October 22, 2010

"We go together like rama lama lama ke ding a de dinga a dong."

- Danny and Sandy, *Grease*

Dear Client,

In just the last few weeks, stories in both the Wall Street Journal and the Financial Times discussed the macro-driven nature of today's investment markets. Prominent investment strategists were quoted saying, "stock picking is dead." JP Morgan's research shows that the average correlation between all S&P 500 stocks over a two-year period is now approximately 55%.[1] Over a three-month period, it is well over 60%. Does monetary policy or the likelihood of a Greek default really impact the underlying business fundamentals of both Microsoft and Sonic (to name a very specific couple) in the same way?

While we recognize the macroeconomic environment is important, in the end we think long-term investors would do just fine to ignore market statistics like correlation in the same way we suggest they ignore volatility as a measure of risk. Some data just isn't useful. Frankly, we think the overall economy would do much better if the government were to cease publishing economic data as John Cowperthwaite instructed be done in Hong Kong when he was sent by the Crown to oversee the economy in 1945.[2] They wouldn't have the information to support their meddling he thought. That seemed to work pretty well, but we digress.

If one reverts back to the basic investment tenet as laid out by Graham, Buffet, et. al. that purchasing a stock is nothing other than purchasing a small piece of a business, none of these data points matter. All that matters is the future cash flows that business will generate and the discount rate you assign to those cash flows. Over enough time, this truth reveals itself.

[1] Answers.com defines correlation as "the simultaneous change in value of two numerically valued random variables." In the specific example referred to here, the random variables are stock prices and the correlation is indicating the extent to which two S&P 500 stocks (e.g. IBM and GE) are moving in tandem.
[2] The full story of Hong Kong's successful economic experiment is detailed in chapter 9 of P.J. O'Rourke's *Eat the Rich: A Treatise on Economics*.

A more detailed discussion of stock market correlation, as well as an in-depth analysis of our Microsoft investment follows, but first a review of our performance compared to investable options for the major market indices:

	Q310	YTD	TTM	Cumulative Since 10/06
Grey Owl Opportunity Strategy (net fees)[3]	**7.34%**	**4.24%**	**7.84%**	**18.38%**
Spider Trust S&P 500 (SPY)	11.31%	3.91%	10.18%	-9.77%
iShares MSCI World (ACWI and MXWD)	14.92%	3.10%	7.71%	-3.20%

Why are stocks moving as one?

JP Morgan's October 5th report titled "Why We Have a Correlation Bubble" offers some thoughts. First, they posit we are in a period of high macroeconomic uncertainty (and we are). Government-dictated fiscal and regulatory policies are often blunt instruments that impact hiring and investment decisions across multiple business sectors. Monetary policy can lead to inflation or deflation which impacts the discount rate investors use to value future cash flows of all business (and asset) types. Tax rate uncertainty has the same impact. Monetary policy can also lead to currency stability or instability which makes it easier or harder (respectively) for business owners to make investment decisions and contract with each other for multi-period transactions.

Second, increased availability of index futures and exchange traded funds (ETFs) have made it easier to place "macro" bets. Thus in today's world of macroeconomic uncertainty it is easier for investors to speculate on government policy. And speculate they will: in recent months combined trading in futures and ETFs reached around 140% of cash equity volume or 60% of total equity volume. Clearly, many investors are implementing their macro-theses through these broad market vehicles rather than through individual securities. Correlation follows. If 100% of total equity volume were in S&P 500 index futures and ETFs, stocks would be 100% correlated. It therefore follows that the higher the volume in index trading, the higher the expected correlation.

We would add that the context around a decision and how the decision is framed can have enormous influence on the decision. For instance, uncertainty causes investors to shorten their time horizon. As clarity dissipates, the agency conflict becomes more acute: professional

[3] This is the performance of our "risk" model or opportunity strategy, not the performance of your individual consolidated accounts, which may or may not include a broader mandate. Please refer to performance disclosures found at the end of this letter for additional information.

investors become more worried about (short-term) outcomes as opposed to process (and long-term outcomes) because they want to keep their clients. They no longer have the luxury to think long-term. In reality, it's the short-term that is far more volatile than the long-term. This creates an opportunity for patient investors with patient clients.

