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. The S&P 500 index was down about 2%, but adding in dividends it eked out a fractional gain. Likewise, your portfolio was up about 2.5% in the quarter, but down a few percent for the year. [1] It was a tough year for value managers like us – 94% underperformed the market, with the average down more than 4%.[2] Over a two year period, our portfolio remains up about 11%, nicely ahead of other value managers, who are up 5.8% in the same period. Those were the headlines.

But these mediocre figures mask 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. Yet 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.[3] 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* stocks and we'll all make money.' [4] 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

[1] The performance shown is for the GCM Large Cap Value Composite. Your actual performance may be slightly higher or lower and accompanies this letter.

[2] As measured by the Morningstar Large Cap Value universe of 1,335 mutual funds.

[3] 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.

[4] 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.

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, our portfolios 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%, most of our energy stocks were up. That was because we were mostly invested in refining companies, the middlemen of the oil markets, and not companies that drill for oil. Refiners buy (ever cheaper) oil and turn it in to gasoline and diesel fuel. We had successful investments in **Valero** (up 47% in 2015) and **Marathon Petroleum** (up 8% prior to sale in 2015). In addition, in the fourth quarter we initiated a position in **Western Refining**, a small refiner that operates in the Southwest and just announced an acquisition of Northern Tier Energy, a favorite of ours (and a holding in our high income portfolios). 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.

The energy sector was also the site of our biggest mistake in 2015. Our investment in **Kinder Morgan** was the most expensive and frustrating we've made in a long time. As oil was dropping, we were (correctly) scared it 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, sported a nice dividend (about 5%) and had aggressive but realistic plans for growth. The problem was that it paid so much of its cash flow out in dividends in order to grow, that it needed to issue new shares every year. As the stock fell in line with the weak energy group, however, 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

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our sale). This loss hurt doubly, since we invested with Kinder Morgan as a *defensive* energy play.

Besides Western Refining, the only other investment we made in the fourth quarter was **Ralph Lauren**, whose shares were down roughly 40% in 2015. Due to the strong US Dollar and investments in company infrastructure, profitability at the firm has been under pressure. We believe these headwinds are transient and that as these costs normalize, shares could see significant upside. Additionally, we believe the Ralph Lauren brand will retain its premium image in the mind of consumers globally and view its international segment as a compelling avenue for growth (even though the strong dollar is currently hurting international earnings). The company has a strong balance sheet and shareholder friendly management led by a new CEO. It has continually bought back stock and increased the dividend. We like being able to buy a high quality brand at a reasonable price.

2016 started on a downward note for the markets, but your portfolios have outperformed during the first week 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