January 30, 2015

> *"Never think that lack of variability is stability. Don't confuse lack of volatility with stability, ever."*
>
> \- Nassim Nicholas Taleb

Dear Client,

Over the past seven months the price of oil has plunged from a peak above $100/barrel to the mid-$40s today. This is just the most extreme version of the market volatility and divergence we began highlighting in our second quarter letter. A cautious investment stance remains the prudent choice.

After some brief commentary on the state of the world, asset class returns, and underlying market trends, we spend the bulk of the letter discussing our portfolio transactions from both the third and fourth quarter of 2014. After last quarter's more philosophical discussion, we thought readers might find the discussion of individual securities refreshing. After all, no matter the environment, there are always buying opportunities and, no matter the business, every asset can provide value at a certain price.

Here is the performance table for the Grey Owl Opportunity Strategy as of December 31, 2014[1]:

	Q4	2014	Cumulative Since 10/06 Inception
Grey Owl Opportunity Strategy (net fees)	**4.49%**	**9.60%**	**67.50%**
Spider Trust S&P 500 (SPY)	4.90%	13.46%	77.16%
iShares MSCI World (ACWI and MXWD)	0.17%	3.82%	43.22%

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

2014 – A Broad Range of Investment Outcomes

What might have appeared a low-key year from a US-based investor's perspective was really anything but. There was significant return dispersion across geographies, asset classes, and sectors. The table below includes annual performance for the major broad asset classes, as well as some of the best and worst sectors. It highlights the significant breadth of returns.

2014 Total Return – Selected Asset Classes and Sectors[2]

Asset Class (ETF representative)	2014 Total Return
S&P Biotech (XBI)	44.70%
S&P Utilities (XLU)	28.59%
Long Term US Treasury Bond – 20+ years (TLT)	27.35%
S&P 500 – US Large Cap (SPY)	**13.54%**
Russell 2000 – US Small Cap (TWOK)	4.95%
MSCI All World Country World Index (ACWI)	4.64%[3]
Barclays High Yield Bond (JNK)	1.15%
Gold (GLD)	-0.58%
MSCI Emerging Market Equity (EEM)	-2.82%
Emerging Market Local Currency Bond (LEMB)	-4.04%
1-3 Year International Treasury Bond (ISHG)	-10.89%
S&P Metals & Mining (XME)	-25.24%
S&P GSCI Commodity-Indexed Trust (GSG)	-33.60%
S&P Oil & Gas Equipment & Services (XES)	-34.94%

[2] https://www.spdrs.com/product/index.seam and http://www.ishares.com/us/products/product-list#categoryId=0&lvl2=performance&lvl3=nav&lvl4=quarterly

[3] Careful readers will note that the 2014 return for AWCI in this table does not match the 2014 return for ACWI in the table on page 1. For the page 1 table, we always use Bloomberg's daily return assuming dividends reinvested in the security for the price of the security itself. The iShares website, where we obtained the performance for ACWI and other iShares securities listed on this page, uses monthly returns of net asset value (NAV).

How Stable is the "Stable Disequilibrium" Today?

All the way back in May, 2013, Mohamed El-Erian (then CEO and co-chief investment officer at PIMCO) referenced the drop in gold prices, as well as the decline in Apple and Facebook shares as a warning:

> *"Essentially, today's global economy is in the midst of its own stable disequilibrium; and markets have outpaced fundamentals on the expectation that western central banks, together with a more functional political system, will deliver higher growth. If this fails to materialise, investors will worry about a lot more than the intrinsic value of gold."* [4]

In this essay, and a series of contemporaneous articles, presentations, and media appearances, Mr. El-Erian coined the term "stable disequilibrium." While perhaps early, we believe his warning was correct. In just the last few months we have seen two additional "shocks" – the 50%+ drop in the price of oil and a single-day ~50% appreciation in the value of the Swiss Franc – that seem to emanate from a similar source: global central banks attempting to create stability at a level where markets say it does not exist. In the end, like water finding cracks in a dam, market forces will overwhelm even the bottomless pocketbooks of central bankers.