Logical or not, these actions create a positive feedback loop. Macroeconomic uncertainty creates a demand for index products. This in turn increases stock correlation. Increased correlation discourages traditional stock pickers. Individual stock trading volume goes down and index volume goes up leading to even greater correlation. In the end though, all bubbles must burst. JP Morgan suggests that stock correlation is a mean-reverting series. The last peak occurred at similar levels of correlation in 1987 with the program-trading driven stock market crash. The last trough occurred in 1999 when everything dot-com soared and old-world, cash-flow businesses were selling at steep discounts.

We agree that correlation will eventually revert to more normalized levels. Over time, a combination of three factors will help facilitate this. First, if correlation remains mean reverting, as JP Morgan suggests, and it is at a very high level now, by definition it will decline at some point. Second, uncertainty about the macroeconomic environment will vary over time. Although we cannot predict what will cause opinions to change, we are quite confident they will not remain the same. Finally, in the long run, individual company cash flows will be the primary determinant of how much value a company creates. Concepts like volatility and correlation can create short-term opportunities over days, weeks, or months, but over quarters and years cold hard cash is what counts. As Ben Graham said, "In the short run the market is a voting machine. In the long run it's a weighing machine." In the meantime, we will work to identify and purchase undervalued securities. This will be even safer if it is equity in companies with strong competitive advantages, rock-solid balance sheets, and an ability to adapt to both technological and macroeconomic changes. Like Microsoft.

Microsoft – The Quintessential Blue Chip

In its 2000 fiscal year, Microsoft earned $0.85 per diluted share and offered no dividend. The stock traded near $60/share implying an earnings multiple over 70x. Today, the stock trades around $24.50 and offers a dividend yield of 2.6%. In its 2010 fiscal year (ended June 30, 2010), the company earned $2.10 per diluted share implying a return on equity of over 40% and an earnings multiple of just 11.7x. This is a 9.5% compounded annual growth rate in earnings during a ten-year period where Microsoft returned most of their earnings to shareholders via buybacks and dividends. In other words, the 9.5% growth required very little incremental capital; all the more impressive given that Microsoft was a 25-year-old company in 2000.

It is instructive to compare these Microsoft data points to the broad market as defined by the S&P 500. The S&P 500 closed the third quarter of 2010 providing a dividend yield of just under 2%. For the full year period ending June 2010, the S&P 500 companies generated $67 in (reported) earnings on $542 of book value for a return on equity of 12% and an earnings multiple of 17x. In other words, Microsoft is over 3x as efficient with its equity as the overall market, yet it trades at a 30% discount to the market.

In reality, the above analysis understates just how efficient a cash machine Microsoft is and how much more efficient it is today compared to ten years ago. In 2000, Microsoft generated $9.4B in net income on $41.4B in shareholder's equity[4] (which included an average cash balance of $20.5B). Therefore, in 2000, Microsoft generated a return on equity less cash[5] of 45%. In 2010, Microsoft was able to generate $18.8B in net income on $46.2B in shareholder's equity (which included an average cash balance of $34.1B) or a return on equity less cash of 155%.

Microsoft is an extraordinarily high return business and therein lies the rub (or at least part of it). Microsoft has a reinvestment problem. We think this is one of two larger issues weighing on the stock. The second issue is the fundamental shift away from personal computer (PC) centric computing to mobile devices and the "cloud." We believe both issues are over-discounted[6] at the current stock price.

