Grisanti Capital Management

October 16, 2014

# ***High Income Equity Portfolio Third Quarter 2014 Letter to Investors***

| | For the Period Ending September 30, 2014 | | | |
|---|---|---|---|---|
| | Year To Date | Since Inception 2/28/2010 | Current Yield | Current Beta |
| ***Grisanti Capital Management LLC High Income Equity Portfolio***[1] | ***+5.3%*** | ***+59.0%*** | ***4.1%*** | ***0.8*** |

Dear Clients and Friends of Grisanti Capital Management:

While this is a third quarter letter, it is events early in the fourth quarter that have made complacent investors nervous. The market has fallen almost 10% from its peak, and volatility has risen to its highest level in more than three years. After a relatively peaceful and quite profitable three years, the current environment has turned turbulent. That's the bad news; the good news is this is exactly why we created the High Income Equity Portfolio (the HIEP). Your portfolio is performing as it should in the current turmoil, cushioning the downside and continuing to offer well-above-average income (currently 4.1%, the highest in more than a year). While the portfolio has suffered, it is down considerably less than the market (about half as much), and we are using this dislocation to initiate investments in high quality names that have previously been too expensive. With the current market instability, this is an opportune moment to review the last three years, and discuss our strategy for a more challenging environment ahead.

## ***Looking Back***

We believe the last three years represented an ecstatic but aberrational rebound from the financial crisis. Returns have been well above trend, and volatility well below. Going forward, we expect the market as a whole to be a more volatile, less profitable place. China is slowing, interest rates are probably headed higher, and valuations in general are not cheap. In this less benign environment, how do we protect your capital yet still produce a decent return, especially in an interest rate environment that makes fixed income securities unattractive?

[1] Performance for the High Income Equity Composite is shown before deducting advisory fees and transaction costs, if any. GCM's advisory fees are described in Part II of its Form ADV. The HIEP Composite includes all accounts that are fully discretionary, managed in the HIEP strategy and over $200,000 in total assets. Past performance is no guarantee of future results. As with any investment vehicle, there is always the potential for gains as well as the possibility of losses. We use Beta, a widely recognized measure, to assess volatility. The Beta of the HIEP is 0.8, compared to the market's Beta of 1.0. All other things being equal, a portfolio with a Beta of 0.8 will fall (or rise) 20% 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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Based on my confidence in our investment ability, three years ago I bought the part of the firm I didn't already own from my partners. We added to our investment team and renamed the firm Grisanti Capital Management. Over the last three years the high income equity portfolio has appreciated 16.8% annually[2], at the same time offering an average yield of 4% and, most important, has been on average 30% less volatile than the market[3]. This year has been a strong one as well. In the year ended September 30th, the HIEP is up 14.8%. In both cases, the returns were strong but just as important we steered the portfolio away from the risk that pervades a soaring market. Unlike many equity portfolios, we don't manage the HIEP *toward* the market; we manage it *away* from risk.

## ***Looking Ahead***

As risk has grown with higher stock prices, we have sold some winning investments and reinvested the proceeds into less expensive and safer companies. Specifically, we took profits in three of our investments in the quarter, and made three new purchases, in three different industries. That's big news for your portfolio, as we usually only make one or two investments per quarter. (In addition, so far in this turbulent fourth quarter we have added two new investments.) Over the past few years a number of themes have resonated in the portfolio, including financials, refining and autos. But now, with the market up so much, it is difficult to find broad sectors of companies that are inexpensive enough to merit investment. For that reason, our new investments have company-specific (rather than industry-specific) rationales.

**Abbvie** is an attractive pharmaceutical company with an ugly name. It was spun out of Abbott Labs almost two years ago when that company wanted to divest its FDA-supervised drug business. Abbvie is in the process of merging with Shire, a British company, which would diversify Abbvie's business away from its reliance on Humira, the best selling drug in the world (used for the treatment of arthritis). Selling at 15 times next year's earnings, while growing earnings at over 20% a year, we believe investors' fear about Humira-centricity are overblown. We like the business, its growth profile, and the management, as well as the 3% yield.

**Western Union** is a high return business with a powerful franchise that enjoys considerable barriers to entry in its core money-wiring business. WU's market share is in the mid-teens, or roughly four times the size of its next largest competitor Moneygram International, whose network is roughly half the size of WU's. At current, WU shares trade at less than 11 times 2014 earnings, despite growing sales 2.5% annually over the past five years and paying a 3.1% dividend. We think the shares' underperformance in 2014 can be tied to restructuring of the company's US-Mexico corridor pricing (late 2012) and higher-than-expected compliance

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[2] The performance shown is for the Grisanti Capital Management High Income Equity Portfolio composite.

[3] We use Beta, a widely recognized measure of volatility. The average Beta of the HIEP over the last three years has been 0.7, compared to the market's Beta of 1.0. All other things being equal, a portfolio with a Beta of 0.7 will fall (or rise) 30% 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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costs (late 2013) rather than increased competition for money transfer from digital peers. With these temporary headwinds set to subside in 2015, we think WU's can benefit from the combination of growing earnings and low investor expectations.

**Apollo Investment** (AINV) is a business development company (or BDC) with a 10% yield that makes loans to "middle market" companies too large for local bank borrowing but too small to issue public debt. We see AINV as a key beneficiary of regulations made to limit large banks' lending. Similar to Real estate investment trusts, BDCs pay no taxes, but are required to pay out 90% of earnings as dividends. AINV yields almost 10%. Since the onset of the financial crisis in 2007, new management has helped remake AINV into a safer BDC, with more creditworthy borrowers and a more sustainable yield. At the current quote, shares trade at 0.9x book (a profitable entry point) despite a shift in lending to safer, higher quality loans with more senior claims. As a result, we have seen six insiders purchase shares since February 2014.

The biggest thematic shift in the portfolio is our move away from the banks after a period of successful investment. As recently as a year and half ago they represented 12% of the portfolio and now are only 3%. Since the middle of 2013, we have sold **Wells Fargo, Citibank,** and **JP Morgan.** But now these companies have risen to reasonable valuations, and their business model is burdened with onerous new regulations. We have exited all banks except for **Morgan Stanley**, which we continue to favor specifically because of its growing asset management business.

With those portfolio changes, we believe we are positioning the portfolio to make money in a market that is neither "bull" nor "bear." More importantly for the HIEP, the portfolio has protected capital. Going forward we expect an environment where earnings matter, and strong managements can make a difference through wise allocation of capital. For those of you concerned about a more difficult market ahead, over our 15 year history, Grisanti Capital Management's Large Cap Value Portfolio has more than doubled the return of the S&P 500 Index (158% versus 77% since January 1, 2000), and, believe me, most of the last 15 years were not filled with bull markets! We look forward to reporting back to you at the end of the year in what is shaping up to be an eventful quarter.

Very truly yours,

Christopher C. Grisanti