Grisanti Capital Management

High Income Equity Portfolio Third Quarter 2013 Letter to Investors

October 16, 2013

We cannot direct the wind, but we can adjust the sails.

--Bertha Calloway[1]

Dear Clients and Friends of Grisanti Capital Management:

Through all the turmoil surrounding a government shutdown, the threat of U.S. military action in Syria, the soaring price of oil and the continued rise in interest rates, your high income equity portfolio (the HIEP) was flat in the third quarter. Like other high income portfolios, it was hurt by a rise in long-term interest rates – the largest percentage change in 10-year rates in two generations. While this is frustrating for us, over a two-year period the high income portfolio has performed well, and delivered on its three mandates: low volatility, high income and capital appreciation. Since September 30, 2011, it has risen 38.6%, offered an average yield of 3.8% and has been about 35% less volatile than the market[2].

Portfolio Review

We have included with this letter a Summary of Investments, which includes a detailed investment thesis on each of your portfolio positions.

In the third quarter much of the portfolio performed well, investments in disparate industries like **Ford** (autos), **Morgan Stanley** (financial) and **Dover** (industrial), each up over 10% in the quarter. But these strong performers were offset by losses early in the quarter in preferred stocks. For the last several years, the preferred stocks had offered both high income *and* low volatility, protecting your portfolio during difficult market periods. But in a rising interest rate environment, these securities declined as much or more than the market. So, while we can't direct the headwind of higher interest rates, we can adjust the sails: Because we think rates will continue to rise, we have eliminated these securities from the portfolio and are achieving our income and stability goals by other investments. These adjustments were set forth in detail in our mid-quarter update (sent to you last month), a copy of which is enclosed with this report. With these adjustments to our sails, in September the portfolio performed well (up one percent in a choppy market). The strong performance is continuing so far in the first two weeks of October. The portfolio continues to offer a yield of 3.5% and is currently about 20% less volatile than the market.

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[1] Bertha Calloway is an historian and civil rights activist living in Nebraska.

[2] We use Beta, a widely recognized measure of volatility. The average Beta of the HIEP over the last two years has been 0.65, compared to the market's Beta of 1.0. All other things being equal, a portfolio with a Beta of 0.65 will fall (or rise) 35% 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.

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The tailwind of a stronger economy has certainly helped our economically sensitive investments in 2013. Perhaps the best example is Ford, our largest position, which is up 10% for the quarter and 25% for the year. Not only is the company making record profits while producing 30% *fewer* cars in North America, but the dramatic losses it has experienced in Europe finally seem to be leveling off. *Any* improvement in Europe (e.g., losing "only" a billion dollars instead of two) would lead to higher total company profits than expected and should lead to a higher stock price. Even though Ford is up about 25% since our initial purchase earlier this year, it is still relatively inexpensive. Earnings could reach $3.00 a share in 2016 (assuming Europe finally makes money), and the stock sells for $17, or less than six times our earnings estimate. Another strong performer has been **Dover**, an industrial conglomerate that has a 50 year history of both managing businesses efficiently and also buying and selling within the corporate portfolio in a profitable manner. The recent announcement that it is spinning off its communications technology business was warmly greeted by the market, and the stock is up 16% in the quarter and 24% since its purchase in May.

The strongest group of stocks in the portfolio this year has been the financials, which continued their improvement in the third quarter. This is a sector we invested in heavily after the 2008-09 crash, so in some cases we have held positions for more than four years. **Morgan Stanley** is up 10% for the quarter, 26% for the year, and has more than doubled since its initial purchase in August of 2011 (during the last debt ceiling debacle). Of course, as these stocks rise, the valuation discount that attracted us to the financials in 2009 is not nearly as steep as it used to be. We have started to reduce positions, and have sold **JP Morgan** at an impressive gain (JP Morgan was up 174% since its initial purchase in March 2009). We expect the group will play a smaller part in the portfolio in quarters to come. While we are in perhaps the seventh inning, the game is not over. Morgan Stanley has risen back to book value (we bought it at half of book), but is transforming itself into more of an asset manager, like T Rowe Price, which sells at (an admittedly lofty) five times book value. **Citigroup** remains an under-earning bank, and is currently trading at less than 80% of book value. With long-term interest rates finally rising, it can now profit from by borrowing short-term at the current minuscule rates and lending at the new, higher long-term rates. (It's been more than half a decade since this plain-vanilla banking business model has been profitable.) The new CEO (the first chief executive with a banking background since John Reed and Walter Wriston) is well equipped to exploit this opportunity.

Last quarter we included our report *The American Oil Renaissance Creates an Opportunity: U.S. Oil Refining – The New Export Industry*, which has been updated and is available on our website (or we'd be happy to send it to you). The trends we discussed there in great detail include strong, multi-year growth in U.S. oil production and refiners with a competitive cost advantage due to both a glut of oil and natural gas. These trends remain intact – U.S. oil production, for example, is up 18% since last year – and will only get stronger over the next two years. Recently, though, all those strong fundamentals have been overwhelmed by the quick rise in the price of oil, even as gasoline prices have declined due to the end of the summer driving season. This oil price spike has caused a lot of dislocation, not just among refiners but also companies in other industries for which oil is an important input cost. We believe for a variety of reasons that the price of oil will be markedly lower in the quarters to come, and in fact over the past three weeks oil has begun to decline sharply. With that move, refining stocks are up over 10% in a flat market.

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Finally, a Tail Wind

In closing, we wanted to point out an investment shift that should affect markets for years to come: for the third quarter in a row, stocks outperformed bonds. In fact, fixed income securities of all kinds suffered another decline in the quarter, though not as sharp as the dramatic losses of May and June. We think there is a straightforward reason for both the bond weakness and the equity strength: after the worst financial crisis since the 1930s, the U.S. economy has stabilized and is now slowly gathering momentum. We are confident that the present mess in Washington will be resolved in a manner that won't affect the markets in the long-term, and when it is the focus should be back on an economy that continues to slowly recover. It is being supported by a potent combination of an incredibly accommodative Federal Reserve, growing employment, strong corporate balance sheets and the lowest inflation in two generations. While we don't know how this will affect your investments month to month, when we take a wider view, we come to the conclusion that the markets have already begun a multi-year trend towards equities and away from fixed income. It has certainly started with a bang – as mentioned, our portfolio is up over 38% in the two years ending September 30. While we're pleased with these returns, it is hard to deny the tailwind of a growing economy and a shift towards equities. It's always easier (and more profitable) to be investing *with* the wind.

We look forward to reporting back to you at the end of the year, and as always do not hesitate to contact me with any questions or comments.

Very truly yours,

Christopher C. Grisanti