Grisanti Capital Management

# ***Large Cap Value Portfolio Fourth Quarter 2011 Letter to Investors***

For the Period Ending December 31, 2011

| | 4Q11 | 1/1/00-12/31/11 |
|---|---|---|
| ***Grisanti Capital Management LLC Large Cap Value Portfolio***[1] | **15.0%** | **49.4%** |
| S&P 500 | 11.7 | 6.4 |

Dear Clients and Friends of Grisanti Capital Management LLC:

The fourth quarter was a powerful one for the Grisanti Capital Management Large Cap Value portfolio, which was up 15%, well ahead of the market. But let's call our strong performance what it truly was: a wonderful ending to a disappointing year. For 2011 our portfolio lagged in a market environment that was as frustrating as any we have experienced. Fundamentals mattered little. Rather, the great majority of stocks were correlated more closely with events in Europe than with their sales or profits. Still, there is good news. In the fourth quarter, the gap between fundamentals and stock prices began to close, and our portfolio outperformed a rising market. For reasons explained below, we believe this trend will continue (and so far in 2012 it has). We correctly predicted there would be no double-dip recession in the Fall as the market was plunging, and we used the panic to buy high quality companies like **Apple Computer** and **Disney** for attractive entry prices. Both are up more than 14% since purchase, and helped power the quarter's gains. We are entering 2012 with momentum.

Whether or not the fourth quarter marked a real turning point remains to be seen, but regardless it was an exceptionally profitable period: The market bottomed on October 3rd, and never looked back. Since then, through the date of this letter, the GCM portfolio is up 25%, (versus the S&P 500 up 18%). Stocks that had been beaten down – especially in the financial, industrial and energy sectors – bounced back with a vengeance. New holding **Morgan Stanley** was up 36%, **JP Morgan** up 28%, **General Electric** up 29%, **BP** up

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[1] Performance for the Large Cap Value Composite is shown after deducting all advisory fees and transaction costs. GCM's advisory fees are described in Part II of its Form ADV. The Composite's benchmark, the S&P 500 Index, include the reinvestment of income but do not include any transaction costs, management fees or other costs.

The Large Cap Value Composite includes all accounts that are (1) fully discretionary, (2) managed in the large cap value strategy, (3) mandated to be fully invested in equities, (4) tax-exempt and (5) over $500,000 in total assets. Prior to 2002, the Composite also included certain taxable accounts that the firm had authority to manage without regard to tax consequences and there was no minimum asset level. The inception date for data in the Large Cap Value Composite is June 1999.

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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27% and new holding **Air Lease** up 36%. Other, less volatile stocks were still good performers. For example, Microsoft was up 5%. The strong outperformance experienced in the fourth quarter has continued through the second week of the new year.

***Snow White and the Apple***

As the market sold off in large part due to European macro concerns, we seized the opportunity to buy two high-quality growing companies – Apple and Walt Disney. We are contrarians who are, frankly, disposed *not* to buy a "market darling" like Apple, but we are first and foremost analysts, and the math is just too compelling to ignore: When we purchased Apple, the stock was trading below 11x forward consensus earnings and well below its median multiple of 17.5x. This valuation, the company's cheapest since 2005, was too enticing to pass up as Apple has continued to grow earnings over 20% per year and has delivered shareholders with a 5-year average return-on-equity of over 30%. The main growth engine of Apple is the iPhone, which dominates the global smart phone market and has plenty of room to gain market share in emerging markets where smart phone usage is rapidly expanding. Among the catalysts that should help drive earnings above current street expectations in 2012 are new iPads, increased iPhone presence in China, and the release of the iPhone 5. Additionally, with a cash balance approaching $100B, it is quite possible that new CEO Tim Cook will implement a dividend for the first time this year. The stock declined following the company's first soft earnings announcement in five years, and that's when we bought the shares. We believe, from our own channel checks, that the softness was due to postponed iPhone sales as customers waited for the new model (the "4S") to be released in October. If we are right, fourth quarter sales should be exceptionally strong.

Disney is a lot more than Mickey Mouse these days. Disney is an entertainment conglomerate that successfully monetizes its intellectual property through movies, television, theme parks, and consumer goods. The Disney brand and ESPN franchise are moat-like barriers to entry.[2] While Space Mountain might be more fun, we believe Disney's cable networks are the most attractive part of the business, generating 30% of sales and nearly 60% of operating income. ESPN is the driving force with its recurring fees from cable/satellite television providers and its ability to demand high advertising rates for live sporting events. The theme park business, a key global driver of the Disney brand, is in the midst of multi-year expansion that includes growing Fantasy Land at Disney World and Hong Kong Disney, adding cruise ships, and building out its new Hawaiian hotel. The Studio business includes the Walt Disney brand as well as Pixar, which was acquired in 2006 (and which makes the estate of Steve Jobs the single largest holder of Disney stock). The company also monetizes its movie characters through its consumer products business. We view Disney as a high-quality, defensive company that provides protection to the portfolio in a down market while offering plenty of growth potential as the economy recovers.

