Grisanti Capital Management

Large Cap Value Portfolio Third Quarter 2013 Letter to Investors

October 10, 2013

Dear Clients and Friends of Grisanti Capital Management:

Through all the turmoil surrounding a government shutdown, the threat of U.S. military action in the Middle East, the soaring price of oil and the continued rise in interest rates, the Grisanti Capital Management portfolio was up slightly in the third quarter, and has risen more than 50% in the last two years. Much of the portfolio performed strongly, with large holdings in disparate industries like **Ford** (autos), **Morgan Stanley** (financial), **Dover** (industrial) and **McKesson** (healthcare), each up over 10% in the quarter. The laggard was our long-term energy position, which is weighing heavily on the portfolio this year. For reasons set forth below, we strongly believe these positions have bottomed out and have the potential to lead the portfolio upwards over the next 12 months (as they did in 2012). Our belief that we will be rewarded by our patience is not just wishful thinking; such an outcome has occurred frequently in our 14 year history. For example, in this letter we detail our profitable investments in the financial sector, but they were not immediately successful. We made those investments starting in 2009 and in the intervening years they sometimes lagged the market, just like energy today. (Our 2011 investment letters went into great detail about why we were standing by stocks like **JP Morgan** and **Morgan Stanley** even though they were lagging the market.) As you know, we stuck with our core financial holdings and have been rewarded handsomely for the last two years. (**JP Morgan** has nearly tripled, **Morgan Stanley** has doubled.) Our returns have consistently benefited from this patience and long term perspective.

A Few Words about Performance Relative to the Market

We manage a concentrated portfolio, believing the best way to offer superior long-term returns is to undertake intensive research, focusing on a few contrarian ideas with low valuations. **At a time when our current short-term performance is positive but not as strong as the market's, we think it is important to emphasize the long-term track record our concentrated portfolio has produced.** The following chart shows our performance for the last 12- and 24-month periods. As you know, at certain times we have held large cash positions (10-25%) due mostly to fears of dysfunctional government, both at home (during the Fiscal Cliff negotiations in early 2013) and abroad (during the European debt crisis at various points in 2011 and 2012). Raising cash hurt our performance, yet we believed it was a prudent decision because in each case we could not rule out a true 'disaster scenario.' **At those times, we traded potential performance in return for safety, and given the same set of facts, we would do it again.** For the purposes of this discussion, though, we want to show you both how your overall portfolio has done, as well as how your equities have performed without the burden of that cash position. Over two years, our overall portfolio (including cash) has risen more than 50%, and while it has lagged the market slightly during that time, the equities alone (excluding the cash) were up considerably more (58.4%), exceeding the market's return. Of course, most importantly, the chart also shows our long term (14-

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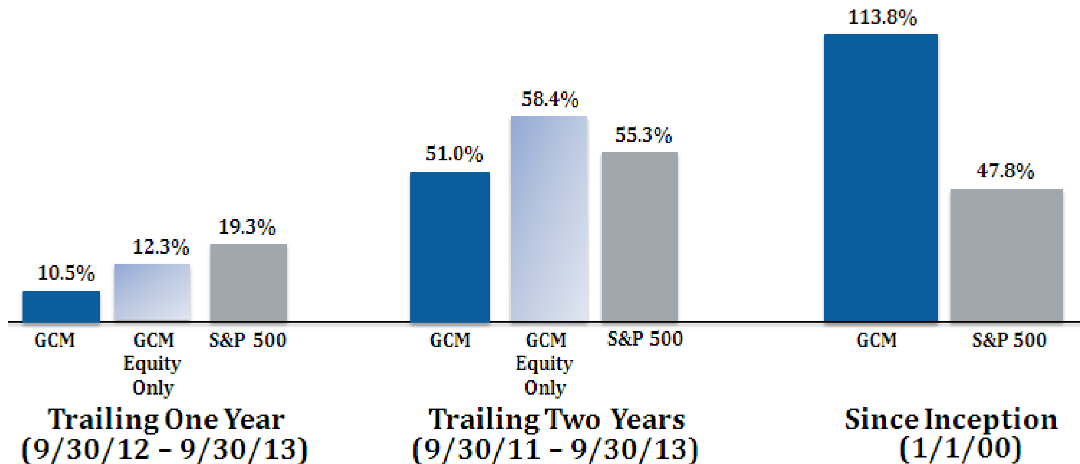
year) record,[1] in which we more than double the market's return (even including the cash that we held at various points over those years).



