Grisanti Capital Management

High Income Equity Portfolio Third Quarter 2012 Letter to Investors

	For the Period Ending September 30, 2012			
	3Q12	Year To Date	Trailing One Year	Since Inception 2/28/2010
Grisanti Capital Management LLC High Income Equity Portfolio[1]	***+4.7%***	***+18.2%***	***+32.3%***	***+30.3%***

Like a 10-year old waking up for school and opening her shades to see a foot of snow, the third quarter was a pleasant surprise. For the first time in three years, stocks survived the summer without double-digit losses. And for investors in our High Income Equity Portfolio (the inelegantly named "HIEP"), we are pleased to offer *two* feet of snow: First, we are ahead of the market for both the quarter and the year – up over 18% year-to-date after fees and in the top 2% of all (302) equity income mutual funds tracked by Bloomberg. But more important, our unusual "barbell" combination of low-volatility preferred stocks and undervalued common stocks ***outperformed while taking 40% less risk and delivering a yield of 4.6%***.[2] We created the HIEP, with its focus on lower volatility, because markets aren't always like the third quarter of 2012 – as even our 10-year old knows, eventually the snow will melt and it will be time to go back to school. What follows is a brief recap of the surprisingly strong quarter, as well as our investment outlook for the remainder of the year and into 2013.

Clearly, if we are ahead of a rising market, and about 30% of the HIEP is invested in preferred stocks that don't change much in price, the common stocks that comprise the other 70% must be doing well. Our three major portfolio themes – the American Oil Renaissance, undervalued financial stocks and the smartphone revolution – all drove our outperformance. Cheap oil in the middle of the continent, a dynamic we have written about often, made our two

[1] The performance shown for Grisanti Capital Management is that of our High Income Equity Portfolio Composite, after deduction of our fees. The performance compiled by Bloomberg is that of all the publicly traded mutual funds in the equity income style, and is also presented net of fees. Even though the HIEP is not a mutual fund (it is a composite of separately managed accounts), we believe the comparison is helpful because these mutual fund records are publicly available and are managed in the same style (equity income) as the HIEP. Your actual performance is enclosed with this letter.

[2] We use Beta, a widely recognized measure of volatility, to assess risk. The Beta of the HIEP is 0.6, compared to the market, which has a Beta of 1.0. All other things being equal, a portfolio with a Beta of 0.6 will fall (or rise) 40% less than the market. Of course, all other things are rarely equal, and Beta is a measure of past volatility, which may or may not hold true in the future.

refiners (**HollyFrontier** and **Marathon Petroleum**) our best performers (up over 20% each for the quarter). **Morgan Stanley** led a strong financial group higher (up 16%). **Apple**, sexier than either refining or banking, only came in fourth out of the 18 common stocks in the HIEP, up 15% in the quarter (65% for the year) with the introduction of the iPhone 5. Evidenced by that eclectic assortment of winners, our outperformance was broad-based.

From a macro-economic standpoint, the third quarter was more remarkable for what *didn't* happen – for the first time since 2009, the market did well in the summer months. Frankly, we were a bit surprised. Economic statistics were weak in July and August. Employment was anemic, GDP growth was revised down to 1.8% for the second quarter, and when the third quarter is reported in late October, we do not think it will be any better. The only piece of good news – and again this is more of an event that *didn't* occur – is that Europe remained relatively quiet. So we find ourselves poised on the eve of an election, with a weak economic backdrop, an out-of-control deficit, a "fiscal cliff" approaching early next year and possible military action in Iran.

If we were merely to invest based on that macro backdrop, it's hard to be optimistic. But, the HIEP is purposely managed in a conservative manner, designed first to protect capital and offer an attractive yield (currently 4.6%). Only after those goals are secured do we focus on capital appreciation, and we do that by identifying specific companies whose prospects are affected by factors other than the bleak economic and political statistics noted above. We've talked quite a bit about the American Oil Renaissance – the exploding production of domestic oil – and the profound effects that has on the business of refiners, which have been terrific investments this year. In spite of their recent strong performance, many refiners are still trading significantly below their highs of 2007, even though industry trends are much more favorable now due to the new oil finds. In fact, in the third quarter, **HollyFrontier** paid *two* special dividends, as cash generation reached record levels. We believe this investment theme will continue to pay strong dividends (figuratively and literally) for a number of years.

