Grisanti Capital Management

Large Cap Value Portfolio First Quarter 2013 Letter to Investors

April 1, 2013

Dear Clients and Friends of Grisanti Capital Management:

	For the Period Ending March 31, 2013		
	Year To Date	Since 9/30/11	Since 1/1/2000
Grisanti Capital Management LLC Large Cap Value Portfolio[1]	+8.0%	+53.6%	+117.5%
S&P 500	+10.7	+43.5	+36.6

As a rule, value investors are terrible party guests. We arrive too early, keep an eye on the clock and as dancers start to climb onto tables, we sidestep toward the exit, mumbling our good-byes. While we may not be much fun, we end up with fewer regrets in the morning.

With that in mind, the market threw quite a party in the first quarter of 2013, and your portfolio participated nicely, even as we edged toward the door. This upsurge, coupled with our strong 2012, has led to our best 18-month period ever, up 53.6%, besting the S&P 500 Index, which was up 43.5% in the same period. Capital appreciation, however, is a double-edged sword. As a consequence of this strength, we now hold investments that are still promising, but are no longer the bargains they once were. As the market surged, we held more cash than normal and gravitated towards stocks with lower volatility and strong dividends. We were up 8.0% in the quarter, slightly lagging the frothy market, but content with that return in light of the more defensive positioning of the portfolio. Our cautiousness does not indicate that we expect a sharp sell-off. It's simply getting harder to find undervalued investments, so until we do, we will hold excess cash.

The end of the 13-Year Dry Spell?

While no one can deny the party atmosphere of the first quarter, at first glance it's not clear what equity investors were celebrating. It could have been that our government somehow avoided a fiscal disaster brought about by (pick your poison) the sequester, the debt ceiling or the continuing funding negotiations. Or maybe it was because Europe didn't sink the markets via (again, the choice is yours) Cypriot banks, Italian elections or French tax hikes. We have to admit, our expectations on these points are so low – we're so convinced that policy makers will do the wrong things – that merely muddling through *is* reason to celebrate.

[1] The performance shown for Grisanti Capital Management is that of our Large Cap Value Composite, before deduction of our fees.

On the other hand, perhaps the market can be forgiven for celebrating because, for the first time in half a decade, there is some unambiguously decent economic news. (And *decent* is the right word, not *stellar* or even *strong*.) When construction of new homes, to pick one example, has been at post World War II lows for five years, *decent* growth is a welcome change. And change is what the market is all about: Are things on the mend or getting worse? Are companies earning more or less than the year before? Is the unemployment rate rising or coming down? The fact is, things are not great, but they *are* improving. Besides home construction, the unemployment rate is declining, as are weekly jobless claims. Retail sales are improving and consumers continue to shed debt and retreat from their extremely over-levered position a few years ago.

Moreover, investors are taking note of these positive developments and becoming more confident. Equity mutual funds are seeing net inflows for the first time since before the financial crisis. As a result, the S&P 500 Index surpassed its 2007 highs on the last day of the quarter. But all the while, as this chart shows, investors have not made much money over the last 13 years.[2]

What is most important from an investment perspective, however, is that earnings have progressed through this period of market stagnation (see the dotted line in the graph). *In 2013 earnings for the S&P 500 companies will be double what they were in 1999, even though the market has gone nowhere.* The current price-to-earnings ratio for the market based on 2013 earnings estimates is about 14. In 1999 that number was 29, and interest rates were much higher then, which should have *lowered* the market multiple. But if investors didn't realize how expensive the market was in 1999, perhaps they also don't appreciate how attractive it may be

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2 Investors with Grisanti Capital Management fared better than the general market. Since March 2000, the large cap value composite of Grisanti Capital Management has appreciated 87% net of fees.

