



# Grisanti Capital Management

October 8, 2015

## Large Cap Value Portfolio Third Quarter 2015 Letter to Investors

For the Period Ending September 30, 2015

	<u>Year To Date</u>	<u>One Year Since 9/30/2014</u>	<u>Since Inception 12/31/99</u>
<b><i>Grisanti Capital Management LLC</i></b>			
<b><i>Large Cap Value Portfolio (net of fees)</i></b> <sup>1</sup>	<b>-7.6%</b>	<b>+2.5%</b>	<b>+136.6%</b>
S&P 500	-5.6	-1.0	+75.0
Average US Large Cap Value Fund (Morningstar)	-8.3	-5.0	+105.2

Dear Clients & Friends of Grisanti Capital Management,

**What a caterpillar calls the end of the world, we call a butterfly.**

*--Richard Bach*

At certain times – like on August 24<sup>th</sup> when the Dow was down 1,000 points in 15 minutes – the market seemed filled with caterpillars announcing the end of the world. We want to assure you that even though the third quarter of 2015 was the toughest in four years, the 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,

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<sup>1</sup> The GCM Large Cap Value Composite performance is in compliance with the Global Investment Performance Standards (GIPS) through 2014. Performance for the Large Cap Value 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 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.

The performance shown is for the GCM Large Cap Value Composite. Your actual performance may be slightly higher or lower and accompanies this letter. The S&P 500 Index performance includes reinvested dividends. The comparison to other value managers is made via the Morningstar large cap value universe, which includes 1,339 U.S. large cap value mutual funds. While we are not a mutual fund, we compare our net results (after fees) to those of publicly traded mutual funds with a similar style (U.S. equity large cap value) because we believe it is a fair comparison and the data is publicly available.



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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.

First, the necessary and ugly short-term statistics: The market was down 6.8% in the quarter, and your portfolio declined about 2% more than that, for what we believe are short-term reasons, explained in detail below. In fact, during the first week of October, your portfolio has risen 7% (2% ahead of the S&P 500). More importantly, over the past 12 months, your portfolio has performed well. Not including October's 7% comeback, as of September 30<sup>th</sup> your portfolio is up 2.5% over the past year, with the market down 1%. The outperformance is more notable when compared to other value managers, who have been suffering in the recent environment. The average value mutual fund is down 5%, and while we'd certainly like to be up more than 2.5% in a year, our 12-month performance places us in the top 3% of value managers. We think we are well positioned to take advantage of a sustained rebound, which very well could have started last week. 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, double-digit 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.



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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 12<sup>th</sup> 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 **Alibaba**) 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 highly 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. As we wrote in last quarter’s letter, we are using the carnage in the energy industry to initiate investments that we feel good about long term, but have suffered this quarter. Perhaps the best example of a new energy investment that is down, in our opinion, for non-fundamental reasons, is **Kinder Morgan**. This is the largest pipeline company in the United States. It doesn’t drill for oil and 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 \$33 in August (where we bought it) to \$27 on September 30. It is now yielding over 7%, and maintains its investment grade rating. We have bought more (and we’re pleased to report that the stock is up 16% in the first week of the new quarter).

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 the investment that hurt us most 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 think price regulation in the drug industry is unlikely, or at least a long way off. 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.

Two high quality financial companies, **Morgan Stanley** and **Blackrock** have been great investments in your portfolio over the last several years (up 140% and 91% respectively since initial purchase), but were down 18% and 13% respectively in the quarter. They were especially



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hard hit when the Federal Reserve declined to raise interest rates in mid September, as investors were hoping the companies could start to earn the additional interest income that would be available in a higher rate environment. These are well-managed companies that are selling for attractive valuations, especially if we are not staring a recession in the face. Again, we added to these positions.

As you can see, we are deploying cash in the face of this market downturn in investment grade companies across a number of industries. 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