April 26, 2013

> *"Come writers and critics who prophesize with your pen*
> *And keep your eyes wide the chance won't come again*
> *And don't speak too soon for the wheel's still in spin*
> *And there's no tellin' who that it's namin'*
> *For the loser now will be later to win*
> *For the times they are a-changin'."*
>
> \- Bob Dylan

Dear Client,

In his April 2013 commentary, PIMCO's Bill Gross wrote, "PIMCO's epoch[1], Berkshire Hathaway's epoch, Peter Lynch's epoch, all occurred or have occurred within an epoch of credit expansion … What if an epoch changes? What if perpetual credit expansion and its fertilization of asset prices and returns are substantially altered? … What if a future epoch favors lower than index carry or continual bouts of 2008 Lehmanesque volatility …?" In other words, the investment approaches that worked from the late 1970s until the 2000s (buy-and-hold, long only, selling volatility, etc.[2]) might not continue to work in the next epoch. Given considerable developed-market debt levels, massive central bank interventions, and high, across-the-board asset valuations, one should consider whether an epoch shift has occurred (or is about to). Prudent investors will acknowledge this possibility.

In this letter, we will expand on the epoch idea, discuss the current investment environment, comment on the gold selloff, and provide rationale for some of our most recent sell actions. First, here is the standard performance table for Grey Owl Opportunity Strategy as of March 31, 2013[3]:

	Q1	TTM	Cumulative Since 10/06
Grey Owl Opportunity Strategy (net fees)	**7.86%**	**7.17%**	**41.61%**
Spider Trust S&P 500 (SPY)	10.50%	13.74%	30.40%
iShares MSCI World (ACWI and MXWD)	5.55%	10.13%	19.18%

[1] "Epoch: a particular period of time marked by distinctive features, events, etc." Dictionary.com
[2] "Buy-and-hold" refers to investing in a security and holding it for years if not forever. "Long only" refers to an investment strategy that is not hedged, is usually fully invested, and thus tends to move with the overall market over shorter periods. "Selling volatility" refers to collecting a premium for assuming the obligation and therefore risk of acquiring an asset if prices change significantly.
[3] For more information regarding performance, please refer to the performance disclosure at the end of this letter.

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<u>Shifting Investment Epochs?</u>

The 1980 to 2000 investment period began with low(er) national debt levels, low price to earnings ratios for equities, and high yields on fixed income. Those twenty years saw robust economic growth, strong equity and fixed income returns, and significant growth in the national debt.

The 'naughts[4] brought slower economic growth. Each dollar of incremental debt proved less and less productive. Two major equity market corrections ensued, yet the bull market in bonds continued. A new bull market in gold began. In many ways, it appears that a new epoch arose with the crash of the telecom, media, and technology (TMT) bubble in 2000. The S&P 500 ended 1999 at 1469 and is now only around 1550 over twelve years later. On the other hand, debt levels were still able to grow from already lofty heights. At least on that count, the old paradigm has persisted. Perhaps the 'naughts were just an extended "critical point" and we are on the verge of a more dramatic and complete "phase transition."[5]

If we are on the brink, or already in the midst, of a shift to a new investment climate epoch, what are the potential scenarios?

1. **Grow our way out.** In this ideal situation (really the best on a menu of bad choices), the economy would grow in the high single digits. Over a five to ten year period, debt as a percentage of GDP would decline from the high-300s to the mid-100s. Gold would perform well in real (i.e. after inflation) terms and equities would perform well in nominal (i.e. before inflation) terms (over the full period, not necessarily consistently). Bridgewater's Ray Dalio describes this as a "beautiful deleveraging."

2. **Stagflationary[6], muddling, sideways economy and market, with frequent spurts of volatility.** This scenario does not really get us to a new starting point for another 1980-2000 type strong economy and security bull market. (Or, if it does, it will take a <u>really</u> long time.) Rather, it is a long, drawn-out, holding period. Federal government transfer payments (i.e. food stamps, social security old-age and disability, Medicare, Medicaid, etc.) funded by increased deficit spending and central bank debt monetization barely keep the economy above water. The support is artificial and thus when the market questions the government's ability to continue, volatility ensues. Wainwright's David Ranson's "markets forecasting markets" model implies this is where we find ourselves

[4] 'Naughts refers to the decade between 2000 and 2009.
[5] A phase transition is the transformation of a thermodynamic system from one phase or state of matter to another. The term is most commonly used to describe transitions between solid, liquid and gaseous states of matter. The critical point is when a fluid is sufficiently hot and compressed that the distinction between the liquid and gaseous phases is almost non-existent. From Wikipedia.
[6] Stagflation: a situation in which inflation is combined with stagnant or falling output and employment. From Dictionary.com

today. When volatility picks up, markets start to behave as if scenario #3 is the relevant epoch.

