January 20, 2012

"It's déjà vu all over again."

\- Yogi Berra

Dear Client,

2011 was a frustrating year. In late 2010, we outlined an expectation for volatile and range bound markets in an investment guide. Then, in our second quarter 2011 letter, we explored just how fragile the economic recovery has been. Throughout the year, we made the case that "high-quality" companies would outperform the market. High-quality companies were modestly cheap (on an absolute basis) and significantly cheaper than the overall market (on a relative basis). In addition, these companies have far stronger business characteristics than the "market." In the end, high-quality companies outperformed the overall market by a sizeable margin no matter how you look at it.[1] The lowest 2011 return on the various high-quality portfolios we track was 6.79%. Yet, we ended the year with slight underperformance.

In this letter, we discuss our 2011 results and our 2012 game plan. First, our typical performance table as of December 31, 2011[2]:

	Q4	YTD	Cumulative Since 10/06
Grey Owl Opportunity Strategy (net fees)	**6.31%**	**-1.83%**	**22.26%**
Spider Trust S&P 500 (SPY)	11.62%	1.89%	1.72%
iShares MSCI World (ACWI and MXWD)	8.96%	-7.85%	-3.31%

[1] GMO's largest equity strategy, "GMO Quality," returned 10.22% for 2011. (GMO is the $80B institutional investment manager whose insights we often reference and whose accuracy in predicting overall asset class returns on a 7-year basis is almost uncanny. GMO terms firms "high-quality" if they have low leverage, high profit margins, low earnings volatility, and low market beta.) The Morningstar Wide Moat Focus ETN returned 6.79% for 2011. (Firms designated "wide moat" by Morningstar are deemed to have competitive advantages that will allow them to earn returns greater than their cost of capital for a significant amount of time. This is another cut at "high-quality." The focus list is the 20 cheapest wide moat names across all sectors. Interestingly, Morningstar's overall wide moat list performed even better in 2011 than the focus list.) Finally, Credit Suisse's "Better Than Bonds" strategy returned an astounding 21.3% for 2011. (This strategy selected 20 companies based on high dividend yields, low beta, and low leverage.) For comparison, as indicated in our table on page 1, the S&P 500 total return index returned 2.11% for 2011. This quality outperformance was despite the significant correlation between securities that we have highlighted repeatedly.

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

Executive Summary

Despite expecting dull economic growth and market outperformance by high-quality company stocks in 2011, we did not give our own macro analysis enough credence. We expect 2012 to be a lot like 2011: slow economic growth in the US, market volatility driven by political events, and issues in Europe and China (with the potential addition of Japan) continuing to play out. We begin 2012 continuing the portfolio "high-grading" process we started in late 2011. This is not an epic shift in our approach. Rather, it is a reflection of our increased conviction that the "macro" overhang will continue for many years.

2011 Review

Entering the year, we thought we had designed a portfolio strategy to deal with our expectations for a muddling economy, generally extended valuation levels, and the reasonable chance for exogenous shocks coming from Europe, China, or Japan: higher quality names made up the bulk of our portfolio, and we held a significant cash position. However, we also held exposure to really beaten up names that we thought were fully washed out and could provide meaningful upside and/or significant and rapid return of capital because of catalyst(s) or a very high yield. We even added additional investments in this category during the year. To date, six of these ideas have worked, but eight have not. Unfortunate timing and, in two cases, too big positions further tipped the balance against us. In addition, while the market was range bound, as we had anticipated, the range was tighter and whipped more frequently than we ever imagined likely. In fact, from early August through the October 4th market low, there were 10 6% to 10% swings in the S&P 500's price level. The daily volatility in 2011 was so extreme that there were a full 30 days where the percentage gain or loss was greater than 2% (which was the final tally for the year). Thus, we did not trim exposure enough when the cycle was up, nor did we put enough cash to work when the cycle was down.

