Grisanti Capital Management

High Income Equity Portfolio Fourth Quarter 2012 Letter to Investors

	For the Period Ending December 31, 2012				
	4Q12	Year To Date	Since Inception 2/28/2010	Current Yield	Current Beta
Grisanti Capital Management LLC High Income Equity Portfolio[1]	***+0.5%***	***+18.8%***	***+30.9%***	***4.7%***	***0.6***

2012 was an exceptional year for the High Income Equity Portfolio (or HIEP), where we invest in the equity market with a focus on safety and income. In accordance with our mandate, we took considerably less risk than the S&P 500 Index,[2] including a 30% position in very stable preferred stocks, and yet the portfolio delivered returns above those of the market. In addition, the portfolio had an average yield in 2012 of 4.9%. We concentrated on what was possible to achieve given daunting economic and political risks. For that reason, we often sailed close to shore, keeping position sizes relatively small and preserving some cash when potential investment alternatives didn't offer enough return to compensate for the risk. But we also invested significantly in the three themes discussed in previous letters – the American oil renaissance, undervalued financials and smartphone technology. This combination of prudence and targeted investment produced strong absolute returns for the HIEP. In the fourth quarter, the High Income Equity Portfolio was up 0.5% net of fees (while the S&P 500 Index was down -0.45%). For all of 2012, the HIEP was up 18.8% net of fees (while the S&P 500 was up 15.9%). More importantly, this performance put us in the top 2% of the 303 U.S. equity income managers measured by Bloomberg, who were up an average of 12.2% in 2012. We believe this comparison is more appropriate than the S&P 500, because these equity income managers are trying to do what we do – offer a lower risk and higher yield profile than the S&P 500 Index. On a personal level, I am pleased that our strong year came after making the decision last January to invest in the firm by paying off our debt, buying out my partner and growing our investment team to five professionals, the largest in our 13-year history.

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[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.

[2] We use the measure of Beta to assess risk. A Beta of 1.0 is equivalent to the market, while the HIEP has a Beta of 0.6, or 40% less volatile than the S&P 500 Index.

The goal of the HIEP is to offer equity exposure in a conservative way. Unlike a lot of other equity income portfolios, we employ preferred stocks to lower the volatility and raise the yield of the HIEP. Because the use of preferred stocks lowers the volatility so much, we are also able to buy some common stocks that have more appreciation potential than the blue chip but often slow growing companies typically found in other equity income portfolios. This "barbell" approach of very low volatility preferred stocks (30% of the portfolio) and common stocks with greater capital appreciation (70%) was a powerful combination in 2012, far outdistancing more run-of-the-mill equity income portfolios. (With this letter, we've included an article about the HIEP from Value Investor Insight magazine. It explains our barbell philosophy, and includes a chart that compares our preferred stocks to the senior debt of the same issuer.)

The Year in Review

2012 was a lot better for our investments than either the headlines or our own expectations would have led us to believe. The overwhelming reason was stock selection that differed from the market mainstream. The fourth quarter saw nine of our 17 common stock holdings up more than 8 percent in a period when the market was down. The refiners, the financials and our defensive healthcare stocks all were standouts. That explains why we performed well, even though **Apple**, one of our larger common stock holdings, declined 19 percent in the quarter. And in a down market, the 30% preferred stock investment (yielding over 6%) did what it was intended to do – maintain price stability while its dividends added to performance. In a solid year, most investments contributed to the bottom line, but the American oil renaissance stood out. After three decades of decline, since 2008 there has been an unrelenting increase in the production of crude oil in the United States. In 2012, the United States grew oil production by the most since 1958. We expect a similar increase this year. As mentioned (ad nauseum) in previous letters, we are exploiting this phenomenon by investing not in oil production companies, but in refineries that transform this abundant and relatively less expensive oil into essential material for of our economy, like gasoline, diesel and jet fuel. The three refiners we owned in 2012 were up an average of over 30%. **Holly Frontier**, our largest refining position, paid *five* special dividends in 2012, amounting to over 10% of the share price.

