Grisanti Capital Management

July 2, 2012

Dear Clients and Friends of Grisanti Capital Management:

We're pleased to report that the world "feels" a lot worse than the investment returns we've been able to produce this year. After a quarter that included slowing U.S. jobs growth, *two* Greek elections, several European summit meetings, a momentous Supreme Court ruling, and the specter of a slowing Chinese economy, the Grisanti Capital Management value portfolio remains up 10.4% year-to-date (after fees), ahead of both the S&P 500 Index (up 9.5%) and our benchmark, the Russell 1000 Value Index (up 8.7%). Our performance would place us in the top 5% of the 699 mutual funds in the value category tracked by Bloomberg.[1] The second quarter was a difficult one for the market, as events in Europe and downbeat U.S. economic statistics dampened first quarter optimism. It was a frustrating quarter for Grisanti Capital Management as well. While most of our investments outperformed the market, the portfolio was dragged down by the disappointing performance of two holdings, **JP Morgan and Morgan Stanley**. We strongly believe that these two financial stocks are oversold and their sharp rebound in June (each up more than 7%) is a foreshadowing of future gains. This is admittedly a controversial opinion, so we discuss our case for those financial investments later in this letter. Our position in the energy refiners was a bright spot during the quarter. Our largest position there, **HollyFrontier**, continues to pay large special dividends, buy back its stock and report near-record earnings in a mediocre economic environment. The stock was up 16% for the quarter, even as the S&P Energy Sector declined by 6%, following the price of oil lower. When we explained our restructuring of the firm last month (including our new name), we wrote to you of our renewed focus on quality and an intentional reduction in economic sensitivity. We have added investments with less volatility to the portfolio, such as **Disney** (parks and cable channels), **Direct TV** (satellite television) and **Enbridge** (oil pipelines). That emphasis has paid off: Since the market bottom in early October, the Grisanti Capital Management value portfolio is up 32% (net of fees), compared to 26% for the S&P 500 and 27% for the Russell 1000 Value Index. While it's impossible to call a "bottom", it is historically true that stocks tend to turn upwards *prior to* the economy showing signs of improvement.

Three Themes

Summer is the time for amateur theater. Unfortunately this summer, the production is the same as the last two years: Europe is playing Hamlet, constantly vacillating between staying together

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[1] The Grisanti Capital Management value portfolio is not a mutual fund, but a composite of separately managed accounts. We compare ourselves to the Bloomberg universe of U.S. equity value funds because that is our style of management, and the performance of those funds is publicly available (as opposed to the unpublished performance of other competitors who utilize separately managed accounts). In both cases the comparisons are made net of fees. The specific performance of your portfolio is enclosed with this letter, and may vary (up or down) from the performance of the value portfolio composite.

Grisanti Capital Management

and breaking apart. China is the enigmatic strongman, whose strength appears massive, but is it? And the United States – the dysfunctional polity which has lost its civility/pioneer-spirit/frugality (you fill in the blank) – plays the fading star, with its best days behind it. These are the roles that we see in the papers (literally or electronically) every day. But our opinion is that these portrayals, while possessing some truth, are superficial and banal. Worse, by believing the current drama is the whole story, investors can miss important trends that have little to do with events in Europe or the other members of the supporting cast. To further the cause of more thoughtful analysis, we want to discuss three investing themes that are working well for us this year. Together, investments that emanate from these three themes account for about 60% of the portfolio, and have been able to make money even in the face of the absorbing melodramas playing daily around the globe.

The first theme is the **American Oil Renaissance**, which is summarized in the research piece we distributed to you in June. (Please do not hesitate to call or email for another copy, which is easily dispatched.) In brief, it posits that we are at the beginning of a decade-long increase in U.S. domestic oil production, reversing a 40-year decline. By 2020 production will be more than twice its lows of 2007, which should reduce our dependence on foreign oil by more than half. While the research piece talks about this in great detail, for the purposes of this letter we focus on the investment consequences of all this oil in our own backyard. We believe this means lower oil prices in the geographic center of the U.S. (where the oil is coming from) versus imported oil. This in turn means the **refiners** located in those low-price areas will have a tremendous strategic advantage over foreign competitors in the production and sale of *refined products* like diesel fuel, gasoline and jet fuel. Recent evidence bears this thesis out: For the first time in over 60 years, in 2011 the U.S. **exported** more refined products than it brought in. That trend has increased more than 15% in the first six months of this year. Refiners are still seen as cyclical companies that do poorly in a mediocre economy like we have today. But instead, because of exports, they are reporting near record earnings and cash flow. We own three refineries: **HollyFrontier, Marathon Petroleum** and **Valero**. Each has performed well in a tough energy sector this year, due to what we think is a disconnect between how most investors *think* of refiners and the *new reality* of a U.S. exporting success story.