A second portfolio theme is our investment in undervalued financial stocks, which continue to sell at deep discounts to their valuations prior to the financial crisis. While they do not deserve the rich valuations of 2006, nor should they be priced at half their liquidation value (as is the case with Morgan Stanley). They were strong performers in the quarter, with both **Morgan Stanley** and **JP Morgan** up significantly more than the market. JP Morgan was an especially important contributor to the portfolio, because after the large trading losses announced earlier in the year, we used some of our cash to add to the JP Morgan position and it is now our second largest holding. It is up over 30% since the stock plunged after those losses were announced.

Finally, the smartphone revolution continues to reap rewards for the portfolio. As mentioned, Apple was a strong performer, as iPhone 5 pre-sales were twice those of the iPhone 4s. We are premising this investment on the *global* acceptance of the iPhone, especially in

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newly emerging economies. So far that thesis seems to be credible, but as the holiday selling season approaches we will know more.

The quarter was not all good news. One mistake we made was our investment in Lowe's, the home improvement store. Sales had previously been weak, and we were viewing Lowe's as a way to invest in the nascent residential home recovery, which is beginning to pick up steam. Right after we purchased the stock, the company announced what we believed to be a distracting hostile bid for a Canadian chain store. That, coupled with another sales disappointment that was Lowe's-specific (competitor Home Depot reported strong sales), was enough to force us to admit we had made a mistake, and we sold the shares, down about 9%.

Looking forward, we made several new investments in the quarter. Two – **McKesson** and **Baxter International** – are in the healthcare sector, a space where we have been underinvested for several years. Both of these companies are selling at reasonable valuations and generate strong and growing free cash flow. McKesson distributes pharmaceuticals, while Baxter is a market leader in products that treat blood disorders like hemophilia. Both have quality balance sheets and bring added stability to the portfolio. **Blackrock** is one of the world's largest money managers, has a strong executive team, and if the markets continue to rebound should offer investors attractive returns from a currently depressed stock price. It is committed to returning capital to shareholders, and has a yield over 3%. During the quarter, we trimmed **Annaly Capital** and bought **American Capital Agency** to diversify our exposure to Mortgage Real Estate Investment Trusts (REITs). We like these particular REITs as they are the market leaders and have proven management teams that have done exemplary jobs of navigating not only the current environment, but also the financial crisis.

One of the most significant characteristics of the HIEP is its large investment in preferred stocks (currently 30% of the portfolio). These high-yielding securities simultaneously raise the current yield of the portfolio while lowering its risk, because they tend to be more than 90% less volatile than their common stock counterparts. When considering a preferred stock investment, we analyze the fundamentals of the business as we would for a common stock, examining not only current credit worthiness (all of our current holdings are investment grade), but also the sustainability of cash flows to meet future preferred dividend payments. None of our preferred stocks (other than long-time holding Axis Capital) are callable until 2016. This is by design, as we rarely buy a security callable within three years.[3] All of our preferred stocks except the Wells Fargo (Wachovia) Real Estate Investment Trust (REIT) qualify for the 15% Qualified Dividend Income (QDI) tax treatment. We hold the Wells Fargo REIT because of its creditworthiness and the fact that its especially high yield (almost 7%) offsets the higher tax rate.

[3] Two exceptions would be if it is trading near the call price and offers an outsized effective yield for its credit worthiness and/or we do not expect it to be called based on current market conditions.

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The fourth quarter should be an eventful one, with a presidential election, a transition of power in China, and a fiscal cliff that approaches in January. Perhaps the biggest risk, though, is a market that's already up 16% this year in the face of mediocre economic news. Fortunately, we don't have to invest in the whole market. We continue to like the themes in the portfolio that we've discussed in this letter. Further, we have a number of investments in companies that are not part of a specific theme, but represent unique stories, like **Disney, Direct TV** or **Lockheed Martin**, that remain inexpensive. Most of all, the HIEP will stay faithful to its mission of low volatility and high income. We enjoyed the pleasant surprise of the third quarter – our "snow day"– but we believe the High Income Equity Portfolio is ready for any kind of weather.

We look forward to writing again at the end of 2012.

Very truly yours,

Christopher C. Grisanti