Grisanti Capital Management

July 19, 2013

Dear Clients and Friends of Grisanti Capital Management:

The second quarter of 2013 was the most consequential since the financial crisis. It was also exceptionally perilous, as investments labeled "safe", like government bonds and certain high dividend stocks, sustained material losses. This hurt our High Income Equity Portfolio, as we held a number of previously very stable preferred stocks and real estate investment trusts in the safety portion of our "barbell" portfolio. Alternatively, those investments seen as "risky" since 2008, like financial and auto stocks, flourished. We hold these stocks in our "appreciation" portion of the barbell, and they did well. The proximate cause of all this apocalyptic behavior is that interest rates are finally rising, and they did so with a vengeance in the second quarter, spelling bad news to all segments of the fixed income market. The yield on the 10-year US Treasury bond rose from 1.61% to 2.66%, an astounding 65% increase. Mortgage rates fared even worse than government bonds, and the Barclay's aggregate bond index (a widely followed benchmark of corporate, mortgage and government bonds) suffered its worst loss in more than a decade. All this occurred on speculation that the Federal Reserve may begin to taper its aggressive monetary stimulus, a rumor that the Fed did nothing to dispel. We believe this "taper tantrum" is the first salvo in what will be a multi-year evolution to a higher interest rate environment. Years from now, we believe the second quarter of 2013 will be remembered for the death knell of the 31-year bull market in bonds.

This turning point is of great consequence not just for bond investors, but for equity investors as well. We believe that the end of the bond bull market means the start of a multi-year preference for equities that we haven't seen since 1999. This letter sets forth our short-term frustrations with the quarter, which include the counter-intuitive performance of those previously reliable income stocks and also the poor short term performance of our refining investments (which were big winners last year). More importantly, this letter looks ahead and details the various opportunities this new paradigm presents going forward.

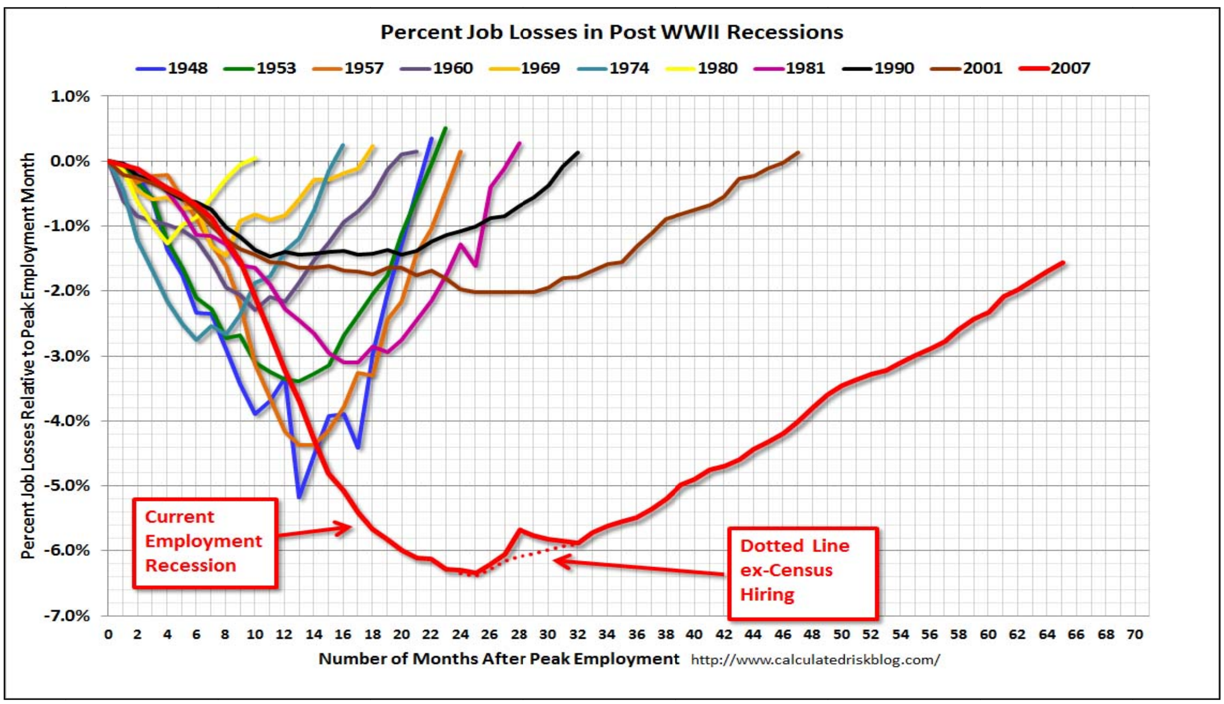
It is one of Wall Street's recurring mysteries that no matter how many pundits are making investment forecasts, higher interest rates still come like a thief in the night, taking everyone by surprise. Rates rise without warning and the effect is dramatic. The recent move has temporarily stopped the equity market's rally, with June being the first down month of the year. **But we believe that the interest rate fears that caused the recent pullback have actually created a buying opportunity in equities.** We have three reasons for this optimism.