3. **Deflation.** Despite the best efforts of the Federal Reserve, banks hesitate to lend and businesses and consumers hesitate to borrow. Debt is paid down, but the economy does not grow. Equities perform poorly, as does gold, and bonds are winners. Fairfax's Prem Watsa considers this a high probability scenario. In his most recent annual letter, Prem points out that deflation took a while to develop in Japan: "…cumulative deflation in Japan in the past ten years and in the U.S. in the 1930s was approximately 14%!! It is amazing to note that including 2012, Japan has suffered deflation in 17 of the last 18 years – beginning about 5 years after the Nikkei Index and real estate values peaked." Gary Shilling, another well-regarded commentator, shares Prem's view on deflation and expects its impact to be felt shortly.

4. **Runaway Inflation.** Given the massive expansion of the monetary base by the Federal Reserve, if borrowing and lending were to expand and/or if inflation expectations increased (causing a rise in the velocity of money), measured inflation (i.e. the CPI) could easily increase into the high single digits.

From our perspective, a version of the stagflation scenario (#2) has been the relevant framework since the early 2000s. Given current government policies (both fiscal and monetary), this seems likely to continue for some time.

Key point: The risk is that as overall national debt levels rise and central bank interventions grow bigger, we could eventually reach a tipping point. We need to be mindful that deflation (scenario #3) and runaway inflation (scenario #4), become more possible as time goes on and disequilibrium in the system continues to grow.

A Grey Owl Governing Principle – No Binary[7] Bets

Our approach has been to avoid binary bets (where we either win or lose and there is no grey area) on any of these outcomes. We also continue to avoid investing as if the 1980-2000 cycle persists. What this means is that a bottom-up (i.e. looking at each security as a stand-alone business) investment framework needs a top-down (i.e. considering the macro environment) overlay. We aim to perform well in most environments, at the cost of not performing perfectly in any specific environment.

[7] Binary: consisting of, indicating, or involving two. From Dictionary.com

Several examples should illustrate this point:

A. **Gold.** We own gold which should do well if the economy can grow its way out of debt (#1), stagflation prevails (#2), or if runaway inflation kicks in (#4). Gold will likely lose value and act as a drag on performance if the economy experiences deflation (#3).

B. **Cash.** We often hold larger-than-conventional cash positions that should do well in a deflationary environment (#3) and during fits of volatility that are likely under a stagflationary scenario (#2), but will underperform in a growing economy (#1), as well as during the muddle phase of scenario #2.

C. **Fixed Income – shorter maturities and high quality credits.** Our fixed income portfolio has a shorter maturity than the benchmark. While we recognize interest rates can remain low for a very long time (see Japan today and the US in the 1930s), the limited upside from here is not worth the risk should rates begin to rise. The low duration will help if growth (#1) or runaway inflation (#4) develops; it will underperform in a deflationary environment (#3). Lower exposure to credit risk will suffer in growth (#1) or inflationary (#4) environments, but will likely prove profitable during the volatile periods of stagflation (#2) and throughout a deflation (#3).

The Current Investment Environment

While working within the framework of the correct investment epoch is critical, it is also important to consider shorter, cyclical phenomenon. We wrote in our last quarterly letter, "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." Across the developed world, central bank intervention is now measured in hundreds of billions of dollars per month. This intervention has been able to prop up the US economy (for now) and push investors into riskier and riskier securities. Despite similar efforts from European and Japanese central banks, both areas are experiencing recessions today. Recognizing the likely impact of QE3, we increased our overall market exposure beginning at the end of 2012 and into early 2013.

