



January 28, 2010

*“Speculators often prosper through ignorance; it is a cliché that in a roaring bull market knowledge is superfluous and experience is a handicap. But the typical experience of the speculator is one of temporary profit and ultimate loss.”*

- Benjamin Graham

Dear Client,

2010 proved to be an “ok” year for the Grey Owl Opportunity Strategy. Our strategy provided a total return, net of fees, of 9.67%. From our perspective, this is a fine absolute return, though by no means record book worthy. On the other hand, compared to the 15.06% return generated by the S&P 500<sup>1</sup>, our performance admittedly looks anemic on a relative basis.

While we always work to improve both our absolute and relative performance, we remain proud of two important facts. First, since inception in October 2006, our strategy has significantly outperformed the S&P 500 with a cumulative return of 24.55% vs. -0.06%. While this is not a complete market cycle<sup>2</sup>, four years and a few months is a much more reasonable time-period over which to assess performance. Second, while we underperformed in 2010 on a relative basis, we did so with far less risk than the S&P 500. During the year, our strategy’s asset allocation averaged over 33% in cash. Additionally, our investments were in higher quality companies (i.e. companies with lower beta and higher return on equity profiles than the market). Our process remains focused first on preservation of capital.

A more detailed discussion of our investment process in the context of 2010 and the current market environment follows. In addition, it has been over six months since we first articulated our proprietary (or for-profit) education investment thesis in our [second quarter letter](#) and on the website [Seeking Alpha](#). Over that time, the controversy has swelled and so has our position

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<sup>1</sup> More specifically the SPY S&P 500 Index ETF.

<sup>2</sup> A full market cycle would be from peak to peak or trough to trough. We began tracking our strategy in the middle of the previous bull-market and we will not be able to identify where we are in the current bull-market until we reach a peak and the bear-market phase begins.

size. Therefore, we will take some time to describe how our thinking has evolved and how this has played out in our portfolio management. First, our typical performance table<sup>3</sup>:

	<u>Q410</u>	<u>YTD</u>	<u>Cumulative Since 10/06</u>
<b>Grey Owl Opportunity Strategy (net fees)</b>	<b>5.21%</b>	<b>9.67%</b>	<b>24.55%</b>
Spider Trust S&P 500 (SPY)	10.76%	15.06%	-0.17%
iShares MSCI World (ACWI and MXWD)	9.38%	12.77%	5.15%

### The 2010 Roller Coaster

Despite a strong gain from the beginning of the year to the end, equity markets did not move in one direction. After a brief dip in February, the S&P 500 regained its 2009 momentum and rallied through the end of April as the economy showed signs of modest improvement. Then, on April 27<sup>th</sup>, Standard & Poor's downgraded Greek government debt to a "junk" rating. This set off a panic across world debt and equity markets. Investor sentiment instantly switched to "risk off" and the panic reached an apex on May 6<sup>th</sup> with the "flash crash." However, the market continued to sell off through the end of August. Despite the rally early in the year, between January 1<sup>st</sup> and August 31<sup>st</sup> the S&P 500 was down 4.62% including dividends reinvested. Conservative strategies, including our own, outperformed.

Then, on August 27<sup>th</sup>, Federal Reserve Chairman Ben Bernanke spoke at the annual Jackson Hole symposium. In [that speech](#), Chairman Bernanke made three important statements. First, he indicated that the Federal Open Market Committee (FOMC) believed that economic growth, while still positive, was slowing in the first half of 2010. Second, he went on to enumerate the full set of tools still available to the FOMC to further ease monetary policy (despite what was already some of the easiest monetary policy in US history with short rates at the zero bound). Most importantly, he said the FOMC would "strongly resist deviations from price stability in the downward direction." To say investor sentiment changed again would be a significant understatement.

From August 31<sup>st</sup> through December 31<sup>st</sup>, the S&P 500 rallied 20.64%. More importantly, lower quality securities significantly outperformed higher quality securities. The S&P 500 Low Quality Rankings Index was up 28.16%, while the S&P 500 High Quality Rankings Index was up only 18.42% over the same period.<sup>4</sup> Conservative strategies, including our own, underperformed.

