Grisanti Capital Management

January 11, 2016

Dear Clients and Friends of Grisanti Capital Management,

"A house divided against itself cannot stand." – Abraham Lincoln

"If you didn't dance at the wedding, you don't have to go to the funeral." – Anonymous

When we recap the markets and your portfolio in 2015, there's the headline story and then there's what's beneath the surface. The headline is that the market had a mediocre year. But that fact masks more troubling fundamentals beneath the surface. While the "market" as represented by the highly publicized S&P 500 Index was flat, the average stock was down over 4% in 2015. Worse, if you measure the decline from the highs in May to today, the average S&P 500 stock is down 19%, quickly approaching bear market territory, not even including the rocky start to 2016.

Frustratingly, your High Income Equity Portfolio suffered in 2015 because some of the stocks we believed were the safest – pipeline and infrastructure companies – turned out to be the worst performers. They sported high dividends and typically had little risk to oil prices (since the pipeline companies don't drill for oil), yet the market painted with a broad brush and it hurt you performance (a copy of which accompanies this letter). We go into the reasons for this below, but we have taken our lumps in that group and your portfolio is constructed to protect your capital at turbulent times, like the beginning of 2016. It is now almost 25% cash/preferred stocks and yields approximately 4.0%. It is protecting capital well so far in 2016, being down much less (about 30%) than the market.

Even though the average stock was down 19% at the end of 2015 (considerably more now), the S&P 500 Index is down just 7% from the highs. Why? The answer is simple, troubling and significant for the market going forward. The S&P 500 Index is market-cap weighted, meaning the larger companies exert much greater influence.[1] In 2015 there were a tiny number of very big, very expensive companies that rose sharply, dragging the index to its fractional gain, even as most stocks declined. The market has become a house divided, where the strong performance of a few masks the weakness in the great majority of securities.

The best examples of these market behemoths are companies who have wonderful products, but really expensive shares: Netflix (up 134% in 2015), Amazon (up 118%), Google (up 47%) and Facebook (the laggard, up 34%). 'So what?' you might respond, 'Just own *those*

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[1] A 1% move in Apple affects the S&P 500 Index *100 times more* than a similar move in a stock like Staples (the office retailer), even though both are components of the index.

stocks and we'll all make money.'[2] The problem is, those stocks are extremely expensive, and priced for perfection. They are good companies, but they epitomize the old saying "There's no investment so attractive it can't be ruined by a high enough entry price." The price-earnings ratios of these companies highlight their frenzied popularity: Amazon sells at *895* times its 2015 earnings, Netflix 304x, Facebook 98x, and Google 34x (versus the market at 16x).

Does this list of market darlings sound familiar? Well, for those of us who lived through the 1998-99 technology stock bubble, we've seen this movie before, and it doesn't have a happy ending for investors riding the speculative wave. The tech boom drove the averages up in 1998 and 1999, while the great majority of stocks – and value investors like us – lagged behind. Then, over the next two years, the market fell to earth. But there's an old saying: "If you didn't dance at the wedding, you don't have to go to the funeral." Value investors who kept their convictions and refused to buy expensive stocks suffered on the way up, but then reaped a windfall as the tech stocks plunged and value in the forgotten stocks was rediscovered. For example, when the market rolled over in 2000, Grisanti Capital Management did well: we were up 18% in 2000 (versus a 9% market decline) and 9% in 2001 (versus a 12% market decline). We write to you in the middle of a similar top-heavy-market phenomenon. We have shied away from the risk of owning these expensive market leaders, and therefore we have lagged for the moment. But we believe opportunity is coming.

In addition to the market dynamics weighing down your portfolio, we had a number of specific successes and failures in 2015. Oddly for a year in which crude oil declined 35%, some of our energy stocks contributed positively to the portfolio. That was because we retained an investment in refining companies, the middlemen of the oil markets. Refiners buy (ever cheaper) oil and turn it in to gasoline and diesel fuel. In 2015 our investment in **Valero**, for example, was up 14%. And, in the fourth quarter we established a new position in **Western Refining**, a small refiner that operates in the Southwest and just announced the acquisition of Northern Tier Energy. We think the combination will be very profitable, and the stock has underperformed competitors (like Valero) by about 30% this year. We also like refining because with gas prices so low, we expect people will be driving more and buying larger cars, spurring gasoline demand.

But the energy sector was also the site of our biggest mistake in 2015. Our investment in pipeline company **Kinder Morgan** initially worked well for our high income portfolio, as it had both a safe business model and a high yield with steady cash flow. But it turned out to be the most expensive and frustrating mistake we've made in a long time. As oil prices began to fall, we were (correctly) scared they would fall more, so we avoided large investments in companies that explore for energy. But, we (incorrectly) figured a safe way to exploit lower prices was to own an investment grade company that didn't depend on the *price* of oil, but on increased *volumes* being pumped. This led us to Kinder Morgan, the largest energy pipeline company in the United States. It has a strong, investment grade balance sheet and a nice dividend (about 5%) and had aggressive but realistic plans for growth. The problem was that it paid so much of its

[2] Careful readers will point out that we did own Amazon throughout 2015. It was attractively valued on a price-to-sales basis when we bought it in late 2014 after a terrible year, and after rising over 100% in 2015, is a candidate for sale.

Grisanti Capital Management

cash flow out in dividends that, in order to grow, it needed to issue new shares every year. That was never a problem when the energy markets were buoyant and capital was widely available. But as the stock fell in line with the weak energy group, the prospect for equity issuances at low prices became a sword of Damocles hanging over the share price, and the company slashed its dividend. The stock dropped from the low 30s to the high-teens, taking our investment along for the ride before we sold our stake (the company dropped another 20% after our sale). This loss hurt doubly, since we invested with Kinder Morgan as a *defensive* energy play.

Besides Western Refining, the only other new investment we made in the fourth quarter was **Synchrony,** a financial company that was spun out of GE in 2015. Although most people haven't heard of it, Synchrony is the largest issuer of private label credit cards in the United States. If you have a Walmart Card, or one from JC Penney, Brooks Brothers or dozens of other companies, you are a Synchrony customer. It sells for less than 10 times earnings (40% cheaper than the market), and its origin as a spin-off from GE has led it to be underfollowed by investors. We think there is 25-40% upside in the shares, as investors get to know this profitable business.

2016 started on a downward note for the markets, but we are not panicking. Your portfolios have outperformed during the first weeks, as several of our "forgotten" investments have attracted investors. We do not know what the future will bring – or perhaps stated more accurately, we don't know *when* our strategy of buying reasonably priced stocks will again earn outsized returns, but historically valuation has always mattered sooner or later. We will continue to look for businesses that can thrive in a slow growth environment *and are also priced attractively* (many investors forget this last part). We look forward to reporting back to you in the Spring.

We have also enclosed our Summary of Investments, so that you could appreciate the reasons behind the investments we hold in your portfolio. We'd be happy to answer any questions you might have about any of these companies.

Sincerely yours,

Christopher C. Grisanti