With regard to the reinvestment problem, Microsoft has made strides over the past decade and appears as if they may take further steps to optimize their balance sheet and return additional capital to shareholders sooner rather than later. In a recent report, Goldman Sachs highlighted the fact that since 2002, Microsoft returned $148B to investors: $93B via stock repurchases and $55B in dividends including over $30B via a one-time dividend of over $3/share in 2004. To put this in perspective, Microsoft's market capitalization is $210B today. If you were to buy Microsoft in its entirety today and the company returned $148B over the next eight years as it did over the past eight years, your cost basis would be $62B on which Microsoft would be generating well over the $18.8B in net income they generated last year. However, therein lies the second rub. Investors seem to think Microsoft's franchise is at significant risk and they will have a difficult time maintaining, let alone growing, their net income.

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[4] Shareholder's equity is the capital investors have provided to the firm along with any retained earnings (i.e. earnings not paid out as dividends).

[5] We use the concept "shareholder's equity less cash" because, in Microsoft's case, the vast majority of the cash on their balance sheet is "excess" and not required to fund working capital or other aspects of the business. The cash could easily be distributed to shareholders if the company chose to.

[6] By "over-discounted," we mean that investors have (in our opinion) assigned too high a probability or too excessive a damage scenario to the possible event.

Today, Microsoft generates the vast majority of their profit from the Windows and Office franchises. They are, respectively, the operating system and productivity suite used on the vast majority of business and consumer PCs. These franchises are under threat from multiple fronts: tablet PCs and mobile devices with "light" operating systems, processing done at central servers (i.e. the "cloud"), and free applications offered as an Internet-based service to name the most prominent.

Microsoft has beaten back threats before. In the late 90s, Linux was the threat. Today, Linux's share of the desktop operating system market is 1%. Windows' share is 89%. Linux's sever share is 21%, down from 24% in 2005. In 2008, fewer than 10% of netbook computers (the precursor to tablets?) were running Windows operating system. By 2009, the number was 96%. Microsoft has also proven competitive in the online (or "software as a service") market. Windows Live Mail has 360 million users compared to 173 million for Google's Gmail and 284 million of Yahoo! Mail. Xbox Live has 26 million subscribers downloading games and movies and interacting with other members (up from 3 million in mid-2006).

The threats are certainly real, but so is the margin-of-safety in today's stock price. Going forward, Microsoft doesn't need to be the dominant player it was over the past twenty years in order to provide investors with an adequate return. In addition, catalysts abound. We are on the front-end of important product cycles in the core franchises: Windows 7 and Office 2010 were both recently released. Windows 7 is already the fastest selling operating system of all time selling 175 million licenses as of the June 30, 2010 quarter. New areas are beginning to bear fruit: Xbox Live is a clear winner, the Bing search engine is taking market share, and Windows Phone 7 (just launched) has the potential to offer a unique mobile platform with Office and Xbox Live integration. The 4-6 million .NET developers are a very large market for Microsoft's "cloud" development platform (Azure). Finally, a repatriation tax holiday is one of many events that could allow Microsoft to more efficiently return capital to shareholders. Based on the recent debt offering, this is clearly top-of-mind in the executive suite.

We think Microsoft is cheap. By our estimate, the market is pricing in an immediate 3% drop in EBITDA margin and zero sales growth over the next five years. In addition to being cheap, we see Microsoft as a hedge against an uncertain macro environment. Microsoft requires little capital investment, so it won't be subjected to replacing assets at much higher prices if inflation should develop. Likewise, it has little leverage and won't suffer from increasing real interest and principal payments should a deflationary environment set it. In addition, technology is one of the few areas where corporate America is willing to invest – increased productivity is seen as the best way to grow earnings. **Other investors can try and time the macro winds using futures and ETFs. We would rather own individual businesses (Microsoft being just one example) where we understand the underlying business dynamics.**

Market Climate

Uncertainty abounds and all broad asset classes are beginning to look expensive again. Unemployment shows few signs of improvement and business confidence is low, yet the stock market continues to climb the "wall of worry." Frankly, we have little confidence in the economy or in the broad stock market. However, we continue to find pockets of value in out-of-favor names across industries and market capitalizations. Macro uncertainty may continue to drive the market for some time, but eventually the weighing machine will win out. Not everything can stay together forever like Danny and Sandy.

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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