Interest Rates and Consensus

Beware the consensus and predictions in general. "Interest rates must go up," seems the most broadly held investment thesis today. And, it has been for several years now. In January of 2014, Bloomberg's average analyst estimate for the fourth quarter 2014 10-year US Treasury yield was 3.4%. Expectations were that yields would rise from the 2.6% level where they began 2014. Yet, the 10-year US Treasury yield finished 2014 at 1.97%. The interest rates that "must" go up went **down**!

We continue to hold long-dated US Treasury bonds in our fixed income portfolios, balanced accounts, and our private investment vehicle, Grey Owl Partners, LP. Until such time as the US dollar loses its reserve currency status, US Treasuries will remain the best portfolio hedge against slowing growth and deflation.

It strikes us as interesting that investors (or at least the pundit-class) continue to worry that bonds are overvalued but show no concern for equities trading at a Shiller PE[5] over 26 compared to the long-term average in the mid-16s. Commodity prices generally and oil specifically have declined at a precipitous rate. Chinese growth is slowing. Japan and Europe

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[4] http://www.ft.com/intl/cms/s/0/07def1c8-bf07-11e2-87ff-00144feab7de.html?siteedition=intl#axzz3Q2qx2Vsp

[5] http://www.multpl.com/shiller-pe/

continue to fight very low economic growth and deflation. With new leadership, there is a heightened possibility of a Greek Euro exit. Finally, widening credit spreads and increasing dispersion within US equity markets suggest to us that maybe, just maybe, the bond market is more right than the stock market.

Portfolio Adjustments during the Second Half of 2014

There was quite a bit of transaction activity in the second half of the year. We spent the bulk of last quarter's letter discussing investment philosophy and did not have the opportunity to comment on individual investments at all. Therefore, six months of transaction rationale follows.[6]

We sold our entire position in **Enbridge (ENB)** in July at just under $50/share. ENB is a wonderful collection of midstream energy assets (steady, toll-booth like businesses that for the most part are not tied to short-term commodity prices or volumes) and has a massive ($20B+) pipeline of new projects. Yet, at $50/share and ~30x next year's earnings, the stock offered little margin for error if funding or other issues jeopardized the build-out of these new assets. Our return between our November 2012 acquisition and July 2014 sale was approximately 33%.

In August, we made what will likely be the most important transaction of the entire six month period, adding to our stake in **Leucadia National Corporation (LUK).** The initial position was established in late 2012 when we purchased stock in the investment bank Jefferies. This first purchase occurred just after the announcement that LUK would merge with Jefferies, acquiring the 71% of Jefferies it did not already own. The deal economics were such that purchasing Jefferies stock before the merger's consummation let us "create" a LUK share at a price which was lower than the then current quote. Both the initial purchase and our recent purchase were acquired at a meaningful discount to (then) book value. Book value has grown modestly since.

LUK is considered by some a "mini-Berkshire." It is a collection of businesses that vary from investment banking to beef processing to auto dealerships to Berkadia – the third largest commercial real estate loan originator in the US and a 50/50 joint venture with Berkshire Hathaway (to list a few). Given its "merchant banking" profile, leadership is more important than the current collection of assets. Rich Handler (CEO) and Brian Friedman (President) have a terrific track record creating shareholder value – between January 2000 and October 2012, Jefferies stock provided shareholders a 159% return. By comparison, Goldman Sachs (GS) was the (distant) second-best performing large investment bank security over the period with a 30%

[6] The transactions discussed in this letter are specific to our "opportunity strategy" unless otherwise noted. The Grey Owl "Opportunity Strategy" is an equity-focused separate account strategy. Grey Owl Capital Management, LLC also manages tactical fixed income portfolios, balanced accounts, and a private investment partnership: Grey Owl Partners, LP.

return. Every single other large investment bank had a negative return over that time frame (from -20% for JP Morgan to -91% for Citigroup), as did the S&P 500 (-4%).