More recently, we have begun trimming our exposure to the equity market. This is mostly a function of several successful ideas reaching or beginning to exceed the top end of our range of fair value. In three cases, new information caused us to believe our original theses invalid and we sold at very limited losses in two cases and a tiny gain in the third (an opportunity afforded us by the margin of safety we required when buying in the first place). Each of our 2013 sales to date are detailed in a later section.

While the primary driver of these sales was a bottom-up analysis of our individual holdings, the overall environment also influenced us. Quarterly S&P 500 (operating) earnings reached their current cycle peak in the second quarter of 2012 at $25.43. The third quarter saw a slide to $24.00. The fourth quarter witnessed a further decline to $23.15. Yet, analysts are predicting a rebound to $25.40 in the current quarter with steady growth to $27.12 in the second, $28.05 in the third, and all the way to $29.75 in the fourth quarter of the year. This seems a bit aggressive to us given the recent trends combined with the payroll tax increase and the sequester, both of which just hit in the beginning of this year. Additionally, commodities are signaling a global slowdown. Copper is down 17% from its February 2013 high. Gold has experienced a similar selloff, which we will discuss in a later section.

The earnings trend and commodity selloff combined with the waning impact typically experienced several months after the start of a new round of quantitative easing are reason for caution. However, not all indicators are flashing red. Credit spreads remain tight and tax receipts were solid in March.

Calling turning points is always difficult – and particularly so now. Toward the end of 2011, two very prominent market and economic analysts predicted a recession would occur in the US by the middle of 2012. Their prominence is not a function of a loud voice or frequent appearances on CNBC. Rather, it is due to their high "batting averages" forecasting similar economic or market turns. Hussman Funds' John Hussman wrote about the likelihood of a recession on August 8, 2011. A little over a month later, Economic Cycle Research Institute's Lakshman Achuthan discussed their recession prediction with Bloomberg's Tom Keene on September 30, 2011. Yet, here we are in the second quarter of 2013 and we have not had a recession in the US. These forecasts will likely prove correct, but timing has become more difficult given the extent of government intervention. We are cautious, but not positioned as if a significant slowdown is certain.

The Grey Owl View of Gold's Role in an Investment Portfolio

Gold is down 26% from its September 2011 peak. It is down over 15% in 2013 alone. We have owned shares in GLD (a gold ETF) and GDX (a gold miner ETF) for several years now. Gold is primarily a hedge against currency debasement. A weaker currency may show up in measured inflation (i.e. CPI) and/or higher interest rates, but it might not – particularly over shorter (even several year) time periods.

We do not think of gold as a hedge against all forms of risk. Clearly, some do and that will add to the metal's volatility. However, five or ten years from now, we believe gold will be higher as long as the federal government continues to run trillion dollar deficits and as long as the Federal Reserve monetizes those deficits (i.e. buys the Treasury's debt) via the zero interest rate policy (ZIRP) and its $85B per month quantitative easing (QEIII) bond buying extravaganza. If equity growth slows and/or if equity markets experience a correction (particularly a liquidity-driven one), gold will likely go down too. Historically, a 5% position in gold has proven to immunize a portfolio from currency debasement. The "price" of this insurance is worth it to us (though the pain of the recent selloff is real).

Bottom-Up Stock Picking Still Matters

While awareness of the salient factors of the epoch and identifying cyclical shifts matter more today than in the past, bottom-up security analysis can still add significant value. As such, we focus the majority of our time looking at individual investment ideas. The beginning of 2013 saw a larger than typical number of sells, so we thought it would provide a helpful perspective to explain our approach for each sale. First, here is a table[8] that lists each sale and the returns earned.

Company	Symbol	Sell Date	Position Size[9]	Total Return[10]	Annual Return
Lexmark	LXK	1/17/2013	5.10%	-2.58%	-1.61%
Procter & Gamble	PG	2/06/2013	2.00%	53.89%	14.00%
Howard Hughes[11]	HHC	2/15/2013	1.50%	26.97%	14.44%
BMC Software	BMC	2/26/2013	1.00%	1.73%	1.70%
Weight Watchers	WTW	4/16/2013	2.00%	-2.37%	-1.49%
Abbott Labs	ABT (and ABBV)	4/15/2013	2.70%	64.35%	27.50%
Pepsico	PEP	4/18/2013	2.90%[12]	26.75%	23.91%

Lexmark, BMC Software, and Weight Watchers are all examples of situations where new information caused us to reevaluate our initial thesis and decide that the potential upside was not what we had originally thought or the downside might be more. In each case, our purchase price proved to provide an adequate margin of safety and we were able to exit with a tiny gain or a minimal loss. In the case of BMC and WTW, at the time of purchase we recognized that the cone of possible outcomes was wider on these names and we sized the positions accordingly (i.e. smaller) further mitigating any actual damage or opportunity cost.

