GREY OWL
CAPITAL MANAGEMENT

January 25, 2013

"I will gladly pay you Tuesday for a hamburger today."
- J. Wellington Wimpy

Dear Client,

During the second half of 2012, central banks turned their massive and coordinated monetary intervention "up to eleven."[1] This is the overwhelmingly dominant economic and market force today. Despite the long-term consequences (which are very real), we believe the central bankers' commitment is steadfast. It has and will likely continue to mute both real economic and financial market volatility (at the expense of long-term growth). Hamburgers do not provide the nourishment that salads do, but they do provide a burst of energy. In the economic sense, it now appears Tuesday is a long-way off. Given this backdrop, we became increasingly more invested (i.e. we are holding less cash) as 2012 progressed and will continue to do the same into 2013. A deeper analysis of what has changed, our assessment of the impact, and our portfolio response follows.

Here is the standard performance table for Grey Owl Opportunity Strategy as of December 31, 2012[2]:

	Q4	YTD	Cumulative Since 10/06
Grey Owl Opportunity Strategy (net fees)	**-1.03%**	**7.38%**	**31.28%**
Spider Trust S&P 500 (SPY)	-.38%	15.99%	18.01%
iShares MSCI World (ACWI and MXWD)	4.00%	16.78%	12.91%

[1] From *This is Spinal Tap*. http://en.wikipedia.org/wiki/Up_to_eleven
[2] For more information regarding performance, please refer to the performance disclosure at the end of this letter.

In our last quarterly letter, we emphasized the staggering degree of central bank monetary intervention, not only in the US, but also in the UK, Europe, and Japan. In the US, the Federal Reserve is now on a path to expand their balance sheet by $85 billion per month (or just over $1 trillion annually) indefinitely.[3] This is after already expanding it from $850 billion in 2007 to $2.6 trillion last year. The current targeted increase will be a growth rate of almost 40% this year. In addition, cash continues to yield nothing due to the Fed's "zero interest rate policy" (or ZIRP).

Some have stated that the Fed is no longer just a referee, but has become a financial market player. In fact, while they are buying $85 billion worth of financial assets each month, they are the biggest, fastest, and strongest player on the field and they are dominating the game. Frequent readers of our letters are familiar with our belief that the US economy is significantly out of balance. Despite that, the sheer magnitude of the Fed's intervention has caused us to become increasingly more constructive regarding common stocks as a broad asset class.

The concerns we have expressed in different ways over the past few years are by no means gone. The economy remains in disequilibrium. The housing market has still not cleared (though it is getting better as time heals all wounds). The federal government still runs unsustainable deficits. Interest rates remain artificially low. Business investment is too low to provide the historical 3% GDP growth everyone continues to expect prospectively and too low to improve the employment situation. Real personal income growth is stagnant. The situation in Japan and Europe is similar and probably worse. China is likely in the late stages of a credit bubble. However, the Fed's intervention has had numerous effects on the underlying economy and on financial markets to the point that the above concerns are being overwhelmed. Importantly, there is no visible near-term catalyst to change that.

Acting as the single largest buyer of government securities, the Fed is driving/holding down interest rates on longer-term Treasuries. This limits/prevents the market (i.e. the "bond market vigilantes") from imposing discipline on the Congress to control federal spending. Despite the over $16 trillion federal debt, the cost to fund it is manageable in the context of the $4 trillion annual federal budget given the Fed-supplied low interest rates. The lack of forced spending restraint enables Congress to provide $2.4 trillion in transfer payments[4] annually (or 17% of the $13.5 trillion in total personal income).[5] This in turn provides artificial support for consumer spending (despite stagnant real income) which contributes, along with low interest payments, to wider (than the historical average) corporate profit margins. Additionally, the Fed's buying of mortgage backed securities ($40 billion of the $85 billion monthly asset purchases) serves to

[3] To purchase the assets, the Fed creates newly issued liabilities. Some refer to this as "money printing."
[4] This includes unemployment insurance, social security (old-age, survivors, and disability), Medicare, Medicaid, and veterans' benefits.
[5] http://www.bea.gov/newsreleases/national/pi/2012/pdf/pi1112.pdf

narrow credit spreads[6] further lowering mortgage rates for home buyers. This makes houses more affordable, and it has probably helped to clear some areas of the housing market. Finally, low interest rates allow subpar businesses to survive, limiting the economic volatility that bankruptcies cause.

From our vantage point, there is a significant cost to this approach. As the federal government commands a larger share of the economy, the more efficient private sector experiences a "crowding out."[7] The Fed's balance sheet expansion will eventually lead to inflation and thus malinvestment. This slows the economy's long-term growth rate leaving us all poorer than we otherwise would be. However, in the near-term, economic cyclicality is muted and thus recessions, a typical catalyst for equity market corrections, are less frequent. Given the current policy approach, slower but smoother economic growth is a likely outcome – almost a certainty.

In addition to influencing the "real economy," the Fed has had significant influence on financial markets. Writing in the January 7, 2013 edition of the Financial Times, Pimco's CEO Mohamed El-Erian put it this way, "The investment recommendations made by many financial commentators are now dominated by cross-asset class relative valuation rather than the fundamentals of the investment itself. A typical refrain runs something like this: buy X because it is cheaper than other things out there." Given the manipulation that has occurred, seemingly safe securities can be quite dangerous. This is certainly the case with very low-yielding, long-dated Treasury bonds. The day after El-Erian's piece, a headline in the Wall Street Journal read "Long Treasurys Wipe Out a Year's Worth of Yield in One Week." This is why Jim Grant has referred to Treasury bonds as "return free risk." Today, this is also the case with cash as it provides a negative real (i.e. after inflation) rate of return. [8]

While the relative valuation argument is certainly an important one, there is also an argument that long-term financial repression can actually change absolute fair value. The analysis behind this statement delves too far into financial jargon to include in this letter (yes, even further than we have already gone).[9] Nevertheless, the conclusion is that if the current "financial repression" [10] continues for years, the 1500-level on the S&P 500 is probably reasonable.