<sup>3</sup> For more information regarding performance, please refer to the performance disclosure at the end of this letter.

<sup>4</sup> These simple price returns do not include dividends.

In the context of the 2010 market environment just described it is easy to perform a back-of-the-envelope attribution to explain our approximately 5% of underperformance. Simply, our average cash balance of 33% could explain the entire difference. However, we expect to be able to beat the market over longer periods through stock picking even if we carry large cash positions. Therefore, it is worth considering two other factors. First, while we do own some names with leveraged balance sheets and more cyclical earnings profiles, the majority of our portfolio is of much higher quality than the market and certainly of far higher quality than the S&P 500 Low Quality Rankings Index that rocketed higher over the last four months of the year.<sup>5</sup> We are satisfied with this outcome because history shows that during market corrections quality goes down far less than junk.<sup>6</sup> Quality also outperforms in the long run.<sup>7</sup> Second, our exposure to the proprietary education space was a significant drag on performance. Despite this, we remain optimistic about our holdings in this space and believe these investments will provide solid returns over their life.

### **An Update on our Proprietary Education Thesis and a Case Study in our Portfolio Management Process**

Our investment in the proprietary education sector has proven to be one of the most volatile that we have made. In addition, while all investments involve uncertainty, in this case the uncertainty has lingered and in some ways expanded. We thought a chronological review of the investment would be helpful for clients to understand both our analysis of the idea, as well as how we approach portfolio management to minimize our downside and allow for poor timing and an evolving landscape. What follows is lengthy and probably a bit tedious. We will not blame you if you cut to the chase by skipping to the last two paragraphs in this section.

We first purchased shares of Apollo Group (APOL) on March 5, 2010 at just over \$62/share. At the time, it made up a 4% position in our portfolio. The Department of Education had proposed enhanced regulations in February putting pressure on the entire universe of proprietary education names. In addition, an SEC inquiry into revenue recognition practices at APOL had caused the stock to trade down more than the other names in the space. After significant

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<sup>5</sup> As of 12/31/10 our portfolio had a beta of 0.82, a debt/EBITDA ratio equivalent to the S&P 500, much higher return on equity of 29.51% compared to the S&P 500 at 21.48%, and a five-year average profit margin slightly lower than the S&P 500. In calculating debt/EBITDA we excluded two holdings that have high leverage but whose assets are backed by a government guarantee: Annaly Capital Management, Inc. and SLM, Inc.

<sup>6</sup> William Hester of Hussman Funds makes this point in detail in his December 2008 piece "[Low Quality's Round Trip](#)." He presents a graph that shows that from the beginning of 2008 through the article's publication in mid-December stocks rated C for quality by S&P were down 75% compared to those rated A+ which were down a bit more than 30%.

<sup>7</sup> In "[The Case for Quality – The Danger of Junk](#)," GMO shows that from 1980 through 2003, every form of quality outperformed riskier stocks. They provide a logical explanation: "As a result of a casino mentality in the stock market, risky stocks are generally overpriced because investors are trying to own the next big thing, be it a Starbucks or an EBay. The tantalizing prospect of generating stratospheric returns from a small investment seems to blind people to the overwhelming probability of loss. Similarly, investors tend to underpay for less risky stocks because these companies do not offer the theoretical possibility to shoot the lights out with one great stock selection."

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research, we became confident that the market was over-discounting<sup>8</sup> both the potential impact and likelihood of enactment of the regulations. We were also confident that a resolution of the SEC inquiry would have no impact on valuation.

On April 28<sup>th</sup>, Robert Shireman, the then-Deputy Undersecretary of Education, gave a [speech](#) in which he read statistics demonstrating the growth in proprietary education. He followed these data points by arguing that the existing accreditation system is not capable of adequately overseeing the proprietary education sector. He also argued in favor of a much more rigorous definition of gainful employment. The next day the sector sold off by ~5% on average. The sector continued to sell off through mid-May when we decided to increase our APOL position, bringing it up to just under 5% of our portfolio.