[8] This table lists all equity security sales in our separate accounts for the year 2013 through 4/26/2013. Additional details about the positions, such as inception date, buy price, and sale price are available upon request.
[9] The position size listed is at inception.
[10] Return numbers are approximate and individual accounts will not match exactly.
[11] This was only a partial sale.
[12] We made an initial purchase on 1/25/2012 of 1.50% and then a second purchase on 2/9/2012 bringing the position to 2.90%.

We initially purchased Lexmark at a low single digit multiple and a nice yield. Our expectation was that as Lexmark exited the deteriorating consumer printer business, their stronger business printer and consumables business would become evident to the market, growth would resume, and the market would reward the company with a higher multiple. What we found over time is that some combination of the recession in Europe, heated competition from other printer companies (all in a deteriorating, commodity business), and a shift from printed pages to tablets even in the business world caused difficulties with Lexmark's business segment. We were not able to quantify just how quickly this deterioration might occur, so we worked to exit the position at a modest loss.

We bought both BMC Software and Weight Watchers after they had stumbled on sales execution. Unfortunately, their stumbling continued. While both have quality franchises, neither fit all of the parameters of a business we would be happy to own forever. In addition, the economic environment is providing more headwind than tailwind. Thus, we decided to exit.

In late 2009, we began our purchase of a basket of "Big Pharma" names. Initially, this included Pfizer and Novartis. Approximately a year and a half later, we added Abbott Laboratories. The basket eventually grew to an 11% position. For each name, the general thesis was the same.

Through the mid-2000s, Big Pharma earned high returns developing and marketing drugs for primary care issues such as acid reflux or high cholesterol. The targeted ailments are common across the population and thus these "blockbuster" drugs each generated multiple billions of dollars per year in sales. Then, halfway through the 'naughts the research and development pipelines started to dry up; there were few primary care issues left to address. Additionally, the existing roster of blockbuster drugs started to come off patent. Business returns dropped, sales growth slowed, and with it market multiples compressed from the mid-teens to around 10x earnings across the group. If that was not enough, the threat of Obamacare cast a shadow over everything healthcare.

Our view was that an industry shift was in progress, but the market remained focused on the old model. Research and development shifted from primary care issues to niche conditions affecting smaller populations (such as genetic disorders). Executives now emphasized return on investment rather than pure R&D. Capital allocation was now a priority: cost rationalization programs, acquisitions, divestitures, and spinoffs were all on the table. Finally, emerging markets were developing into sizable markets. Despite being the last name we added to the basket, the market fully recognized this new reality at Abbott first. With the spinoff of Abbvie, the market began to value both companies at much higher levels. We felt the valuation was full and thus we sold. We see similar fundamental business progress at Pfizer and Novartis, but the market has not entirely caught up. We are happy to own them both at today's prices.

Proctor & Gamble and Pepsico are large, quality businesses with wide moats due to their distribution scale. In addition, we were able to purchase each of them at favorable multiples when there were questions about recent execution. Over the past several years, almost every mega-cap, consumer-staple name has provided significant investment gains as investors decided that blue-chip stocks with dividend yields were better than bonds. With this change in investor sentiment, both companies' valuations became stretched. We sold.

Conclusion

There is a high probability that Bill Gross is correct in anticipating an epoch shift. Long time readers of these letters are no doubt familiar with our analysis of the disequilibrium in the US and world economy. Our objective has been to be invested and participate when conditions are favorable, however we also recognize that we are likely in a secular bear market that began in the early 2000s and the late stages of a cyclical bull market that began in early 2009. While various rounds of QE have provided several quarters of boost to securities markets following their initiation, their impact has faded over time. This may well be the case for QEIII too.

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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