One final point -- When performance turns, it can turn quickly. In the fourth quarter of 2011, (coincidently, after the last debt ceiling negotiations), our portfolio was up 15% over three months, far ahead of the market. The rise was led by many of the same energy investments we hold now. It is not difficult to imagine similar dynamics in the coming quarters. In short, your portfolio dances to its own drummer, not to the overall market. **Over the past 14 years our long-term outlook has allowed us to double the market's returns. We remain focused and confident that your current portfolio has that same potential.**

Portfolio Review

The tailwind of a stronger economy has certainly helped our economically sensitive investments in 2013. Perhaps the best example is Ford, our largest position, which is up 10% for the quarter and 30% for the year. Not only is the company making record profits while producing 30% *fewer* cars in North America, but the dramatic losses it has experienced in Europe finally seem to be leveling off. *Any* improvement in Europe (e.g., losing "only" a billion dollars instead of two) would lead to higher total company profits than expected and should lead to a higher stock price. Even though Ford is up about 70% since our initial purchase last year, it is still relatively inexpensive. Earnings could reach $3.00 a share in 2016 (assuming Europe finally makes money), and the stock sells for $17, or less than six times our earnings estimate. Another strong performer has been **Dover**, an industrial conglomerate that has a 50 year history of both managing businesses efficiently and also buying and selling within the corporate portfolio in a profitable manner. The

[1] The performance shown is for the Large Cap Value Composite and includes all accounts that are (1) fully discretionary, (2) managed in the large cap value strategy, (3) mandated to be fully invested in equities, and (5) over $1,000,000 in total assets. Prior to 2002, there was no minimum asset level.

Performance for the Large Cap Value Composite reflects the deduction of transaction costs, reinvestment of dividends and other earnings but not actual withholding taxes, if any. GCM's advisory fees are described in Part II of its Form ADV. The Composite's benchmark, the S&P 500 Index, includes the reinvestment of income but do not include any transaction costs, management fees or other costs.

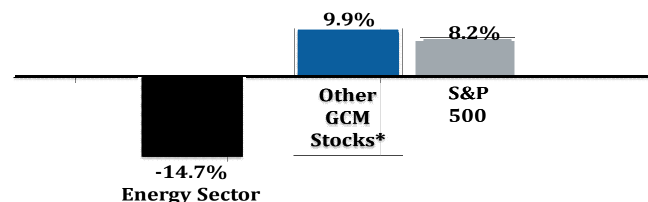
Past performance is no guarantee of future results. As with any investment vehicle, there is always the potential for gains as well as the possibility of losses.

recent announcement that it is spinning off its communications technology business was warmly greeted by the market, and the stock is up 16% in the quarter and 24% since its purchase in May.

The strongest group of stocks in the portfolio this year has been the financials, which continued their improvement in the third quarter. This is a sector we invested in heavily after the 2008-09 crash, so in some cases we have held positions for more than four years. **Morgan Stanley** is up 10% for the quarter, 26% for the year, and has more than doubled since its initial purchase in August of 2011 (during the last debt ceiling debacle). **Blackrock** continued its recovery and was up 6% for the quarter and 27% for the year. Our large holding in **JP Morgan** was down 1% for the quarter, but is up 13% this year and 174% since its initial purchase in March 2009. We say this not only to highlight the profitable investments, but to emphasize that the valuation discount that attracted us to the financials in 2009 is not nearly as steep as it used to be. We have started to reduce positions, especially in JP Morgan, and would expect that the group will play a smaller part in the portfolio in quarters to come. While we are in perhaps the seventh inning, the game is not over. Morgan Stanley has risen back to book value (we bought it at half of book), but is transforming itself into more of an asset manager, like T Rowe Price, which sells at (an admittedly lofty) five times book value. **Citigroup** remains an under-earning bank, and is currently trading at less than 80% of book value. With long-term interest rates finally rising, it can now profit from by borrowing short-term at the current minuscule rates and lending at the new, higher long-term rates. (It's been more than half a decade since this plain-vanilla banking business model has been profitable.) The new CEO (the first chief executive with a banking background since John Reed and Walter Wriston) is well equipped to exploit this opportunity.

The laggard in the portfolio was energy and the refining stocks in particular. In fact, energy stocks were down for the last six months as the rest of the portfolio was up nicely, in both absolute terms and against the market:

Energy – the Weight on the Performance for 2nd and 3rd Quarter



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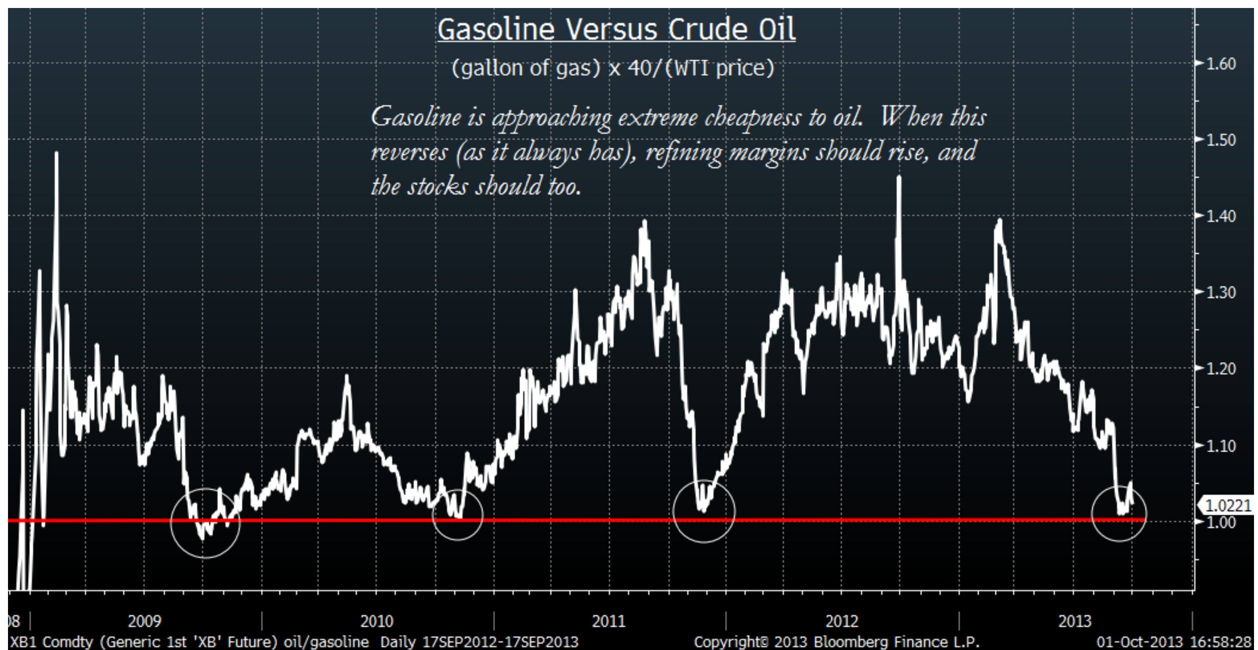
Last quarter we included our report *The American Oil Renaissance Creates an Opportunity: U.S. Oil Refining – The New Export Industry*, which has been updated and is available on our website (or we'd be happy to send it to you). The trends we discussed there in great detail include strong, multi-year growth in U.S. oil production and refiners with a competitive cost advantage due to both a glut of oil and natural gas. These trends remain intact – U.S. oil production, for example, is up 18% since last year – and will only get stronger over the next two years. Recently, though, all those strong fundamentals have been overwhelmed by the quick rise in the price of oil, even as gasoline prices have declined due to the end of the summer driving season. This oil price spike has caused a lot of dislocation, not just among refiners but also companies in other industries for which oil is an important input cost. We believe for a variety of reasons that the price of oil will be markedly lower in the quarters to come. In fact, the chart below shows the relationship between the cost of oil and the cost of gasoline. The lower the line, the more oil costs in relation to gasoline, and therefore the



worse for refiners (who buy oil and sell the resulting gasoline). We seem to be at the bottom, since refining capacity tends to shut at times of low profitability, driving up the price of gasoline. At that point the margins, and also the stocks start to outperform. In short, exogenous factors have hurt these stocks recently, but we believe they should perform better in the coming months.

Finally, a Tail Wind

In closing, we wanted to point out an investment shift that should affect markets for years to come: for the third quarter in a row, stocks outperformed bonds. In fact, fixed income securities of all kinds suffered another decline in the quarter, though not as sharp as the dramatic losses of May and June. We think there is a straightforward reason for both the bond weakness and the equity strength: after the worst financial crisis since the 1930s, the U.S. economy has stabilized and is now slowly gathering momentum. We are confident that the present mess in Washington will be resolved in a manner that won't affect the markets in the long-term, and when it is the focus should

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be back on an economy that continues to slowly recover. It is being supported by a potent combination of an incredibly accommodative Federal Reserve, growing employment, strong corporate balance sheets and the lowest inflation in two generations. While we don't know how this will affect your investments month to month, when we take a wider view, we come to the conclusion that the markets have already begun a multi-year trend towards equities and away from fixed income. It has certainly started with a bang – as mentioned, our portfolio is up over 50% (51.0% to be exact) in the two years ending September 30. While we're pleased with these returns, it is hard to deny the tailwind of a growing economy and a shift towards equities. It's always easier (and more profitable) to be investing *with* the wind.

We look forward to reporting back to you at the end of the year, and as always do not hesitate to contact me with any questions or comments.

Very truly yours,

Christopher C Grisanti

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