



January 2, 2015

High Income Equity Portfolio Fourth Quarter 2014 Letter to Investors

For the Period Ending December 31, 2014

	Since			
	Year	Inception	Current	Current
	To Date	2/28/2010	Yield	Beta
<i>Grisanti Capital Management LLC</i>				
<i>High Income Equity Portfolio</i> ¹	+10.4%	+66.6%	4.0%	0.8

Dear Clients & Friends of Grisanti Capital Management,

When the Gods wish to punish us, they answer our prayers.

– Oscar Wilde

2014 was a solid year for the High Income Equity Portfolio (the HIEP), especially at the end of the year as volatility returned to the markets when oil prices plunged. The portfolio was up 4.8% for the fourth quarter, in spite of the negative effect of the decline in energy prices on our pipeline and refining stocks, which we discuss below. For all of 2014, the portfolio rose 10.4%. It also met its goal of high current income, with a yield of 4% and its conservative investments make the portfolio about 25% less volatile than the market. While the HIEP is a conservatively-managed product, our performance was still strong when compared to other less conservative value managers. The average U.S. value mutual fund was up 8.7%,² but those funds do not generally have the high yield or low volatility characteristics of the GCM high income equity portfolio. In other words, your portfolio delivered greater performance with less risk and a higher yield.

Our performance in 2014 was determined, of course, by the investments we owned (like **Liberty Global, Covidien, Morgan Stanley and Kinder Morgan**) but it was also a result of what we *didn't* own. Our research into the American Oil Renaissance led us to conclude that oil would be in over-supply, pushing its price lower. As a result, for three years we have made no energy investments except for refiners that benefit from falling oil prices, or pipeline companies

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.

² As measured by the Bloomberg data base of 606 U.S. value broad market mutual funds. While we are not a mutual fund, we compare our net results (+9.5% after fees) to those of publicly traded mutual funds with similar styles (U.S. value broad market) because we believe it is a fair comparison and the data is publicly available.



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that simply collect a toll on the volume of oil or gas transported, regardless of its price. This insulated us from the worst of the energy decline. The price of oil is now down 49% from its high six months ago. *This is an unprecedented drop during a period of economic health in the U.S.*

Which brings us to Oscar Wilde. The great majority of Americans (as opposed to Saudis or Venezuelans) view lower oil prices as an answer to prayer. Everything from gasoline and heating oil to groceries and airfares becomes less expensive. That's why, in mid-November, when oil prices were down "only" 20%, the market was ecstatic. But as oil continued to decline 30%, 40% and now 50%, one could almost hear the market pause, skip a beat and start to ask questions. In mid-December, as oil surpassed a 40% decline, the Dow dropped almost 1000 points in seven trading days. It has since rebounded, but there remains a sense of unease. Perhaps the Gods are punishing us by giving us what we always wanted. After all, we've never had such a drop in commodity prices without a recession. We believe further price drops will make the market more fearful – it will ask 'why are prices falling so much when the economy is healthy?' And finally the unspoken conclusion – maybe oil is trying to tell us something – maybe the economy isn't so healthy after all....

We disagree. Like Freud's cigar, sometimes oil prices are just oil prices, with no deeper meaning. From our work on the American Oil Renaissance, we're confident prices are dropping because there's just too much oil, and they don't portend a weaker U.S. economy ahead. Further, we think we are nearing an inflection point. What will turn things around? The cure to low oil prices is low oil prices. They have already been cut in half from their 2014 highs; now, with companies already announcing sharp cutbacks, we expect new drilling projects to slow by mid-2015. As supply is curtailed, and demand picks up in a growing economy, prices should begin to rebound. For that reason, we believe any broad market turmoil caused by falling energy prices is an *opportunity* rather than a precursor of calamity, and we plan to take advantage of it in two ways. First, we will look for non-oil-related investments that are suffering unnecessarily. Second, for the first time in almost ten years we are evaluating investments in the energy patch that rely on the *higher* oil prices we think are coming down the road (don't ask us for a specific date). We believe we are early in the cycle but opportunities are now being created for meaningful capital appreciation over a three year period. We suspect we will be writing more as the year progresses about changes to the energy portfolio.

Our performance in 2014 was broad-based and not reliant on any one theme. We had three takeovers in the portfolio (**Covidien**, **AstraZeneca** and **Direct TV** appreciated 52%, 25% and 19%, respectively). In addition, performance was aided by gains from European cable operator **Liberty Global Plc** (up 28%) and investment bank **Morgan Stanley** (up 23%). Notably our energy positions, which make up 23% of the portfolio's assets, contributed outsized returns thanks to our aforementioned pipeline and refining investments. During the eleven months we owned it, **Western Refining** returned 22% and shares of **Kinder Morgan, Inc.** rose 19% as the company merged its publicly traded pipeline affiliates into one corporation and hiked its already robust dividend by 15%. We made our mistakes in 2014 as well, but we kept them manageable. **IBM** (down 8%) was a classic "value-trap," which we bought in hopes of a turn-around that never materialized. But the cheap valuation and relatively small position (2%) at time of purchase prevented the mistake from costing us a lot.



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In the market downturn in early October, we took advantage of the market dislocation to initiate a new position poised to benefit from the digital payment revolution. We love investments that have two (or more) things going for them. In this case, the trend to pay with a credit card (digitally) has two growth engines. The first is demographic. If you are over 70, you pay for things with your credit card 30% of the time. It does not occur to many septuagenarians to use a credit card for groceries or a taxi or a cup of coffee at Starbucks. A twenty-five year old does the exact opposite. She carries very little cash, and it wouldn't occur to her *not* to use a credit card. She never opens an envelope or licks a stamp to pay a bill. Instead, she links her credit card to automatically pay for her electricity, phone and student loan. The second way to win is international growth. The United States is *way* ahead of the rest of the developed world in using credit cards, whipping them out almost twice as much per capita as their German or French counterparts. To profit from this secular trend, we invested in leading global payment processor **Mastercard**, a wonderful business with strong margins and an attractive growth runway over the next five years. Because we were opportunistic and purchased this investment during the October decline, it is already up 21%. We see further gains ahead over time and we are pursuing additional research in the digital payments theme.

As we look to 2015, we see a benign backdrop for U.S. equities due to a strengthening economy and low commodity prices. There are two main risks to our general outlook. First, with recent economic growth, we believe the Federal Reserve will probably raise interest rates sooner rather than later. This is not necessarily bad – after all, strong economic growth is a good thing for our investments and for the world at large – but it will add volatility. The other risk, which we think is less likely but more severe, is that the slowdowns in Europe and China become more pronounced and drag down the rest of the world. In this scenario, interest rates and commodity prices would continue to fall, and stock prices would eventually follow suit. Of course there is always the chance of an unforeseen event – Russia invades Ukraine, a debilitating disease, terrorist attack or storm, etc. However, while we will remain on guard for these events, we want to underscore that the most likely version of the future is a strong economy that produces earnings growth and some stock appreciation. With the stronger dollar, investors should continue to see the United States equity markets as the most attractive place for their money, especially on a risk-adjusted basis.

We enter 2015 with momentum. Our portfolio is safer, higher yielding, and considerably less expensive than the overall market, and is composed of out-of-favor, well-run companies. That was a recipe for success in 2014, and we think it should serve us well in the New Year. We wish you a healthy and prosperous 2015.

Very truly yours,

Christopher C. Grisanti