The second theme is the **smartphone revolution.** While we typically try to make money by differing from the consensus and investing in out-of-favor areas, in this case we think the consensus is *right*, they just don't appreciate *how right* they truly are. In other words, it's accepted wisdom that the world is getting more connected every day, and that literally more than a billion people who don't have smart phones right now will get one over the next 15 years. We think this is correct, except for two factors. First, we think it is happening faster than that, and second, several of the key stocks reflect apprehension at the sustainability of the high growth rates and sold off during the quarter. Of course, the primary beneficiary of the smart phone revolution is **Apple.** While the stock is up 59% since we bought it in November, it was down 2% in the second quarter. When Nokia reports slow sales, or when Verizon states that handset usage is down, Apple declines. But Nokia is slowing because Apple is taking share, and Verizon is slowing because other carriers are now carrying the iPhone. The *rate* of sales are slowing in the United States (but sales are still

Grisanti Capital Management

growing), but the rate is still accelerating in the (much larger) markets overseas. A second investment in this theme is **Qualcomm**, which makes semiconductors for *many* types of smartphones (not just the iPhone). In the (unlikely) event that the iPhone loses market share to other smartphones, Qualcomm can still do quite well as the "arms dealer" to all combatants in a world-wide battle. In addition, its many patents force almost every smartphone maker to license technology from Qualcomm, providing a stable royalty stream with virtually no related expenses. Both stocks lagged in the quarter, but the elements of a successful investment – continuing strong fundamentals and a reasonable stock price – remain intact.

Most controversially, the last theme, oddly put, is the **absolute hatred of financial companies.** While they certainly hurt the portfolio in this quarterly period, we continue to think a tremendous return can be had from a multi-year investment in two financial stocks, **JP Morgan and Morgan Stanley**. At the darkest moments of this past quarter, these stocks were again trading at valuations that equaled the low point of the 2008-09 financial crisis. Everyone knows the substantial problems these companies face – regulatory issues, credit exposure, international defaults – but we believe the stocks more than reflect the enormous amount of pessimism. Take Morgan Stanley (please!). If you *ignore* all its *intangible* assets (like future earnings potential, reputation, goodwill, etc.) and liquidated all of its *tangible* assets (most of which are readily salable, such as corporate and government securities) and then paid off all its liabilities, you would have about $27 a share left over to give to shareholders (i.e., its tangible book value). And indeed in early 2011 it was selling well above that amount, which makes sense, since the $27 tangible book value offers zero compensation for future earnings prospects. But the stock is currently trading at $14 a share, or half of tangible book value(!). That is the same valuation it had at its lows in November 2008 when the very survival of many financial companies was in question. Let's contrast the two periods: In 2008, the government was infusing Morgan Stanley with emergency cash (TARP), the company had eliminated its dividend, and was reporting large losses. Now, it has repaid all government investment with interest, it reported earnings that beat analysts' expectations in the first quarter, and is working to reinstate its dividend (pending permission from the Federal Reserve). Yet it still sells at the *same* valuation as it did when things were very dark indeed, and the Dow Jones Industrial Average was about half of what it is today. JP Morgan is an even more compelling story, as its recent terrible trading error has driven the stock back down to 2008 valuations **even though** it will still be solidly profitable this quarter (including the loss). It has not only paid back the government TARP money years ago, but it now offers shareholders a 3.3% yield and has the capacity to buy back stock (once the trading controversy is behind them). While we think Morgan Stanley will probably appreciate more from current levels than JP Morgan, we can't think of a stock in the portfolio which combines dominant market position, strong balance sheet and extraordinarily low valuation better than JP Morgan (and we get paid 3.3% to sit around and wait for our thesis to come true). It's a good example of our renewed emphasis on quality.

Grisanti Capital Management

Looking Ahead

We deal in a highly efficient marketplace, so the three themes that we discuss reflect our best analysis of the discrete, unusual areas where the market might have it wrong going forward. There are a number of other securities in the portfolio that are not part of these themes, but that have compelling characteristics that make them unique investments, like **Disney, Federal Express** and **Lockheed Martin,** to name a few. What they all have in common, in our opinion, are quality businesses, attractive cash flow streams, and a marketplace that underestimates their potential.

It remains a very uncertain world. The three year old European drama – it's no longer accurate to call it merely a "Greek Tragedy" – shows no sign of ending soon. As you can see from your portfolio statement, we have more than 10% in cash. That's for two reasons: first, to *protect* against exogenous events by lowering the volatility of the portfolio, and second, to *prepare* for opportunities that might present themselves upon such an event, the proverbial dry powder. When you receive our next quarterly letter in October, Europe will have probably survived a couple of more crises and we will be on the threshold of a presidential election. Less talked about but more important for our purposes, our companies will have had another quarter of results which we think will continue to help them produce profits for shareholders in an uncertain world. It's by focusing on the details of our companies and the themes that led us to these investments that we have made money so far in this uncertain year, and we plan to stay the course.

We thank you for your support and welcome any questions you may have.

Very truly yours,

Christopher C. Grisanti