First, while the market is alarmed that the Federal Reserve may slow its stimulus, the entire reason for the curtailment is that we may not need it anymore. The U.S. economy is finally getting over the shock of the massive financial crisis and is producing the best economic growth in five years. **That is exceptionally good news for equities.** The biggest positive change is in housing, where prices are finally starting to rise and inventory is dropping sharply, but unemployment, manufacturing and consumer spending are improving as well. The **second** reason that equity investors need not fear the Fed is that a slowing of stimulus (which we think may happen in the Fall)

Grisanti Capital Management

is not the same as the Federal Reserve hiking short term rates, which we believe is significantly further off. It is simply slowing down the unprecedented amount of monetary accommodation, not putting on the brakes. **Finally,** we can all argue whether Chairman Bernanke's dovish stance towards accommodation (e.g., creating QE1 and 2 and 3 in order to spur economic growth) was the right approach, but everyone agrees that *dovish* is the right adjective. He has said time and again that unemployment must come down, that massive accommodation is necessary, and that inflation is under control. This leads us to conclude that if there is the slightest signal that the slowing of stimulus is hurting the economy, the accommodation will resume (QE4?), as it has in the past.

We believe the path forward is one of further economic recovery. The following chart shows that the current recovery lags all other post-war comebacks by a wide margin, at least by one important statistic: regaining the jobs lost since the previous recession. In many ways, this chart is like a Rorschach ink-blot test: some see a broken system, not healing as well as it used to; others see



downside ahead because enough time has passed for another recession to start; but we see (at long last) the growth and opportunity that comes with financial healing after a disruption so severe it took five years to get back on track. We've already lived through the five long years of sub-par employment and paid the price in slow earnings growth and a stock market that has only just returned to highs set in both 2000 and 2007. (In our last letter we wrote about the 13-year dry spell.) Finally, the recovery seems to be gathering steam. The unemployment report released on July 5th, as we were writing this letter, showed continued strength. Your portfolio is poised to take advantage of continued recovery.

Of course, if QE3 is the last dose of this unique (and rather frightening) stimulus medicine, that begs the question of where we go from here, and what effect rising rates will have on our investments. Historically, the end of interest rate declines has been a *good* time to be an equity investor. In the last four interest rate cycles (1988, 1994, 1999 and 2004), the Fed stopped lowering rates and the equity markets performed strongly in the following six months. This is not rocket science: As mentioned above, rates stop dropping because the economy is improving and that's a favorable environment for owning shares of a profit making enterprise (as opposed to owning a fixed income security). What makes 2013 different is the magnitude of the changes. Interest rates were driven so low by artificial means (count your QEs), that a reversion to market interest rates will require a large increase (especially on a percentage basis). Further, it will take time and cause a great deal of pain for fixed income investors. There are millions of investors waking up to the fact that the bonds they relied upon for both income and security are losing value fast and will probably decline a great deal more as rates continue to rise. The trickle of funds switching from bonds to stocks has become a stream, and, we think, will soon be a wide river. ($30 billion moved out of bond funds in the last *week.)* For the first time in thirteen years, investors are favoring equities by a wide margin, and those trends tend to last for multi-year periods. With the resurgence of economic growth, value investing – buying companies that have been hurt by the financial crisis – should be in a particularly advantageous position.

Portfolio Review

The primary goal of the High Income Equity Portfolio is capital preservation. To protect your capital, we manage the portfolio as a "barbell," with typically low-volatility, high-yielding preferred and common stocks on one "side" of the barbell and undervalued (but typically more volatile) common stocks on the other. This structure has generated solid returns with a substantial margin of safety until this quarter, when the sharp rise in rates led to a decline in the portfolio (your specific results are enclosed), although we remain up over 3% for the year as of June 30 (and up another 2% as of the date of this letter). We believe our second quarter performance is an aberration that was shared by many funds with similar defensive strategies. (For example, the PIMCO Total Return Fund, one of the largest defensive funds run by the very competent Bill Gross, was down sharply for the quarter and is now down 3% year to date.) In addition, since the most recent market low on October 3, 2011, the Grisanti Capital Management high income equity portfolio is up 42.5%, which means our investors earned more than 80% of the market's upsurge from that low, while taking only 60% of the risk.[1] The high income equity portfolio is all about risk-versus-reward.

