Grisanti Capital Management

October 1, 2014

Large Cap Value Portfolio Third Quarter 2014 Letter to Investors

	For the Period Ending September 30, 2014		
	3Q2014	One Year	Since 1/1/2000
Grisanti Capital Management LLC Large Cap Value Portfolio [1]	***-1.1%***	***+20.6%***	***+157.9%***
S&P 500	+1.1	+19.7	+77.0

Dear Clients & Friends of Grisanti Capital Management:

Don't Confuse Brains with a Bull Market.

-- Wall Street Adage

For three years investors have enjoyed the tail wind of a bull market, and many professionals who make their living picking stocks believe they've solved the mysteries of life. Yet, a strong bull market actually produces little evidence of who is (and who isn't) a talented investor. We managed to own stocks that beat the market over the last three years, but we'd be the first to admit that anyone can sail across the ocean in sunny weather. We think most passengers would agree that a fast ship in calm weather isn't nearly as important as a safe one in a more turbulent sea.

And that's important, because we believe the last three years represented an ecstatic – but aberrational – bounce-back from the financial crisis. Returns have been well above trend, and volatility well below. Going forward, we expect the market as a whole to be a more volatile, less profitable place. China is slowing, interest rates are probably headed higher, and valuations in general are not cheap. The question then becomes, in this less benign environment, where do we find our future investments? We think this is an opportune moment to review the last three years, and discuss our strategy for a more challenging environment ahead.

[1] 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. The Composite's benchmark, the S&P 500 Index, includes the reinvestment of income but does not include any transaction costs, management fees or other costs. The Large Cap Value Composite includes all accounts that are fully discretionary, managed in the large cap value strategy and over $500,000 in total assets. Prior to 2002, there was no minimum asset level. 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.

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Looking Back

Based on my confidence in our investment ability, three years ago I bought the part of the firm I didn't already own from my partners. We added to our investment team and renamed the firm Grisanti Capital Management. As mentioned above, it's easy to make money in a bull market. On the other hand, it's a lot harder to outperform in a sharply rising market without taking a lot of risk. We recognized that trade off, and I think we managed it well. Over the last three years we accepted a bit less return (but still exceptional by any absolute standard) in exchange for less risk. Specifically, we invested in terrific companies but at times – like when the U.S. government was shutting down, or European debt was plunging -- we kept cash aside, sometimes almost a quarter of your portfolio. Over that three-year period, our portfolio (including that cash) was up 22% *per year* just a bit behind the S&P 500 Index (up 23%). Our investments alone, excluding the dampening effect of the cash, were well ahead of the market, **up 25% per year or 94.4% cumulatively over the three year period ending September 30, 2014.**[2] The last year has been a good one as well, with your portfolio up 20.6%, while the market is up 19.7%. Again, excluding cash, your investments were up 23%. In both cases, you made a lot of money but our caution lowered your returns slightly. This is not a mistake -- we don't manage *toward* the market; we manage *away* from risk.

Since this is a *quarterly* letter, we should speak to the short term performance, though we do not manage your portfolio with that in mind. The market over the last three weeks of September has been volatile, punishing especially those stocks that would benefit from a continued economic recovery, like airlines, industrials and refiners. For that reason, we were down 1% for the quarter (versus a market that was up about 1%). As mentioned above, even including this period we remain ahead of the market for the last 12 months. We think the current volatility represents an opportunity to invest cash, a prospect that has been lacking as the market has headed straight up. We initiated new investments (more on that below) as well as added to companies we already own at attractive prices.

Looking Ahead

As risk has grown with higher stock prices, we have sold some winning investments and reinvested the proceeds into less expensive companies that we think will bear tremendous fruit over the next three years. Specifically, we took profits in five of our [eighteen] investments in the quarter, and made four new purchases, in four different industries. That's big news for your portfolio, as we usually only make one or two investments per quarter (and sometimes we do absolutely nothing). Over the past few years a number of themes have resonated in the portfolio, including financials, refining and autos. But now, with the market up so much, it is difficult to find broad sectors of companies that are inexpensive enough to merit investment. For that reason, our new investments have company-specific (rather than industry-specific) rationales. This quarter we made new investments in companies in the retail, auto rental, pharmaceutical and technology industries.