Mr. Handler and Mr. Friedman have also demonstrated an exceptional ability to manage through crisis (see MF Global and Egan Jones letter) and to strike quickly when opportunity presents itself (see Knight Capital Group, Harbinger, and within the last few weeks, FXCM). In addition, Mr. Handler and Mr. Friedman have plenty of skin in the game. LUK provides a bigger canvas and broader palette for their talents. We believe time will (continue to) prove them "Outsiders[7]" in the mold of Henry Singleton, Warren Buffett, and John Malone. LUK is now a large, core holding – one we intend to keep indefinitely.

In September, we swapped our position in **Ultra Petroleum (UPL)** for **Cabot Oil & Gas (COG)**. COG is now the third natural gas position we have owned[8] since the fracking revolution developed and drove the price of natural gas down ~75% over the past 10 years.[9] Despite the fact that we have yet to see a price rebound to what we think is the marginal cost of production ($5-6/mcf), we managed to make money on our original natural gas positions: Range Resources (RRC), as well as UPL. Between December 2012 and September 2014, our UPL holding earned a total return of approximately 24%. We are currently in the red on COG, but it has a far cleaner balance sheet than UPL (thus less dependent on a modest increase in gas prices over the next year or so) and there is a near-term catalyst: should the north-east Constitution Pipeline be approved and built, COG will be able to move gas from an over-supplied region to an under-supplied region and sell its production at a much higher price. While we have not yet earned a positive absolute return with COG, it has fared much better than UPL since we made the switch. From the buy and sell dates in September, 2014 through January 30, 2015 COG has outperformed UPL by over 26%.[10]

In late September and early October, we trimmed two positions. We locked in a gain of approximately 22% on a portion of our **Apple (AAPL)** stake. We have held AAPL now for almost two years. We bought too early as the stock price corrected from its (pre-split) $700 highs in September of 2012, but held on as the business continued to grow and the valuation got cheaper. Some loud activist investors, better capital allocation, and most importantly a business that continues to thrive led to a significant rebound in the stock price from mid-2013 through today. Despite all the positives, AAPL is still mostly a one-product company (iPhone) and there

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[7] http://www.amazon.com/The-Outsiders-Unconventional-Radically-Blueprint/dp/1422162672/ref=tmm_hrd_title_0?ie=UTF8&qid=1422397262&sr=8-3

[8] This refers to our separate account strategy. We hold/have held additional natural gas-related positions in Grey Owl Partners, LP.

[9] From over $13/mmBTU at its peak in 2005 to ~$3/mmBTU today. http://www.eia.gov/dnav/ng/hist/rngwhhdm.htm

[10] We purchased COG at $33.20 on September 19, 2014. We sold UPL at $23.82 on September 23, 2014.

is a modest threat that wireless carrier subsidies shrink. This could slow the upgrade cycle. It seemed prudent to take some money off the table.

Berkshire Hathaway (BRK/B) was the other position we trimmed, locking in a gain of 131% since we started Grey Owl Capital Management in May 2009.[11] Prior to this, Berkshire was our largest holding. Today, it is still our fourth biggest. Our largest positions (ones that can be 8-10% of the portfolio) need to be both excellent businesses with excellent stewards of capital at the helm, but also to trade at a meaningful discount to our estimate of fair value. Berkshire continues to fit the first half of the profile. While it is likely still modestly undervalued today, it no longer trades at a screaming discount.

Our final transactions in September were two sales, both for losses. We discussed **Post Holdings, Inc. (POST)** at length and in glowing terms in our first quarter 2014 letter. We believed we were purchasing a classic rollup story with a proven "Outsider" at the helm in Bill Stiritz of Ralston Purina fame. We paid what we thought was a fair (though not cheap) price if the company executed on its stated plan. Unfortunately, the core ready-to-eat cereal business continued to decline and there were integration issues with a few of their recent acquisitions. To make matters worse, we added to our small initial position before all of the bad news was in the stock price. Eventually, in September we decided to exit the position in the hopes of avoiding end-of-year tax-loss-selling pressure. We closed the first lot down 41% and the second down 34%.

