Grisanti Capital Management

October 16, 2015

High Income Equity Portfolio Third Quarter 2015 Letter to Investors

	For the Period Ending September 30, 2015			
	Year-to-Date 3Q2015	Since Inception 2/28/2010	Current Yield	Current Beta
GCM High Income Equity Portfolio Net of Fees[1]	***-8.6%***	***+46.0%***	***4.0%***	***0.8***

Dear Clients & Friends of Grisanti Capital Management,

At certain times – like on August 24th when the Dow was down 1,000 points in 15 minutes – the market seemed filled with caterpillars announcing the end of the world. Even though the third quarter of 2015 was the toughest in four years, for the reasons discussed below we believe U.S. economic fundamentals look sound and the world does not appear to be ending. In fact, we believe the accompanying panic says more about the complacency of the recent past than about the underlying economy. Markets used to experience this type of downturn more often, and in fact, since we began managing money in 1999, the market has had 11 quarters worse than this. This is not to downplay the recent decline. These sharp downward market movements result in capital loss and bring feelings of anxiety to individual and professional investors alike, but they do pass. Moreover, they present opportunities. This letter will explain how we are managing through the downturn, why we believe it will be relatively short-lived and what opportunities we are finding.

As of the date of this letter, our average High Income Equity Portfolio is down about 0.8% for the year, after a difficult third quarter.[2] In addition, your portfolio has a 4% yield and is significantly less volatile than the market.[3] We used the recent turmoil to add to positions that that were caught up in the panic selling, and we believe we are well positioned to take advantage of a rebound, should one occur. (So far, we have rebounded strongly in the first two weeks of

[1] Performance for the High Income Equity Composite is shown net of advisory fees and transaction costs, if any. GCM's advisory fees are described in Part II of its Form ADV. The HIEP Composite includes all accounts that are fully discretionary, managed in the HIEP strategy and over $200,000 in total assets. 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. We use Beta, a widely recognized measure, to assess volatility. The Beta of the HIEP is 0.8, compared to the market's Beta of 1.0. All other things being equal, a portfolio with a Beta of 0.8 will fall (or rise) 20% less than the market. Of course, all other things are rarely equal and Beta is a measure of past volatility, which may or may not hold true in the future.

[2] The performance shown is for the GCM High Income Equity Portfolio Composite through October 16, 2015

[3] As measured by Beta, a standard metric of volatility.

October.) Now onto why we think a rebound is more likely over the next six months than further declines.

Not all downturns are short-lived, as the 2008 crisis proved, so why do we think this one is more benign? The key question is whether we are entering a period of economic slowdown. If we are approaching a recession, then the market is anticipating the drop in profits and is appropriately adjusting share prices downwards. But the problem is, the market is often wrong – as the old saying goes, the all-seeing market has predicted eight of the last two recessions. Those sharp declines that are not reinforced by a slowing economy tend to be short-lived. As companies end up reporting decent profits, hiring employees and growing their dividends, the pervasive fear gets replaced by greed and stocks rise.

So, in the face of the panic of the third quarter, our job is to determine what's really going on in the economy and with our portfolio companies. Is this a market "head-fake" or the herald of an economic slowdown? We look at indicia like unemployment, inflation, industrial production and the spreads on high-yield bonds. Crucially, with the exception of rise in riskier (junk) bond yields (which are indicating increased concern over weaker companies), none of our recession forecasting tools are even blinking yellow. Unemployment is improving, inflation and wage growth are not threatening and industrial production remains solid, at least domestically. Finally, stocks are not expensive, and after this recent downturn are slightly cheaper than average. In short, the current market decline has more in common with the brief bouts of panic that we saw last October (the Ebola scare) or during the government shutdown in 2011. Both of those witnessed sharp market downturns, but neither was a precursor to an economic slowdown, and because of that, the market surged back to record levels relatively quickly (within 2 months last year, and within 8 months in 2011). In fact, over the last 25 years whenever the market performs as badly as it did in the third quarter, *and* we are not in a recession, the next quarter sees higher stock prices.