In aggregate, and as expected, our high-quality holdings performed very well during the year. Our pharmaceutical basket (Abbott Laboratories, Novartis, and Pfizer) showed sizable positive gains. Abbott and Pfizer ended the year up 21.77% and 28.77% respectively, while Novartis was essentially flat. We were net positive on the insurance front with Markel showing nice gains, which more than made up for the fact that Berkshire Hathaway showed a modest loss in value. This was despite steady gains in Berkshire's business fundamentals (detailed in our third quarter letter) and the rally that occurred early in the year after the stock was added to the S&P 500 index. Long-term technology holdings, Microsoft and Western Union, were flat for the year, while second-quarter purchase Lexmark provided a mid-teen return. Rounding out our high-quality holdings, services firm Copart ended the year up 28% while consumer staples juggernaut Proctor & Gamble was up 7%. We did manage to ignore at least half of Warren Buffett's well-placed advice against pruning flowers and watering weeds. Regarding the flowers, early in the year we sold Altria Group and VF Corporation (both of which could be categorized as high-quality companies). The stocks went on to post 27.66% and 50.92% annual gains respectively.

In contrast with the high-quality portfolio returns cited above and our own high-quality holdings, low-quality and more mixed strategies performed poorly. Our own low-quality holdings generated a negative return in aggregate. This appears to be the case across other low-quality portfolios as evidenced by the plethora of traditional "value investors" with negative returns in 2011. Of the 70 investment recommendations made by Barron's round table in early 2011, the average return was -7.6%.[3]

Given its large position size, Transocean had, by far, the biggest negative impact on our portfolio for the year. We missed the opportunity in early 2011 to sell the stock (or at least trim a portion of our holdings) in the low to mid-80s. The thesis we articulated in our second-quarter 2010 letter had, in many ways, played out. Unfortunately, the stock ended the year at $38.39, well below our cost basis and well below the $69.51 price level at the beginning of the year.

We made an error not correctly categorizing the position. As you may recall, on April 20, 2010 an oil rig exploded in the Gulf of Mexico while working the Macondo prospect. The rig was contracted to British Petroleum, but was owned by Transocean. Prior to the Macondo disaster, Transocean was much closer to a high-quality company than a low-quality company. It commanded high profit margins, had low earnings volatility, and for the 10-year period ending in December 2008 had a beta less than the market. It did (and continues to) carry significant debt, which expanded with the GlobalSantaFe acquisition in late 2007.[4] Transocean was not a true "high-quality" company in the GMO parlance, but it was close. (While Transocean had high profit margins, low earnings volatility, and low market beta, it did not have low leverage.) However, after Macondo, which introduced significant earnings volatility, crushed near-term operating margins, and increased the stock's beta[5] to well above the market's, it surely became a low-quality company. The correct response on our part would have been to re-categorize the position as such. This would have had two portfolio management implications: First, it would have limited the position to a smaller holding and required a greater discount to fair value (i.e. margin of safety) than a high-quality holding. Second, we would have managed the position more aggressively by trimming our exposure as the price appreciated. Instead, we continued to think of Transocean as the company we had invested in during 2007, prior to Macondo.

---

[3] The median was -7.8% indicating that one or two large negative outliers did not skew the average.
[4] While tangible assets back the debt, it is debt none-the-less.
[5] Measured against the S&P 500 index.

Of the four attributes used by GMO to define the quality of companies, leverage may deserve a higher weighting than the other three as it can be the most pernicious. In the case of Transocean, their leverage magnified the issue of increased earnings variability that occurred post-Macondo. An ill-timed acquisition and dividend initiation further complicated the situation.[6] Management was forced to issue shares and new debt to fund the acquisition, maintain the dividend, and provide the working capital to manage through the eight to ten quarters it will take to upgrade their fleet to meet new post-Macondo regulations.

With the position now at 4.5% of our portfolio, did we really learn a lesson? At $40/share the stock is close to 40% below our cost basis, trades at ~60% of the net asset value of their drilling-rigs, and is extraordinarily cheap relative to the $9-11/share we believe the company can earn in 2013 or 2014. The dividend provides a 7.5% yield while we wait. Importantly, while still quite levered, the balance sheet is much improved. Debt maturities have been lengthened limiting short-term refinancing risk. Our objective is not to limit volatility at all costs or to "bat a thousand". Attempting either objective will limit long-term returns. The company is far cheaper today than it was in early 2011 and the capital structure is much cleaner. Even though we now categorize Transocean as "low-quality," we think the margin of safety and asset quality warrants a medium size position in Transocean today.