Financial stocks also helped performance in 2012. While refiners as a group added the most to the portfolio's bottom line, **JP Morgan** was the single largest contributor. Not only did the stock rise 30% during the year, but when it announced the "London Whale" trading loss, and the stock plunged 25% in a month (ending in early June), we doubled our position. The stock is up 43% from those lows. **Morgan Stanley, Goldman Sachs** (sold in April), and **BlackRock** were also strong contributors. We have believed in the undervaluation of certain financial stocks for a long time, and it seems we're finally getting paid for waiting.

There weren't a lot of mistakes in 2012, but one stands out. We didn't sell a single share of **Apple** even though it went from our initial purchase price of $366 to $705. Such a sale would have been a large short term gain for our taxable clients, but there are worse things than paying taxes (like watching a stock drop 25%). We believe in Apple, and continue to hold the position. Even with its recent decline, Apple is still up 22% for the year in our portfolio, but there's an old saying – you can make a lot of money by selling too early – and we should have followed that advice.

What's Ahead for 2013

While Congress has dispensed with one fiscal cliff, another looms at the end of February, when we reach the U.S. debt limit and mandatory spending cuts kick in. If you thought the recent compromise was a difficult one, upcoming negotiations promise to be worse, with the most difficult issue – entitlement spending – looming as the 8 trillion dollar elephant in the room. Still, after significant turbulence we think some resolution is more likely than not, and we remain focused on things we can analyze with greater insight, like how much our companies are going to earn and what promising business ventures they might embark upon. In spite of the political turmoil, we will continue to commit capital, but only when a potential investment can produce returns commiserate with the risk we are taking. Our current themes – the oil renaissance, financials and smartphones – performed strongly in 2012. The double-edged sword of value investing is that when your investments do well, they become less attractive. We have taken some profits in our refining investments because there were large gains in a short amount of time, and the winter months are typically poor ones for refiners. The profitability of the financial industry has been reduced significantly by regulations like Dodd-Frank. With this in mind, the stocks are still too cheap. Morgan Stanley trades at 68% of tangible book value (liquidation value), and ought to trade at least *at* tangible book value. The Smartphone investment theme seems to have hit a wall, but we believe this is where the short-term potential lies, as we think the market is way too pessimistic about Apple's future. The stock is selling as if growth has practically evaporated. It has not. We believe holiday sales figures will confirm our optimistic view. Either way, we'll know by the end of January.

We added three new stocks to the portfolio in the fourth quarter. **Enbridge** is a pipeline company, and **Valero** a refinery, but both are plays on the American oil renaissance. Increased oil production in the Plains states must be transported through newly built pipelines. But most pipeline companies focus on natural gas, a commodity suffering through a price slump. Enbridge is the "oiliest" of all the major pipeline companies, which is why we like it. Refiners like Valero benefit from the relatively cheap oil now being produced in the middle of the continent, which allows them a cost advantage over most foreign refineries. For this reason, for the first time since 1948, the United States is now a net *exporter* of refined products. Valero is the U.S.'s largest exporter of diesel fuel and gasoline, and joins two other refiners in the portfolio. Both Enbridge (up 8% since purchase) and Valero (up 16%) have been good

investments in a down market. In addition, both pay above average dividends that have been increased recently. Late in the quarter we also purchased **McDonalds,** a stock that has underperformed in 2012. The franchise business model allows McDonalds to own the store and land and then lease them to the franchise operator. This gives the company stable rental and licensing income with little cost, leading to an impressive gross margin for the franchised part of the business. Within the key US market, sales growth is mature, but the company is growing internationally, with single digit sales growth leading to 10%-plus earnings growth. McDonalds is a good investment in the HIEP given its low beta (0.5, or half as volatile as the market) and growing dividend (3.4% yield, nearly 15% annual dividend growth).

As we bring 2012 to a close, we would like to thank you for your support. I am truly pleased to report strong results at the end of our first year as a restructured, newly-energized firm. I look forward to our future and realize that the performance of your portfolio is essential to our success.

Very truly yours,

Christopher C. Grisanti

p.s. *As mentioned, we have included in your materials a piece written about the High Income Equity Portfolio published in a recent edition of Value Investor Insight.*