[2] When we think of the value placed on the Disney brand, we recall former CEO Michael Eisner's often stated dictum to Disney employees: "Whatever you do, protect the Mouse."

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### *2011 Successes and Failures*

We think it is important to communicate our success and failures for the year in our fourth quarter letter. Even though the fourth quarter was strong, our successes were not enough to salvage our out-of-favor portfolio in 2011, but there were some noteworthy strong points. First, for the most part we sold investments well, which is something that many investors don't analyze, but which is crucial for making money in the long run. For example, we sold Bank of America at a gain early in 2011, and it has since declined 59%. Similarly: Freeport McMoran, sold at a large gain, is down 27% since; Best Buy sold at a slight loss, is down 22% since; Schwab sold at a gain, is down 35% since sale. The second success is more subtle: the construction of a portfolio exiting 2011 with exceptional appreciation potential *and* higher quality, less volatile investments. We sold General Motors and purchased Disney. We sold Marathon Oil and bought Apple Computer. And we did so at moments when each of those higher quality stocks were bargains that fit our value criteria. It remains to be seen whether these new investments will be sold at profits, but so far each has appreciated nicely.

As for the failures of 2011, the single largest was being overly optimistic about the U.S. economy at the start of 2011. Economically sensitive stocks like General Motors hurt the portfolio, even though the company performed well given the circumstances. And our worst investment, **Goldman Sachs**, was down 34% for the year, yet still remains well above the price we paid for it in 2009 (which gives you a sense of the volatility and appreciation potential when things work out). More broadly, our Goldman investment bespeaks of our investment in the financial sector, which was represented in 2011 by Goldman and JP Morgan, and, since late September, by Morgan Stanley as well.[3] The financial sector has now underperformed the broad market *five* years in a row, something that has never happened. In fact, the S&P Financial Index is down 60% during that period, while the broad S&P 500 Index is down only 1%. It's hard to find a more despised area, and we are attracted to that type of pessimism. These stocks are sporting 2008 valuations, but their balance sheets and the U.S. economy are dramatically better now. All three stocks are making money but selling at a fraction of book value (the value of all assets minus liabilities, giving no credit for future earnings potential). We are not making the case that the boom years have returned, but if these stocks merely returned to sell at their respective book values – a level that was 50-100% *below* their average selling price of the last ten years, we would make a lot of money. We believe they will be among our best performing investments of 2012. (And most emphatically not be included once again in the "failures" paragraph next year.)

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[3] It is worth noting that while the financial sector as a whole hurt us this year, each of the three financial stocks we own are up since their original purchase (Goldman in 2008, JP Morgan in 2009 and Morgan Stanley in September, 2011).

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***Value Investing: Here for the Long Run***

In order for us to make you money, the market needs to return to its long-term function as a weighing machine of the fundamental value of profit-making enterprises.[3] Our work is company-specific. To take a real-time example, right now **Valero** is working on a new capital project that will add an additional $2.00 a share to earnings next year. We put those extra earnings in our model and that's a factor in assessing the company's future value. Eventually, so our investment thesis goes, when the market sees the extra $2.00 coming, the discrepancy between stock price and increased value (due to the increased profits) will close, and we'll be there to cash the check. That's how our investment process is supposed to work, but for the most part this year the market ignored company fundamentals like extra earnings power, and instead focused on macro-economic uncertainty caused by European credit issues, even though Valero has little European exposure.

But the fourth quarter was the exception, and we were pleased that when fundamentals did come back into consideration our portfolio strongly outperformed. The critical question now is whether fundamentals will continue to drive share prices as they did in the fourth quarter, or whether the market will lurch back to a fear-driven panic. In any given week, that's anyone's guess. But taking a slightly longer view, U.S. economic statistics are exiting 2011 more strongly than at any point in the past three years. The unemployment rate has (finally) dropped to June 2008 levels, jobs are being created at a faster clip, and holiday sales were strong. Yet clouds remain. Housing prices may not improve for a decade, and the large amount of foreclosures still to come will weigh on prices this year. Presidential elections are generally good for stocks, and this year we expect market movements around primary contests and, later on, the prospects of one candidate or another triumphing in November. All in all, we believe the outlook for the economy falls on the positive side of the ledger, but not by much. We will continue to search for quality investments that can navigate uncertain times, generate strong positive cash flow and care about their shareholders. We look forward to reporting to you in early April.

Very truly yours,

Christopher C. Grisanti

[3] As quoted in our third quarter letter, legendary investor and Buffett mentor Benjamin Graham would say: "In the short run, the market is a voting machine, but in the long run it is a weighing machine."