This is typical of our process. We often take a position in a name when there is still significant uncertainty. Sometimes the stock will continue to sell off. At this point, we re-examine our thesis and often do additional work. If we are still confident in our thesis and are comfortable with the position's impact on our overall portfolio risk, we will buy more. In the case of APOL, Shireman's speech presented no new information. It merely shifted investor sentiment, creating an opportunity for us to buy more of a business we liked at a cheaper price.

Little did we know, the negative news would begin to cascade. On May 5<sup>th</sup>, the PBS show *Frontline* aired a negative exposé on the industry. Steve Eisman presented his now infamous short thesis at an investment conference on May 26<sup>th</sup>. From there, negative articles followed in numerous publications. The summer gave way to hostile Senate hearings on June 24<sup>th</sup> and August 4<sup>th</sup>. The August 4<sup>th</sup> hearing presented a Government Accountability Office (GAO) audit of the enrollment practices of a number of proprietary schools. (The GAO audit was later subject to significant corrections in the proprietary schools' favor.) Each of these events caused further sell-off in the stocks.

Every negative analysis we reviewed was based on anecdotes and data taken out of context. To simplify and summarize, while it was possible to present graduates of proprietary schools who are unable to find jobs or payback debt, it is also possible to find graduates of prestigious private schools in the same situation. The *New York Times* did just that in an [article](#) that described a 26-year-old New York University graduate with over \$100,000 in debt. Regarding the data, it is not correct to say that the proprietary schools are costing tax payers more per student educated than traditional private or public institutions. These analyses leave out the fact that public and private schools receive significant direct grants and that proprietary schools pay significant corporate taxes.

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<sup>8</sup> In our opinion, the market price for APOL factored in too negative a scenario compared to a probabilistically weighted set of outcomes based on our assessment of the situation.

After the sell-off caused by the second Senate hearing, we took the opportunity to add again and, this time, diversify our theme. In early August, we purchased shares in Bridgepoint Education (BPI), a smaller, online-only educator that has the potential to grow at a much faster rate than APOL. By the middle of September, APOL and BPI made up 8.7% of our portfolio.

We typically make investments in specific companies that we believe to be cheap on an absolute basis, but also relative to others in the same industry because of unique company issues. In this case, the entire proprietary education industry was under pressure and more than one name was cheap. Adding an additional name to our investment allowed us to diversify from some company-specific risk while still averaging down our cost basis in the idea.

We purchased our last positions in this theme in the middle of October after APOL announced earnings and indicated that enrollment growth would slow significantly in the near-term as they introduced a free three-week orientation program designed to weed out unqualified students. Again, the news caused a broad-based sell-off across the industry. This time, we were able to further diversify our basket of stocks and significantly upgrade our portfolio. At this point, the highest quality names<sup>9</sup> in the space, Capella Education (CPLA), Devry Inc. (DV), and Strayer Education (STRA) were sufficiently cheap that we were willing to buy them too. When we finished buying, we owned a diversified basket of proprietary education names that made up just under 13% of our portfolio.

While we ended the year with our original APOL purchase down -37%, the basket of five names, thought of as a single investment, was up just shy of 0.5%. Our goal with your money and ours is clearly not just to break even. However, it is critical from a portfolio management perspective to be able to adapt to a changing market environment. We began with a meaningful position, but not one that was so big that it could not be expanded. As the market environment offered us an even more compelling risk/return proposition, we had dry powder and used it to expand the position.