We also closed our position in the **Vanguard Emerging Market ETF (VWO)** at a small loss in September. We had purchased VWO in the second quarter of 2014 to fill a growth/inflation quadrant role in our "all-weather" overlay, but as credit spreads continued to widen (signaling slower global growth) and commodity prices continued to decline (signaling disinflation), we decided to cut our losses down a modest 2.7%.

The fourth quarter was as active as the third from a transaction standpoint. In early October, we added two new positions. **Baxter International (BAX)** is a large-cap biopharmaceuticals and medical equipment company that intends to spin off the biopharmaceuticals business in the middle of 2015. The company has oligopoly/leadership positions in hemophilia and renal treatments. One of these treatments has new competition and this threat has weighed on the stock. Shares have traded sideways for two years. Spinoffs have done an excellent job of unlocking value for healthcare companies recently (e.g. Abbott and Abbvie, Pfizer and Zoetis) and we think a similar outcome is possible for Baxter.

[11] Although many relationships held shares in Berkshire Hathaway under our advisement prior to the founding of Grey Owl Capital Management, LLC, we felt it was more representative in this case to use May 31, 2009 as a starting point. In addition, the lot we purchased August 2011 had a total return of 100% through October 2, 2014.

On the same day as the Baxter purchase, we also acquired shares in **Bluerock Residential Growth REIT (BRG)**. BRG is a micro-cap ($170mm market capitalization) that we were able to purchase at a then current yield of 9% following selling pressure after a secondary offering. The executive team has an excellent pedigree and we expect the stock's multiple will expand as the team grows the platform to a larger scale. It is a similar concept to our Wheeler REIT (WHLR) holding, only BRG focuses on apartments while WHLR specializes in retail shopping centers. The combined WHLR and BRG positions are under 2% of the portfolio today. There are two reasons for the unusually small position size. Both stocks are micro-cap securities with low trading liquidity. In addition, these securities play a role in ensuring the portfolio has an "all-weather" overlay – REITs typically perform best when economic growth is strong and there is inflation. Neither of these factors exist today. While we like the hedge against a shifting economic environment, we do not want the hedge to be too big given prevailing trends.

In mid-September, Alliance Data Systems (ADS) announced it would acquire **Conversant (CNVR)** for both ADS shares and cash. In mid-October, we decided to sell our CNVR position into the open market rather than wait for the transaction to close. The ADS share price was under pressure (along with the rest of the US stock market) and close to a price threshold where CNVR shareholders would receive a lower consideration. We purchased Conversant in May, 2013 when it was still called ValueClick. We were excited about the collection of internet advertising assets – particularly the recent Dotomi acquisition. The stock went sideways until the deal was announced and we wound up with a 28% return. One more piece of evidence that solid returns can come in a lumpy fashion.

During mid-October the overall market was under pressure for a number of reasons including an Ebola outbreak in Africa which had led to a few isolated cases in the United States. At the same time, the price of oil was three months into its now six month (and counting) decline. Oil – the airlines' number one cost component – was down approximately 25%, yet **American Airlines (AAL)** traded from a $45/share high in the middle of June to the upper $20s by the middle of October. Investors were over-discounting the Ebola risk and vastly under-discounting the cost savings from the oil price change. We purchased AAL shares in the lows $30s on October, 17th and sold them nineteen days later in the low $40s for a 29% return.

We finally sold our **Exelon (EXC)** position in November after holding it for over two and a half years. This idea was a backdoor way to play a rise in natural gas prices – it was too cute by half. Exelon's merchant power generation business benefits when the price of natural gas rises. They are able to sell power at a higher price while their nuclear reactors continue to produce the power at the lowest possible cost. We thought the dividend and the regulated business segment would provide stability if it took time for gas prices to increase. During our holding period multiple issues ensued. The "heat rate" thwarted upward moves in gas prices. Then, the company cut their dividend to protect their credit rating. Eventually, they made a large

acquisition of another regulated business that diluted away a significant amount of the upside from rising gas prices. 2014's flight to safety and yield in the utilities sector allowed us to exit with a modest gain including dividends of almost 7%.