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[6] The difference between the interest rate on a "risk-free" Treasury bond and a risky corporate or agency bond.

[7] This is not a political statement. See HC SASr-0612 research summary: "Why federal government "stimulus" doesn't stimulate" for empirical evidence.

[8] Real returns are after inflation. The return on short term cash is now 0.25% and the January 2013 consumer price index (inflation) report showed year over year inflation was 1.7%. This implies a -1.45% rate of return on "cash."

[9] Refer to James Montier's "The 13th Labour of Hercules: Capital Preservation in the Age of Financial Repression" for the details. Midway through the article he summarizes the key point: "The price of your equities is determined by the flow of dividends… and the discount rate… It should be clear that a policy of financial repression in and of itself has no impact upon the cashflows/dividends. In contrast, if you base your discount rate on another rate such as the government bond yield plus an equity risk premium, then it will clearly be affected by the policy of financial repression."

[10] Financial repression refers to the Fed's actions to keep interest rates artificially low and punish risk-averse savers.

We should also note that while the US economic system today has more leverage than it did in 2006, the leverage today is quite different. We have argued that excessive leverage leads to increased volatility. However, when the leverage is on the government's balance sheet and denominated in the sovereign currency, that may not be the case. As El-Erian goes on to write, "Unlike private sector institutions, it is hard to force a central bank to delever without some dramatic combination of exchange rate, inflationary and political pressure." So, not only is a (significant) economic contraction less likely in the near-term, volatility from excessive leverage is also less likely. This is another argument for slower, smoother growth for the time being.

Prior Fed action was episodic and, frankly, we underestimated the political will for the Fed to continue to re-up. We also underestimated the will of Congress (and the will of the people to enable Congress) to deficit spend at such extreme levels. With the introduction of QEU (quantitative easing unlimited) and the outcome of the November elections decided, we expect the current scenario of massive monetary intervention and significant fiscal deficits to continue for at least the next year.

With that backdrop, we face an interesting decision. We can hold a larger-than-typical cash position (which we have), waiting for the monetary manipulation and fiscal imbalances to cause market dislocations (as they eventually will). Alternatively, we can increase our exposure to the common stocks of great businesses. These businesses are earning real returns today and, of equal importance, have the financial and business flexibility to navigate difficult economic environments. They will certainly experience more market volatility than cash and we would typically like to make purchases with a wider "margin of safety," but the alternative of negative real returns in cash is worse. This is particularly true the longer the "financial repression" continues.

With thirty one individual securities in our portfolio today, we are not (nor have we been) at a loss to find select, individual securities with strong business franchises trading below fair value and offering (based on our best assessment) prospective returns in the low to mid teens. We have chosen to "hedge" our exposure to these individual equities by holding cash. If the broad equity market was overvalued and the economy was on artificial support, we wanted the cash available in order to take advantage of likely dislocations. Today, our analysis says that the value of holding this cash is lower than in the past few years. Dislocations are a little bit less likely (at least in the nearer-term). Our typical "risk" account ended 2011 with 68% equity, 2% short-term, "high-yield" bonds, and 30% cash. At the end of 2012 the mix was 76% equity, 7% short-term, "high-yield" bonds, and 17% cash. We will likely add further to our equity exposure over the next few months.

We are not conceding the point that monetary policy can create real growth. If it could, you would also be able to make a pizza bigger by cutting it into twelve slices instead of eight. We have stated before that this is a fallacy and our position has not changed. However, the real economy will find ways to grow despite (not because of) government intervention be it regulatory, fiscal crowding-out, or monetary.

All of that stated, we are not of the mind that modest, near-term volatility is impossible. On the fiscal side of the political front, three significant events, set to occur in the next few months, could cause modest dislocation in asset markets:

1. Between mid-February and early-March, the Treasury's extraordinary debt measures will run out and the Federal Government will no longer be able to borrow money to fund the ongoing deficit unless Congress votes to allow the government to take on additional debt. As we write, the GOP appears set to propose a bill that would increase the debt ceiling enough to fund the government through mid-May or early-June.
2. On March 1st, the federal government budget sequester will begin. This was set to occur on January 1st, but was pushed out two months as part of the "fiscal cliff" deal reached on New Year's Eve.
3. On March 27th, the federal government's "stop-gap spending measures" will expire, requiring Congress to pass new legislation appropriating spending for the second half of the 2013 fiscal year. (Remember, the Senate has not passed a budget since 2009 and thus the current budget was authorized as a six-month "extension" to get "us" through the November election and into the new Congress' term.)

Additionally, our analysis should not be construed as confidence in Mr. Bernanke or in the US Congress. In fact, it is the opposite. There will be unintended consequences and there will be black swans because of the market manipulation. However, the businesses we own via public market equity securities are adaptive entities with very strong financial characteristics. Our results could follow a range of possible outcomes, but they will not be a binary bet on the success or failure of the Fed. At this point, too large an allocation to cash might prove to be a bet on Fed failure. More likely, the performance of the underlying businesses will determine our results.

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

The securities discussed above were holdings during the last quarter. 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.

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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.