The reasons for our difficult second quarter performance are straightforward. Quickly rising interest rates caused most securities that offered a generous yield to decline substantially in price, *regardless of their previous stable nature* or the improving fundamentals of the underlying companies. For example, the JP Morgan preferred stock that we own declined 5.8% in price in June, underperforming a declining market. This was startling behavior for what was previously a model of

[1] As measured by Beta, a frequently used measure of volatility and risk.

safety. Just so you appreciate how unusual this was, we measured the days during which the market declined more than 1% in the last 18 months. There were 33 such days. On *every single one* of those days, the JP Morgan preferred stock either declined substantially less than the market or was actually *up*[2], until June, when the JP Morgan preferred was down *more* than the market. As mentioned earlier, interest rates rise like a thief in the night, and our safety portfolio suffered. The stocks that were our anchor to windward can no longer be trusted to play that role in a rising rate environment.

We believe rates will continue to rise in fits and starts for the next few years. For that reason, we have taken several steps to re-position the portfolio going forward, always with the priority of capital preservation, even at the expense of potential appreciation or yield. We have trimmed the preferred stock position by two-thirds (from 30% to 10%). We have sold common stocks that have high dividends but low growth (like real estate investment trusts). On the other hand, we will retain those stocks with high dividends that also can grow their earnings (and thus their dividends), like **Ares Capital** and **Brookfield Infrastructure Partners.** We are currently holding a large cash position. This cash lowers the volatility of the portfolio enough to allow us to add to our positions in the financials and the oversold energy sector, which we believe will set us up for appreciation in the months ahead.

Our goal is easily stated: ***We will protect the barbell.*** The high income equity portfolio will continue to have a strong, low-volatility component, now modified to perform well in a rising rate environment. Our cash, remaining preferred stocks and high-yielding but growing common stocks should better play the role of the "safety" side of the barbell in this new paradigm. To be frank, today's soaring market is not when this barbell strategy delivers the most value. That would be in a more difficult market, where the idea of capital preservation is valued more highly. But as we all know, things can change quickly. Your portfolio is up, but not as much as the soaring market. If the market declines, your portfolio should do relatively much better than the market. (And for those of you who want more aggressive exposure on the upside, our Large Cap Value portfolio has a greater emphasis on appreciation.)

While rising interest rates hurt the high income equity portfolio, a second culprit was the decline of our refining investments. In an up market, that portion of the portfolio was down 11% for the quarter. While this is frustrating, especially coming at the same time as higher rates impacted the portfolio, we continue to believe strongly in the American Oil Renaissance and its investment potential. The reason for our continued confidence is included in a separate memo outlining the case for the refining stocks. We urge you to read it so that you will feel, as we do, that our energy investment is not only sound, but offers great potential.

As we mentioned, the high income equity portfolio remains up for the year, due to the non-energy companies that make up the bulk of the portfolio. **Ford** was our best performer for the quarter (up 18%). We think even better days are ahead for Ford, as European losses are masking enormous earnings power at the moment, just as the US division achieves record gains. If Europe simply losses *less* money, Ford should continue to perform well. In addition, the financial sector is

[2] During those days (prior to June 2013), the market was down an average of 1.48%, while JP Morgan preferred stock was down 0.17%.

Grisanti Capital Management

leading the market forward. Our large holdings of **JP Morgan** and **Morgan Stanley** are up 9% and 11% respectively for the quarter and about 15% each for the year. We believe that the healing of the financial markets will continue. The recent rise in long-term rates is actually good for the banks, provided that short term rates remain low. The steeper yield curve (low short term rates, higher long term) allows them to borrow (via deposits) at almost nothing, and lend at higher rates (think higher 30-year mortgages). For the first time since 2007, lending money can be a good business again.

For that reason, in June's pullback, we added **Citigroup** to our financial investments. Its new CEO (Michael Corbat) is a banker in the John Reed/Walter Wriston tradition at Citi, and we believe will focus the company on its core businesses, which include an exceptional international presence. This is a departure from the recent leaders like Sandy Weill or Vikram Pandit, whose background was not banking and who led the company in a myriad of different directions. Like Morgan Stanley, we purchased Citi below book value, and think it should trade at a small premium to book. Further, book value ought to grow over the next few years, leading to an expected return of over 50%. Finally, five years after the financial crisis, Citigroup is at last generating enough excess capital to increase its dividend in a meaningful way over the next few years.

In closing, after the recent interest rate scare and the market's decline in June, we have found attractive investments and are fully invested on the "Appreciation" side of the barbell (about 70% of the portfolio), while retaining a large cash position on the "Safety" side for stability. **For the moment, the cash now plays the role formerly played by longer dated, higher yielding instruments which, in the current rising rate environment, are susceptible to capital loss.** Our anchor to windward has been modified to resist the impact of rising interest rates. Going forward our goal is to continue to offer superior risk-adjusted returns. **We believe this is an exceptionally attractive time to be in equities** (and not such a great moment to be in bonds). With this backdrop, we believe the two most important ingredients for profitable equity investing – earnings growth from quality companies and reasonable valuations – are present in our portfolio companies. We are excited about the second half of this year, and are confident we are positioned to take advantage of the market ahead.

Very truly yours,

Christopher C. Grisanti