Grisanti Capital Management

	For the Period Ending June 30, 2012		
	2Q12	Year To Date	Since Inception (2/28/10) Annualized
Grisanti Capital Management			
HIEP Composite (net of fees)	***+0.6%***	***+13.0%***	***+9.9%***
Current Yield 4.8%			
Beta vs S&P 500 = 0.60			

Dear Friends of Grisanti Capital Management:

Sometimes the best way to make money is not to lose it. While we encourage you to read this review of our high income equity portfolio (the "HIEP"), it can be summarized in a short phrase: We were up in a down market. The portfolio rose 0.6% (net of fees), compared to a decline of -2.8% for the S&P 500 Index. The HIEP is now up 13.0% year-to-date, which is markedly better than the average U.S. equity income mutual fund, which is up 6.2%. Further, the HIEP remains ahead of the S&P 500 Index (which is up 9.5%), even though our goal is to offer a more conservative, less volatile alternative (which generally translates to less upside as well). **This year-to-date performance surpasses all 336 mutual funds in the equity income category tracked by the Bloomberg data base.**[1] Our performance won't always be this good, but it was no accident either. The high-yielding preferred stocks in the HIEP (about 30% of the total portfolio) not only offered superior income, but they didn't decline in price in a falling market, acting (as intended) more like fixed income instruments. The crucial difference between our preferred securities and a portfolio of bonds is that the yield on the preferred stocks – from 6 to 8% – is much higher than similar quality bonds in today's low rate environment.

Most of the common stocks in the HIEP (about 70% of the portfolio) fared better than the market as well, as their dividends and conservative business models kept them from suffering much of the downside. In fact, of all the economic sectors represented in the portfolio, only the financial stocks were down for the quarter. Our position in the energy refiners was a particular bright spot during the quarter. Our largest position there, **HollyFrontier**, continues to pay large special dividends, buy back its stock and report near-record earnings in a mediocre economic environment. The stock was up 16% for the quarter, even as the S&P Energy Sector declined by -6%, following the price of oil lower. We thought we'd take the remainder of this letter to discuss how we are

[1] The HIEP is not a mutual fund, but a composite of separately managed accounts managed from a model portfolio. We compare ourselves to the Bloomberg universe of U.S. equity income mutual funds because "equity income" is our style of management, and the performance of those funds is publicly available (as opposed to the unpublished performance of other competitors who also utilize separately managed accounts). In both cases the comparisons are made net of fees. The specific performance of your portfolio is enclosed with this letter, and may vary (up or down) from the performance of the HIEP composite.

investing in this troubled environment, which, in spite of all its turmoil (or perhaps *because* of the turmoil) presents discrete investment opportunities.

Summer is the time for amateur theater. Unfortunately this summer, the production is the same as the last two years: Europe is playing Hamlet, constantly vacillating between staying together and breaking apart. China is the enigmatic strongman, whose strength appears massive, but is it? And the United States – the dysfunctional polity which has lost its civility/pioneer-spirit/frugality (you fill in the blank) – plays the fading star, with its best days behind it. These are the roles that we see in the papers (literally or electronically) every day. But our opinion is that these portrayals, while possessing some truth, are superficial and banal. Worse, by believing the current drama is the whole story, investors can miss important trends that have little to do with events in Europe or the other members of the supporting cast. To further the cause of more thoughtful analysis, we want to discuss some of the investment themes that are working well for us this year, delivering positive returns even in the face of the absorbing melodramas playing daily around the globe.

One powerful theme is the **American Oil Renaissance**, which is summarized in the research piece we distributed to you in June. (Please do not hesitate to call or email for another copy, which is easily dispatched.) In brief, it posits that we are at the beginning of a decade-long increase in U.S. domestic oil production, reversing a 40-year decline. By 2020 production will be more than twice its lows of 2007, which should reduce our dependence on foreign oil by more than half. While the research piece talks about this in great detail, for the purposes of this letter we focus on the investment consequences of all this oil in our own backyard. We believe this means lower oil prices in the geographic center of the U.S. (where the oil is coming from) versus imported oil. This in turn means the **refiners** located in those low-price areas will have a tremendous strategic advantage over foreign competitors in the production and sale of *refined products* like diesel fuel, gasoline and jet fuel. Recent evidence bears this thesis out: For the first time in over 60 years, in 2011 the U.S. **exported** more refined products than it brought in. That trend has increased more than 15% in the first six months of this year. Refiners are still seen as cyclical companies that do poorly in a mediocre economy like we have today. But instead, because of exports, they are reporting near record earnings and cash flow. We own two refineries: **HollyFrontier** and **Marathon Petroleum**. Each has performed well in a tough energy sector this year, due to what we think is a disconnect between how most investors *think* of refiners and the *new reality* of a U.S. exporting success story. In addition, **Enbridge Energy Partners** is a pipeline company that generates large and growing cashflows by transporting the new oil production from North Dakota, Wyoming and other newly prolific drilling sites.

Another investment theme, controversially, is the current disdain for financial companies. We continue to think a tremendous return can be had from a multi-year investment in two financial stocks, **JP Morgan and Morgan Stanley**. At the darkest moments of this past quarter, these stocks were again trading at valuations that equaled the low point of the 2008-09 financial crisis. Everyone knows the substantial problems these companies face – regulatory issues, credit exposure, international defaults – but we believe the stocks more than reflect the enormous amount of

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pessimism. JP Morgan is the more compelling story of the two, as its recent terrible trading error has driven the stock back down to 2008 valuations **even though** it will still be solidly profitable this quarter (including the loss). It has not only paid back the government TARP money years ago, but it now offers shareholders a 3.3% yield and has the capacity to buy back stock (once the trading controversy is behind them). On the other hand, there are financial stocks in the high income equity portfolio that are inexpensive because they suffer from the same pessimism as the large banks, yet many of the regulatory or credit issues are irrelevant to them. **Annaly Capital Management**, for example, has been a strong performer for the portfolio, rising 9.5% this quarter. This stable stock should continue to do well provided that interest rates stay low, and it pays a 12.8% annual dividend. **American Express** is another financial stock that was inexpensive due to the dislike for the group, but it too has performed well compared to the major banks, rising slightly in the quarter. Its solid credit profile, coupled with strong overseas growth, give it a solid foundation for future earnings.

Looking Ahead

We deal in a highly efficient marketplace, so the themes that we discuss reflect our best analysis of the discrete, unusual areas where the market might have it wrong going forward. It remains a very uncertain world. The three year old European drama – it's no longer accurate to call it merely a "Greek Tragedy" – shows no sign of ending soon. As you can see from your portfolio statement, in addition to our preferred stocks, we have a not insignificant cash position. That's for two reasons: first, to *protect* against exogenous events by lowering the volatility of the portfolio, and second, to *prepare* for opportunities that might present themselves upon such an event, the proverbial dry powder. When you receive our next quarterly letter in October, Europe will have probably survived a couple of more crises and we will be on the threshold of a presidential election. Less talked about but more important for our purposes, our companies will have had another quarter of results which we think will continue to help them produce profits for shareholders in an uncertain world. It's by focusing on the details of our companies and the themes that led us to these investments that we have made money so far in this uncertain year, and we plan to stay the course.

We thank you for your support and welcome any questions you may have.

Very truly yours,

Christopher C. Grisanti