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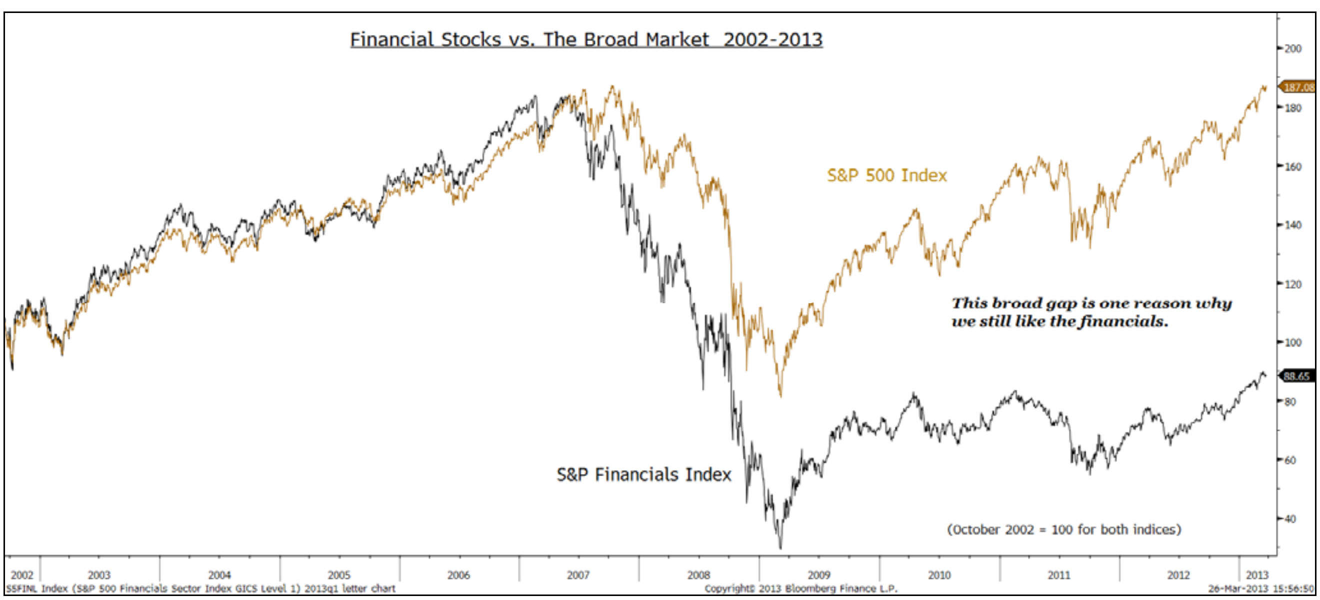
today. While the current 14 times earnings is not dirt cheap, it is low considering that interest rates are practically zero and the economy is now unarguably growing, albeit slowly. The mutual fund inflows mentioned above seem to indicate that investors are concluding that stocks are the only game in town these days. In that regard, we believe that the 30-year bond rally has finally ended, leaving bonds yielding almost nothing, and carrying both interest rate and credit risk.

Our conclusion from this is that we are cautious in the near term because of the market's recent sharp rise, but we are optimistic that the current recovery will continue and will bring about further appreciation for our equity investments over the next three years. In practical terms, this means that we are not afraid to make investments at prices we regard as reasonable, but after the recent surge this has become more challenging. As usual, we will be patient, and we believe that the market is unlikely to continue on its current upward trajectory without some hiccups along the way.

A Review of the Portfolio

The portfolio continues to invest in three major themes, and a number of individual (i.e., "unthemed") investments. The three themes are the American oil renaissance, financial recovery and the smartphone revolution. We have talked at length about the oil renaissance theme in past letters, so here we wanted to review our continued investment in the financials, especially in light of the fact that they have done quite well over the last 18 months.

The question on the table, therefore, is: With Morgan Stanley up 64% from our initial purchase price of $13.80 and JP Morgan up 149% from our initial purchase price of $20.36, why do we still like the financials? The answer is best presented in the following chart, which shows just how badly the financials were thrashed in 2008 and how, even after a strong 2012, they have a long way to go to "catch up."



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The caveat, of course, is that we buy individual companies and not "The Financials." In this way, we try to ensure we invest in a company not simply because it had lagged the market, but because it has unrecognized quality and growth potential. Bears will correctly point out that financials shouldn't really make up all that lost ground, because the regulatory environment is less favorable now than in 2007, when the financials parted ways with the rest of the market. We don't disagree with that, and we've adjusted our financial models to reflect a less profitable environment. But, as you might intuit from the chart, even with some headwinds, there's a lot of room for improvement. We still favor **JP Morgan** and **Morgan Stanley** in the banking and brokerage businesses. In addition, we added two high yielding mortgage REITs, **Annaly Capital** and **American Capital Agency**, which add financial exposure but also lower the volatility of the overall portfolio. Our holdings in asset manager **Blackrock** and financial services company **American Express** round out the diversified financial sector of your portfolio.

As the market surged this quarter, we sold our investments in **Disney** and **Marathon Petroleum**, each because it hit our sell target after good appreciation. Disney, as an example, is still a great company, but we believe it no longer offers superior returns over the next several years as it has already risen over 60% in our portfolio in an 17-month period. It now trades at 18.5 times earnings, so we have sold it, and are retaining the cash while evaluating future investments. We also sold **Lockheed Martin** for a gain of 15%, less than we had hoped for, but with the sequester cutting back defense spending, we felt the thesis was impaired and we took our profit. We have also trimmed but not eliminated a number of other investments as they have approached fair value, even in groups that we continue to favor, like financials and refiners.

In conclusion, while the market may be ahead of itself in the short term, its exuberance is understandable in light of decent economic statistics and the absence of attractive fixed income alternatives. We will continue to be prudent in allocating your capital and we are optimistic about the longer-term prospects. We would be happy to answer any question you have, and we look forward to reporting back to you at the end of the second quarter.

Very truly yours,

Christopher C. Grisanti