But in our business you always have to also answer the question 'What if we're wrong?' In other words, what if there is an economic slowdown caused by (pick the most likely suspect) a slowing China, or the plunge in commodity prices, or higher interest rates? We don't think this is the case, but if it is, our economy will muddle through what would be the 12th recession since World War II. Stocks will decline further, but they are already about halfway towards the bottom of the average recessionary decline. More important, we are invested in high quality companies that have minimal credit risk. Many are relatively insulated from economic cycles, including our healthcare companies, natural gas pipelines, and entertainment businesses. In addition, we have taken some steps to minimize what we see as the biggest risk to corporate profits, which is exposure to the emerging markets, especially China and Brazil. We have sold three investments over the past six months (**Eaton, General Motors** and **General Electric**) that earn substantial revenues in the emerging markets. If we are on the cusp of a recession – and again with low rates and rising employment we think that's unlikely – we will certainly suffer in the short term, but we invest for the long term and we are confident that our portfolio companies would emerge in a strong position for the next cycle.

On the other hand, let's look at the scenario that we think is more likely – a fourth quarter rebound and a decent (not great) economy going into 2016. In that case, the current downturn is an opportunity to initiate (or augment) high quality investments at an attractive price. In particular, while the market as a whole started downward in mid-August, energy stocks have been declining for more than a year. Over the past three months we have been selectively adding exposure to oil and gas producers for the first time in more than a decade, as we believe $40 oil is unsustainably low in a growing world (even if it's growing slowly). In the third quarter we initiated a position in **Occidental Petroleum**, attracted by the company's strong balance sheet and 4% yield. As an extra measure of safety for our high income equity portfolio, OXY's mature oil field assets, where production costs are low, and its robust chemicals business support cash flow even in a lower oil price environment. Balance sheet flexibility also puts OXY in a position to buy smaller companies or attractive assets that may be distressed in the current environment. Management continues to be focused on expanding the company's footprint in the Permian Oil basin where oilfield technology and well optimization are still improving rapidly. We like companies that can play offense when their competition is scrambling to stay afloat.

The panic of the third quarter was indiscriminate, pulling down companies with good prospects along with the bad. Perhaps the best example of this is **Kinder Morgan**, the largest pipeline company in the United States. It doesn't drill for oil or gas; it just transports those commodities, so its revenues are relatively insulated from the plunge in oil prices. But you wouldn't think that from the stock price. It has fallen from $44 in April to $27 on September 30. It is now yielding over 7%, and maintains its investment grade rating. We added to our position (and we're pleased to report that the stock is up 25% from its lows of late September).

It is often the case in market downturns that the portfolio suffers in unexpected ways. Healthcare is usually a haven in times of market uncertainty, as profits are seen as relatively insulated from an economic downturn. But one investment that hurt us in the quarter was the pharmaceutical company **Abbvie.** Caught up in the political discussion about regulating drug prices, the stock dropped 24% in the quarter. It is now selling at 10 times earnings, its lowest price/earnings ratio since it was spun out of Abbott Labs four years ago. Its business remains strong, and we believe it will grow earnings close to 20% this year. Also, we think price regulation in the drug industry is unlikely in the short term. Abbvie, a company with many drugs on the market and in the pipeline, is not like some other companies in the news lately, which are dependent on one astronomically priced drug for outsized profits. We hate the share decline, but based on its strong fundamentals we have purchased more of this company as well.

As you can see, we are deploying cash in the face of this market downturn in investment grade companies across a number of industries. This type of contrarian investing has served the high income equity portfolio well since the foundation of Grisanti Capital Management in late 2011, with an annual return of 12.2% (net of fees), a high yield and lower than average volatility. Your results at September 30 are just a snapshot, taken at a moment of relative fear in the markets. We are using that fear to buy great companies at good prices. We think this will bear fruit relatively soon, and we look forward to reporting back at year end.

Very truly yours,

Christopher C. Grisanti