Five other positions round out the bulk of our losses in the "low-quality" category: Advanced Micro Devices (AMD), Apollo Residential Mortgage (not to be confused with Apollo Group discussed below), Diana Containerships, Howard Hughes Corporation, and Sprint-Nextel.[7] While each of these positions was much smaller than Transocean, we should have kept both AMD and Sprint under 2%. We sold our positions in AMD and Sprint in December in an effort to "high-grade" our portfolio, as well as to capture losses for taxable accounts. AMD and Sprint were the best targets for this effort as the companies both stumbled on execution. AMD had production issues at their (formerly captive) Global Foundries manufacturing facilities. In addition, one of their new chips, whose performance was an important component of our thesis, performed worse than expected in some benchmarks. In Sprint's case, management bungled the timing of a large debt issuance, the cost of which lowered our estimate of fair value. Simultaneously, they added confusion to the story by consummating a large deal with Apple for the iPhone. This was on top of their complex network sharing strategy and on-again, off-again relationship with Lightsquared and Clearwire. As with Transocean, we missed the opportunity to trim our Sprint exposure at a ~35% gain in early summer. It is possible we will return (likely in much smaller size) as the stories evolve.

---

[6] Management did not want to suspend the dividend, as changes to dividend policy are very difficult to achieve under Swiss law.
[7] We detailed our investment thesis for Diana and Howard Hughes in our second quarter 2011 letter.

We continue to hold positions in Apollo Mortgage, Diana, and Howard Hughes, all three of which have performed well in the first two weeks of 2012. Apollo Mortgage and Diana were both subject to the micro-cap decimation that occurred in September when the Dow Jones Willshire US Micro-Cap Index was down 11.2% compared to the S&P 500, which was down 6.6%. We consider both of these “show-me” names. Only in the last few months has there been anything for the market to see.

Apollo Mortgage is a new-issue mortgage REIT that is just becoming fully invested and distributing a dividend in line with more established peers. It still trades well below book value, while the majority of mortgage REITs trade right around book. Similarly, Diana is a spin-off and it did not initiate a dividend until late 2011. It is still below their likely 2012 payout rate and is only just now appearing on dividend screens. It is also worth noting that both of these names belong in the low-quality category due to their lack of history. It is entirely possible they emerge as near-high-quality over the next few years. Howard Hughes is doing steady work putting quality real estate assets to work. Unlike Apollo Mortgage and Diana, this remains a “show-me” name and will likely take years to play out. The position is sized correctly (our smallest), management continues to execute, and there is little debt to cause issues.

We did manage a few winners in the low-quality space. Range Resources being our biggest contributor to positive portfolio performance. Genzyme, SLM Corporation, and Sun Healthcare Group provided solid results as well. We trimmed our exposure to Range near its 2011 peak and have exited all of the other positions.

In the “other” category, <u>formerly</u> high-quality[8], proprietary education names showed a modest, net gain in aggregate. We continued to “trade-around” this position throughout the year and ended 2011 holding only two names: Apollo Group (our original entry into the space) now just a few percent away from our original purchase price after an admittedly painful ride; and Bridgepoint Education which ended the year up almost 50% from our purchase price. Mortgage REIT Annaly Capital Management (a several year holding) provided a solid return. We closed this position late in the year as the SEC initiated a comment period regarding mortgage REITs’ exemption from the Investment Company Act of 1940, as well as the continued swirling rumors about the potential for a large-scale mortgage-refinancing plan and whether it could be issued by executive branch fiat. Given our history with the proprietary education companies, we are highly sensitized to the impact Washington, DC can have on portfolio holdings. That being said, after selling Annaly at a slight premium to book value, we did initiate a much smaller position in Apollo Residential Mortgage (discussed above) at a significant

[8] Using the four-pronged GMO criteria, the proprietary education names were, but no longer are high-quality. While the majority of these companies have very low leverage and high profit margins, their earnings volatility and beta both became very high after the Department of Education initiated a rule change process regarding industry regulations and the opinions of vocal short-sellers became front-page headlines.

discount to book and thus a much greater margin of safety. Rounding out the "other" category, the few bonds we owned, largely as cash surrogates, performed as expected.

Lessons Learned

While we believe the core of our investment process is immutable and eternal, each environment is different. A stock will always be a piece of a real business and the intrinsic value will always be the discounted stream of future cash flows. However, in some environments it does not pay to invest in companies whose future cash flows have a wider range of possibilities. The economic environment (real world volatility) makes it much harder for these companies to hit the upper end of their potential cash flow range AND market volatility makes it less likely investors will give the company the benefit of the doubt before execution is complete. This is especially true when the market is several years into a bull-market rally. At this stage in the market cycle, the number of stocks participating in rallies typically becomes fewer and high-quality companies tend to outperform.