[2] The performance shown is for the Grisanti Capital Management Large Cap Value Composite.

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Bed Bath and Beyond is a respected brand whose stock price is trading as if it is losing money instead of slowly growing healthy earnings. We think fears about internet encroachment are overdone, and the company is one of the best managed in the retail space, producing about a billion dollars (or about 9% of the entire company's value) in free cash flow each year. We love that they are buying back their own stock hand over fist, and have reduced the share count by more than 20% in less than four years. No one on Wall Street likes the stock, creating what we like to call "dry kindling," where any piece of good news can light the stock on fire. In mid-September, the company reported decent (but by no means stellar) earnings, and the stock rose more than 7% in a day.

What we judge to be transitory events (resignation of long-time CEO, acquisition integration delays) have conspired to mask the potential positive impact of **Hertz Rent-a-car**'s 2012 merger with Dollar Thrifty. The aforementioned merger marked the completion of a ten-year consolidation wave that essentially creates an oligopoly between Hertz and its key rivals Avis and Enterprise Group. This trio of competitors gives Hertz an advantage, as it has the lowest cost of doing business. We calculate 2016 earnings power as just north of $2.00; applying a 16 multiple to this estimate (compared to Avis' 17 forward P/E multiple) results in a price target of $34, about 50% higher than the current price. An improving U.S. economy, firmer industry pricing discipline, the spin/sale of the company's equipment rental division, and the stock's heavy discount to Avis all combine to create attractive appreciation potential.

Abbvie is an attractive pharmaceutical company with an ugly name. It was spun out of Abbott Labs almost two years ago when that company wanted to divest its FDA-supervised drug business. Abbvie is in the process of merging with Shire, a British company, which would diversify Abbvie's business away from its reliance on Humira, the best selling drug in the world (used for the treatment of arthritis). Selling at 15 times next year's earnings, while growing earnings at over 20% a year, we believe investors' fear about Humira-centricity are overblown. We like the business, its growth profile, and the management, as well as the 3% yield.

Finally, we made an investment in the Chinese internet company **Alibaba**, which came public in September. We normally don't invest in hot internet IPOs, as we are afraid of speculative valuations. But this one, we think, is different. First, for years we have looked for credible ways to invest in the growth of the middle class in China. Alibaba is China's version of Amazon and Ebay combined, but whereas most of the U.S. is already wired for the internet, only 50% of China is, *and* the government is encouraging a move towards personal consumption and away from savings, which would drive revenues towards Alibaba. Second, we believe the pricing of this "hot" IPO was lower than most, out of fear of a Facebook-like debut in which the stock promptly plunged 50% weeks after the offering. We are excited about Alibaba, and view it not as a trade, but as a long term investment.

The biggest thematic shift in the portfolio is our move away from the banks after a five year period of successful investment. As recently as a year ago they represented 22% of the portfolio and now are only 5%. Over the last year we have sold **Wells Fargo and Citibank,** and, in the third quarter, we sold our long time position in **JP Morgan**, which had more than tripled in price since our original purchase in March 2009. But now these companies are back to reasonable valuations, and their business model is burdened with onerous new regulations. We

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have exited all banks except for **Morgan Stanley**, which we continue to favor specifically because of its growing asset management business.

With those portfolio changes, and a rather lengthy list of new ideas in the pipeline, we believe we are positioning the portfolio to make money in a market that is neither "bull" nor "bear." We expect an environment where earnings matter, and strong managements can make a difference through wise allocation of capital. For those of you concerned about a more difficult market ahead, over our 15 year history, Grisanti Capital Management has more than doubled the return of the S&P 500 Index (158% versus 77% since January 1, 2000), and, believe me, most of the last 15 years were not filled with bull markets! We look forward to reporting back to you at the end of the year.

Very truly yours,

Christopher C. Grisanti