Our last buy in the fourth quarter was an early November increase in our **Lab Corp of America (LH)** position. Until that point, we held a small position in LH that had gone sideways since our initial purchase in the third quarter of 2012. We wrote about this initial purchase in our third quarter 2012 letter. As we wrote then, LH is a duopoly and a terrifically well-run business. They have a significant cost advantage – performing tests for about 1/3 of the cost of the competition, such as hospital labs. Additionally, they occupy a critical niche in the healthcare value chain – blood tests account for only 3-4% of healthcare costs, but are vital in over 80% of diagnostics. Despite these structural positives, over the past few years, LH has faced reimbursement headwinds. In addition, the healthcare value chain has been slow to move business to LH's more cost effective platform as the industry focused on areas of larger cost savings.

We were patiently waiting for an opportunity to add to LH when they announced the acquisition (really a merger of equals) of Covance. Covance operates in the tangential field of contract research. Investors disliked the lack of synergies and the acquisition price. LH shares subsequently sold off. We think the diversifying nature of the deal is a positive. In addition, there is some evidence the recent headwinds to LH's core business are starting to turn. We took the opportunity to add to our position. After this addition and the subsequent rally in the shares, LH is now our third largest position.

Finally, we trimmed our **National Oilwell Varco (NOV)** position in early November. We have owned shares in NOV since March 2013. We added to the position in January 2014 in anticipation of the spinoff of its distribution business (DNOW). Increasing our position into the spinoff worked out well. As we mentioned in our second quarter letter, we sold DNOW shortly after the spinoff and subsequent pop in DNOW's trading price. As the price of oil continued to sink and other signs of global slowing/deflation appeared during the fourth quarter, we thought it prudent to cut our exposure to energy and trimmed our NOV stake. Our total return for this portion of our NOV holding was just above 30%.[12]

[12] This number accounts for the average purchase price across both buys, dividends, the DNOW spinoff, and our sale of DNOW above the spinoff price.

Conclusion

Our second quarter 2014 letter noted the increasing divergences within security markets. Specifically, we highlighted how the large-cap S&P 500 continued to make new highs while the small-cap Russell 2000 was flat for the year through June 30th. Similarly, high-yield ("junk") bonds were barely positive over the same time period.

These divergences widened further in the July to September period. Our third quarter 2014 letter, pointed out that while the S&P 500 returned 1.14% for that three month period, the Russell 2000 was down 7.4%. The energy ETF did even worse – down 9%.

As the table at the beginning of this letter illustrated, the divergences were extreme for the full year as well. To repeat a line from the conclusion of our last letter, "We continue to structure the Grey Owl Opportunity Strategy as well as our tactical fixed income portfolios and Grey Owl Partners, LP in a balanced manner."

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In today's environment, investors are faced with a significant challenge. Across the board, asset prices are elevated. Global debt to gross domestic product is higher today than it was prior to the 2008 financial crisis, creating significant deflationary pressure. Throughout the developed world, coordinated central bank intervention is at unprecedented levels, leading to imbalances and inflationary potential. There is no obvious place for an investor to hide. A traditional indexing approach will likely lead to very low long-term returns with plenty of volatility in the meantime.

If you know of an investor who cannot afford to sit in cash, but recognizes the systemic risk in the global financial system, please ask him or her to give us a call. We believe our approach will allow investors to earn reasonable and consistent absolute returns while protecting against the time when the "stable disequilibrium" will eventually destabilize.

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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 securities discussed above were holdings during the last two quarters. 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 either new purchases or significant holdings (relative to position size) for which we choose to discuss our investment tactics. In this particular letter, we discussed every single transaction in our Grey Owl Opportunity separate account strategy during the July 1 through December 31, 2014 period. 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 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.