Grisanti Capital Management

April 9, 2014

Large Cap Value Portfolio First Quarter 2014 Letter to Investors

Dear Clients and Friends of Grisanti Capital Management:

	For the Period Ending March 31, 2014		
	1Q14	Since 9/30/2011	Since 1/1/2000
Grisanti Capital Management LLC Large Cap Value Portfolio	***+3.4%***	***+79.6%***	***+154.4%***
S&P 500	+1.8	+74.8	+66.4

You can't always get what you want,
But if you try sometimes,
You might just find,
You get what you need.

-- The Rolling Stones

While we don't generally seek investment insight from the Rolling Stones, these lyrics nicely capture the ambivalence investors feel when presented with real opportunity. Investors always *say* they want opportunity, but the fact is opportunity is only created when enough investors *don't* want something – either because they're scared or the investment is out of fashion – and its price falls too low. Real opportunity is *unattractive* to most investors (and a great investment opportunity like 2008 is positively *hideous*). On the other hand, a soaring market like 2013, while quite gorgeous, presents little opportunity. At the end of the day, what investors really *need* is a more volatile, less-than-beautiful environment. That's exactly what the market delivered in the first quarter of 2014, and your portfolio took advantage of it.

After taking a year off, volatility returned to the markets in the first quarter. The Grisanti Capital Management portfolio was up 3.4% in the quarter, continuing our strong performance at the end of 2013. This compares with the S&P 500 Index which was up 1.8%. We are pleased to

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report that since we commenced our restructuring to buy back (and rename) the firm in late 2011, the portfolio is up 79.6%, versus 74.8% for the S&P 500.[1] In 2013 the market rose over 30%, leaving stocks expensive. But the Dow Jones Industrial Average slid more than 1000 points in the first five weeks of 2014, its worst decline in more than a year. We saw a simultaneous surge in volatility – our favorite indicator of panic, and therefore opportunity. In the downturn, we bought six new companies, the most in a single quarter in several years.

Our first quarter performance was encouraging considering that our financial and refining investments – two portfolio themes representing about half the portfolio – were not major contributors to our performance. Instead, our outperformance came from a handful of diverse

investments, including **DirecTV**, a satellite communications company (up 12% for the quarter); and two software companies, **Autodesk** (up 9%) and **Cadence** (up 10%). Our two airline investments were especially profitable, with **United** up 18% and **American** up 45%. Due to our focus on valuations, especially in a volatile market, we have since sold our position in Autodesk and trimmed United Airlines (after a 55% rise since purchase last August). Although American was up sharply in the quarter, our fair value target remains well above the current price.

Financial stocks have been part of the Grisanti Capital Management portfolio since the 2008 crash, but this investment theme may be nearing a successful end. With their strong appreciation since initial purchase (for example, **JP Morgan** up 227%, **Morgan Stanley** up 133%), we have begun to reduce our position. We've always thought the post-crash regulatory environment was hostile for these companies, but we owned them because after the 2008 crisis they were just too cheap. (We bought Morgan Stanley at less than half of book value, for example, when it usually sells for close to two times book.) Now they are approaching fair value and we are beginning to take profits. We have already sold **Citigroup** and **Wells Fargo** (and had previously sold **Goldman Sachs**).

As mentioned, the market's volatility gave us the opportunity to make a number of new investments in the quarter. In fact, we made six, which is the most I can remember in a single quarter: **Altera** (semiconductors), **Eaton** (industrial conglomerate), **T. Rowe Price** (asset manager), **Target** (retail), **General Motors** and **Verizon**. Rather than giving a cursory sentence about each, we want to discuss two opportunities we seized in the quarter in greater detail. As we mentioned at the beginning, these opportunities were created because investors want something more popular or are currently afraid.

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[1] Performance since 9/30/11. We beat the market in spite of the fact that the portfolio held more than 20% cash at times during this period due to fears about political and economic uncertainties. Excluding the cash, the equity-only portion of the portfolio rose 90.8%. Performance for the Large Cap Value 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. Past performance is, of course, no guarantee of future results.

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Unless you've been living in Burundi without an internet connection, you already know that **General Motors** manufactured a defective ignition switch in the mid-2000s that has led to an enormous recall and a Congressional investigation. GM's stock price has dropped from a high of 42 to a low of 34, even as the market has risen. We are impressed with the new CEO Mary Barra, who has worked to disseminate the bad news as accurately and quickly as possible, and we believe the stock's sharp decline is a buying opportunity. We made a strong return with Ford in 2013, and we think GM is about a year behind Ford in its turnaround story. In January GM announced its first dividend in six years and the U.S. government has completely sold its equity stake (established in the 2008 crisis). Further, U.S. consumers are driving around in the oldest car fleet ever, because the financial crisis postponed the cycle of auto buying for several years. Therefore we expect auto sales to be above trend for the next several years. We believe GM will earn close to $4.00 this year and more than $5.00 next year, making the stock less than 7 times earnings. Ford currently sells at 11 times earnings, and even that is not expensive.

Another contrarian new investment is **Target**. Declining traffic in the U.S., a difficult rollout in Canada, and the theft of its customers' credit card information all combined to buffet Target in the last four months. Believing these issues are largely transitory, we bought the stock after it had fallen more than 25% from its high and was trading below 10x our estimate of the company's current earnings power. With customer loyalty rankings consistently in the top 10 for

U.S. retailers, capital spending peaking, and a clear path to significant growth in free cash flow, we expect the company to continue to increase its already healthy dividend (over 3% at our purchase price). In addition, once the costs of the data breach are behind them, we expect the company to again ramp up its share buyback activity. Over the last 10 years Target has reduced the number of shares outstanding by over 30%. The stock is already up over 10% from our initial purchase in February.

We continue to believe that the U.S. economy will grow at a moderate pace in 2014. While we expect decent but not spectacular earnings growth, we also think stock prices will continue to rise faster than earnings. Why? Because, after seven years of outflows, the U.S. equity market is attractive to a broad cross-section of investors, both in terms of its asset class (stocks more attractive than bonds) and its geography (United States seen as a better investment than emerging markets, Japan or Europe). This trend of slow earnings growth but faster market appreciation is not unknown. It prevailed from 1995 to 1999, and it certainly carried the day last year, as earnings grew 8% but the market rose 31%. Successive years of such asymmetrical growth increase valuations and therefore risk, but this trend can last for several years and is not yet overblown. At its extreme, this trend led to the market peaking in 1999 at almost 29 times earnings, but today it sells at 16.5 times, just slightly above the 100-year average.

So far, 2014 has been a good backdrop for concentrated stock selection and we're off to a good start. But we remain wary of valuations, especially because stock prices continue to grow faster than earnings. Therefore, we will be quick to reduce investments that approach our fair

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value targets, as we have started to do with the financials and the airlines. The resulting cash has allowed us to add new companies to the portfolio. We enter the second quarter optimistic about all our portfolio companies and their ability to excel in this moderate growth environment. We remain on the lookout for compelling new opportunities that other investors may have overlooked. As always, we look forward to reporting back to you in early July, and as always we welcome your questions and comments.

Very Truly Yours,

Christopher C. Grisanti