We are now engaged in an effort to label investments as either high-quality or low-quality using GMO's four criteria and to revisit these categorizations on both a regular basis (e.g. quarterly) and also as the individual business changes. While our estimation of the variability of outcomes and the margin of safety have always informed our position sizing this has been somewhat qualitative. There will always be a qualitative aspect to portfolio management, but this new procedure should add an additional level of rigorous risk-management to our already conservative process.

We are currently devoting more research time to looking for investment opportunities in high-quality companies. We expect this type of investment will continue to outperform as we discuss in our 2012 roadmap below. Importantly, this type of investment has the added benefit of being able to compound tax-free for long periods of time and does not incur the tax and trading "friction" that is inherent in well-managed, lower-quality positions.

2012 Roadmap

Despite the new year, our outlook has hardly changed. The United States is likely teetering on the edge of a recession supported only by significant government debt and massive transfer payments (social security, government medical insurance, unemployment insurance, food stamps, etc.). As Carmen Reinhart and Kenneth Rogoff clearly point out in their book, This Time Is Different, there are no historical examples of credit-induced recessions that are not followed by a five to ten-year period of very slow growth as deleveraging occurred. We are in a "Reinhart-Rogoff" economy. In addition, politics will likely continue their influence on both the US economy and the markets. The outcome of the November election has the potential to affect tax rates, dollar policy, and the federal deficit greatly. Empirical evidence shows these items have significant impact on stock market returns.[9] When it is not US politics driving the market environment, the rest of the world will provide plenty of fodder. Europe and China are top of the news now and present real risks to the global economy, as well as to investment securities. We discussed both of these issues in our fourth quarter 2010 letter. In that same letter, we also discussed the risks posed by Japan's budget deficit and demographic shifts. This does not appear to be on many investors' radar today. It could be the surprise of 2012.

We continue high grading the portfolio; a process we began in earnest late in 2011. Despite 2011's outperformance, US High Quality is cheaper today than it was in December 2011.[10] We will still hold some "show-me" names of lower quality, but they will be smaller positions and we will require them to be even cheaper before initiating a position. We believe many of the remaining low-quality names in our portfolio have become "coiled springs" after 2011's sell-off. We have also begun to use short-term, high-yield debt securities to augment our cash position. Given the environment, we want to maintain liquidity, but like the idea of achieving yields above 0%.

<u>None of this constitutes an epic shift in our approach. Rather, it is a reflection of the current economic situation and our increased belief that this "macro" overhang will influence security returns for several years to come.</u>

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

---

[9] Economic consulting firm, H.C. Wainwright & Co. Economics Inc. has developed a proprietary model from nine decades of data that demonstrates significant equity market outperformance when the budget deficit shrinks, the dollar is stable relative to gold, the top marginal income tax rate decreases, and bank reserves grow less than average. Equity markets perform poorly when the opposite is the case.

[10] On December 31, 2010, GMO's 7-Year Asset Class Return Forecast estimated US High Quality stocks would provide an annual real rate of return of 4.9%. As of December 31, 2011, the expectation has increased to 5.3%.

This newsletter contains general information that is not suitable for everyone. The information contained herein should not be construed as personalized investment advice. Past performance is no guarantee of future results. There is no guarantee that the views and opinions expressed in this newsletter will come to pass. Investing in the stock market involves the potential for gains and the risk of losses and may not be suitable for all investors. Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. Any information prepared by any unaffiliated third party, whether linked to this newsletter or incorporated herein, is included for informational purposes only, and no representation is made as to the accuracy, timeliness, suitability, completeness, or relevance of that information.

The securities discussed above were holdings during the year ended December 31, 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 either new purchases or significant holdings (relative to position size) 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.

Grey Owl Capital Management, LLC (“Grey Owl”) is an SEC registered investment adviser with its principal place of business in the Commonwealth of Virginia. Grey Owl and its representatives are in compliance with the current notice filing requirements imposed upon registered investment advisers by those states in which Grey Owl maintains clients. Grey Owl may only transact business in those states in which it is notice filed, or qualifies for an exemption or exclusion from notice filing requirements. This newsletter is limited to the dissemination of general information pertaining to its investment advisory services. Any subsequent, direct communication by Grey Owl with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of Grey Owl, please contact Grey Owl or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov).

For additional information about Grey Owl, including fees and services, send for our disclosure statement as set forth on Form ADV using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

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.