The regulatory overhang still remains. In addition, the negative headlines have had a clear impact on enrollment – some potential students have been discouraged from enrolling. Both of these issues have worked to extend the time it will take for us to realize value from this investment. When we first made our investment, we expected the regulatory issue to be resolved by November, as that was the Department of Education's stated timeline. It has been continually extended. In addition, we did not anticipate the wave of negative publicity that has accompanied the regulatory process and in some ways was fed by a loud contingent of short-

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<sup>9</sup> CPLA, DV, and STRA each have a better program mix, with more advanced degree candidates, as well as lower historic cohort default rates (CDRs) than APOL and BPI.

sellers who have profited from the companies' loss of value. To some extent, they created a self-fulfilling prophecy with their PR and lobbying efforts.<sup>10</sup>

As a group, the proprietary education basket is the largest holding in our portfolio. We should reiterate that from the beginning we believed that the "gainful employment" regulation would have an impact on these companies' growth rates and margins. We also believed growth would slow due to the law of large numbers. We were surprised by the extent of the negative press and the impact it has had more recently on enrollment growth. In that way, the story has changed since our initial investment. But so has our average purchase price – significantly. Today, if APOL had 0% growth for the next 5 years and EBITDA margins went from 31% in 2010 to 22% immediately, we still think it is worth almost \$60/share.

The above case study is characteristic of our investment approach. We attempt to buy into ideas with a sufficient margin of safety and very low expectations for future company performance improvements embedded in our purchase price. In addition, for ideas where very high uncertainty abounds, we look to size our initial position in order to leave room to layer in additional exposure should our timing prove poor or the landscape evolve to our detriment. In the case of the proprietary education names, this conservative approach leaves our overall position currently break-even despite all of the negative news and the real impact this has had on enrollments.

Significant uncertainty remains and we acknowledge that our more positive outlook on the sector could prove too optimistic. However, we believe the worst is more than priced in as demonstrated above with our back-of-the-envelope calculation of APOL's intrinsic value in a scenario where there is no revenue growth and greatly compressed margins.

### **Why We Remain Conservatively Positioned**

In spite of Chairman Bernanke's clear objective to put a floor on asset prices, including equities<sup>11</sup>, we remain conservatively positioned. As we have articulated in past letters, broad equity and credit markets appear meaningfully overvalued. In addition, with the United States and most other developed-market economies significantly more leveraged than in the last fifty years, economic growth will likely be more volatile going forward. If that were not enough, there is almost an unending list of potential exogenous forces that could negatively influence public markets: over-leveraged municipalities, the PIIGS, and continued issues in the US housing

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<sup>10</sup> See the Wall Street Journal's [A 'Short' Plays Washington](#) for a detailed description of the role Mr. Eisman played in Senate hearings.

<sup>11</sup> As a follow-up to the start of the second round of long-term government bond purchases (QEII), Chairman Bernanke published an op-ed piece in the [November 4<sup>th</sup> edition of the Washington Post](#) in which he wrote, "And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

market to name a few. Finally, there is absolutely no evidence that monetary policy can create real growth. The historical precedent is that loose monetary policy leads to bubbles that eventually pop.<sup>12</sup>

Our goal when investing is to permanently increase our capital through steady growth. The miracle of compounding will work in our favor, but only if we can avoid the viciousness of negative return periods. Below is a chart that we show in our marketing overview. It highlights two critical points. First, the average annual growth rate is not necessarily the compound annual growth rate. In the case of the “volatile results” row in the table below, the compound annual growth rate is significantly less than the average annual growth rate. Second, modest smooth returns significantly beat big positive returns followed by big negative returns.

### Smooth and Volatile Returns Compared

	Year 1	Year 2	Year 3	Year 4	Year 5	Average Annual Growth Rate	Compound Annual Growth Rate	Compound Growth Rate
Smooth Results	10%	10%	10%	10%	10%	<b>10%</b>	<b>10%</b>	<b>61%</b>
Volatile Results	50%	-30%	50%	-30%	10%	<b>10%</b>	<b>3.9%</b>	<b>21%</b>

In conclusion, we are willing to miss big market gains when history tells us they will be transitory. We trust that time will show Ben Graham correct yet again.

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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<sup>12</sup> The two most recent are the internet bubble and the housing bubble.

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The performance information presented in the table on page 2 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 transaction 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](http://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.