential upside and continue to be long WWE as of this writing.

**Conclusion**

2013 was a banner year for the US stock market. Despite equities' meager fourteen-year record of accomplishment, investors, broadly speaking, are limited to short-term memory. Last year's performance was enough to generate significant enthusiasm for stocks. We continue to believe, the current environment warrants a more balanced approach.

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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.