Grisanti Capital Management

Large Cap Value Portfolio Fourth Quarter 2012 Letter to Investors

	For the Period Ending December 31, 2012		
	4Q12	Year To Date	Since 1/1/2000
Grisanti Capital Management LLC Large Cap Value Portfolio[1]	***+3.7%***	***+22.0%***	***+82.2%***
S&P 500	-0.5	+15.9	+23.3

2012 was a strong year for your portfolio. We concentrated on what was possible to achieve given daunting economic and political risks. For that reason, we often sailed close to shore, keeping meaningful amounts of cash when potential investment alternatives didn't offer enough return to compensate for the risk. But we also invested significantly in the three themes discussed in previous letters – the American oil renaissance, undervalued financials and smartphone technology. This combination of prudence and targeted investment produced strong absolute returns and our best year relative to the market since 2004. In the fourth quarter, the Grisanti Capital Management large cap value portfolio was up 3.7%, versus the S&P 500 Index, which was down -0.5%. For all of 2012, we were up 22.0%, versus the S&P 500, up 15.9%. This performance put us in the top 2% of the 554 U.S. large cap value managers measured by Bloomberg. On a personal level, I am pleased that our strong year came after making the decision last January to invest in the firm by paying off our debt, buying out my partner and growing our investment team to five professionals, the largest in our 13-year history. What follows is our year-end tradition of reviewing the successes and mistakes of 2012, and what we think will work in 2013.

The Year in Review

2012 was a lot better for our investments than either the headlines or even our own expectations earlier in the year would have led us to believe. The overwhelming reason was stock selection that differed from the market mainstream. The fourth quarter saw nine of our 19 holdings up more than 10 percent in a period when the market was down. The refiners, the financials, our defensive healthcare stocks and our new investment in **Ford** (discussed below)

[1] The performance shown for Grisanti Capital Management is that of our Large Cap Value Composite, after deduction of our fees. The performance compiled by Bloomberg is that of all the publicly traded mutual funds in the large cap value style, and is also presented net of fees.

all were standouts. That explains why we performed well, even though **Apple**, one of our largest holdings, declined 19 percent in the quarter. In a year of strong performance, most investments contributed to the bottom line, but the American oil renaissance stood out. After three decades of decline, since 2008 there has been an unrelenting increase in the production of crude oil in the United States. In 2012, the United States grew oil production by the most since 1958. We expect a similar increase this year. As mentioned (ad nauseum) in previous letters, we are exploiting this phenomenon by investing not in oil production companies, but in refineries that transform this abundant and relatively less expensive oil into essential material for of our economy, like gasoline, diesel and jet fuel. The three refiners we owned in 2012 were up an average of over 30%. **Holly Frontier**, our largest refining position, paid *five* special dividends in 2012, amounting to over 10% of the share price.

Financial stocks also helped performance in 2012. While refiners as a group added the most to the portfolio's bottom line, **JP Morgan** was the single largest contributor. Not only did the stock rise 30% during the year, but when it announced the "London Whale" trading loss, and the stock plunged 25% in a month (ending in early June), we doubled our position. The stock is up 43% from those lows. **Morgan Stanley, Goldman Sachs** (sold in April), and **BlackRock** were also strong contributors. We have believed in the undervaluation of certain financial stocks for a long time, and it seems we're finally getting paid for waiting.

Finally, one of the better things we did for our clients in 2012 was to lose them a small amount money in **Hewlett Packard.** After a disappointing earnings report in February, we sold our investment at a loss of 8% even though we had not held it for very long. We believed the story was changing for the worse in ways that we had not anticipated. The company has subsequently experienced enormous problems, and has dropped an additional 41% since our sale.

There weren't a lot of mistakes in 2012, but we did make a few. We didn't sell a single share of **Apple** even though it went from our initial purchase price of $366 to $705. Such a sale would have been a large short term gain for our taxable clients, but there are worse things than paying taxes (like watching a stock drop 25%). We believe in Apple, and continue to hold a large position. Even with its recent decline, Apple is still up 22% for the year in our portfolio, but there's an old saying – you can make a lot of money by selling too early – and we should have followed that advice. Another mistake was failing to see the forest for the trees, and selling **Lowe's Corp**, the home improvement company, at a loss. We were discouraged when the company announced a questionable Canadian acquisition and we sold the stock, losing about 6%. But with housing on the rebound, the market quickly forgot about that unwise corporate decision (and the company later abandoned the takeover). Since our sale, the stock is up 40%. The rising tide of housing raised even this ship, and we were not on board.

It's tempting in such a good year to say that holding cash in 2012 was a mistake. After all, we were up 23% in 2012, carrying an average cash position of about 15%. If we had held no cash, we'd have been up even more. But having cash does wonderful things in times of uncertainty: Not only does it lower potential losses if the market declines sharply, it also dampens general volatility, and provides the proverbial "dry powder" to utilize for opportunities like the previously discussed London Whale decline of JP Morgan. Especially given the current political uncertainty, we will continue to hold cash during those periods when we can't find better alternatives. We have no problem being measured on the performance of the entire portfolio, including the cash position, for which we are solely responsible.

What's Ahead for 2013

While Congress has dispensed with one fiscal cliff, another looms at the end of February, as we reach the U.S. debt limit and mandatory spending cuts kick in. If you thought the recent compromise was a difficult one, upcoming negotiations promise to be worse, with the most difficult issue – entitlement spending – looming as the 8 trillion dollar elephant in the room. Still, after significant turbulence we think some resolution is more likely than not, and we remain focused on things we can analyze with greater insight, like how much our companies are going to earn and what promising business ventures they might embark upon. In spite of the political turmoil, we will continue to commit capital, but only when a potential investment can produce returns commiserate with the risk we are taking. Our current themes – the oil renaissance, financials and smartphones – performed strongly in 2012. The double-edged sword of value investing is that when your investments do well, they become less attractive. We have taken some profits in our refining investments because there were large gains in a short amount of time, and the winter months are typically poor ones for refiners. The profitability of the financial industry has been reduced significantly by regulations like Dodd-Frank. With this in mind, the stocks are still too cheap. Morgan Stanley trades at 68% of tangible book value (liquidation value), and ought to trade at least *at* tangible book value. The Smartphone investment theme seems to have hit a wall, but we believe this is where the short-term potential lies, as we think the market is way too pessimistic about Apple's future. The stock is selling as if growth has practically evaporated. It has not. We believe holiday sales figures will confirm our optimistic view. Either way, we'll know by the end of January.

We are researching new themes right now, the most promising of which is the manufacturing renaissance that is beginning to occur in the United States. A confluence of circumstances is making the US a terrific place to actually make things again. These factors range from cheap energy costs (oil, gas and electricity), a low dollar and an established legal structure to relatively peaceful labor relations, an educated workforce, strong technology and a good transportation system. The poster child for this theme is our new investment in **Ford.** Purchased several months ago and already up 28%, it represents a 21st century American manufacturing success story. It posted record profits in the third quarter, *even though it made 30% fewer cars than it did six years earlier*. It has streamlined its operations, shed unprofitable auto parts subsidiaries, and renegotiated union contracts. Unlike General Motors, it avoided bankruptcy in the financial crisis and it now has an investment grade rating and sports a decent (and rising) dividend. We are diligently hunting for other companies with similar phoenix-like properties (and hopefully phoenix-like share prices). We look forward to reporting back to you on our progress.

As we bring 2012 to a close, we would like to thank you for your support. I am truly pleased to report strong results at the end of our first year as a restructured, newly-energized firm. I look forward to our future and realize that the performance of your portfolio is essential to our success.

Very truly yours,

Christopher C. Grisanti