Grisanti Capital Management

April 1, 2016

Dear Clients and Friends of Grisanti Capital Management,

2016 started ugly. The S&P 500 dropped 11% through early February, the worst beginning to a year since the 1920s. The perceived reasons for the selloff were varied – stocks near all-time highs, Fed rate hikes, global recession fears, and unprecedented commodity price weakness. However, as recession and rate hike fears subsided, the S&P staged an impressive 13% rally off the February lows. When the dust settled, the S&P ended the first quarter largely where it began the year, despite a wild ride in between (and much anxious hand-wringing). Your High Income Equity Portfolio (HIEP) declined about 1% during the quarter as long-held investments in the financial and energy sectors lagged the market rebound. We view this as a temporary issue and discuss these investments in greater detail below.

The Upside of Volatility: Opportunity

As long-term investors, we welcome the occasional market pullback, particularly when economic signals are not flashing impending signs of danger – it affords us the chance to buy great businesses at attractive prices. Presented with this opportunity in early 2016, we initiated seven new investments and added to three existing positions that we believe suffered disproportionately in the selloff. Only time will tell if these are great long-term investments, but we believe the low multiple paid for these businesses greatly enhances our probability of success.

At this point, it is a good time to review the mandate of the High Income Equity Portfolio. The portfolio strives to deliver low volatility, an above-average yield, and capital appreciation. To accomplish these often conflicting goals in the HIEP, we employ a "barbell" structure: own safer, high yielding stocks to provide stability and income, but also invest in contrarian, deep value investments that have the potential for greater than average capital appreciation. We believe investments made during this quarter help further both goals of the HIEP.

Among our new investments in 2016 were oil major **Chevron**, diversified financial **Wells Fargo**, retail/pharmacy chain **CVS Health** and insurer **Aflac**. We anticipate these holdings will add stability to the portfolio, having historically exhibited consistent earnings growth, superior returns on equity and less volatility than the market. In addition, each name sports a robust yield and a track record of consistent dividend increases. We believe these characteristics will promote healthy investment returns over time, as well as protect capital in choppy markets.

We also added to positions in seasoned portfolio holdings. Payment network **MasterCard** and private-label credit card provider **Synchrony Financial** both sold off sharply in early 2016 owing to fears of slower global spending and credit. Not only do MasterCard and Synchrony boast strong competitive barriers and flexible cost structures to help offset a consumer slowdown, but both names benefit from the multi-year secular shift from paper currency to digital payments. We also added to our stake in Mid-Continental refiner **Western Refining**. We believe investors have miscast the company as a debt-heavy cyclical business with little earnings growth opportunity; we see a best-in-class refiner yielding nearly 6% and underestimated earnings potential once the acquisition of **Northern Tier Energy** is completed in mid-2016. (For those HIEP accounts with Northern Tier, you will receive $15 cash and 0.2986 Western Refining shares once the deal closes.)

In addition to the common stocks acquired during the first quarter, recent investments in preferred securities accomplish our goal of reducing volatility and boosting the portfolio's income. These notes, issued by **Royal Bank of Scotland** and **J.P. Morgan**, pay coupons of 6% and 8%, respectively – well in excess of the S&P 500, which yields 2.2%. Also, we think both notes are likely to be redeemed over the next two years, helping to protect your capital from adverse interest rate moves.

Financials - Fighting the Last War

The modest year-to-date decline in your portfolio stems from contrarian investments in the financial and energy sectors. The biggest drag in the quarter was long-time holding **Morgan Stanley**, which fell 21% and now trades below liquidation value.[1] We see Morgan Stanley's discount to liquidation value as too severe, considering half of its profits are derived from the relatively steady wealth management business. This is not the same business it was in 2008: its balance sheet is cleaner, its businesses less volatile and its payouts to shareholders (via dividends and buybacks) considerably higher. When solid firms sell sharply below liquidation value, the market is exhibiting *existential* fears, which we think presents an opportunity. We recall this phenomenon in September 2011 upon first purchasing Morgan Stanley at 50% of liquidation value. The stock subsequently tripled in value over the next four years. We liked this company then and we're sticking with it now, viewing the weakness in the stock as temporary.

Energy – Is This the Bottom?

The energy sector is another area where we see value in the midst of market dislocation. At 13% of the portfolio (including refiners), our energy weighting at quarter end was roughly double that of the S&P 500. And while the sector hurt performance thus far in 2016 (as value investors, we can be early with our long-term investments), we see long-term potential in the group following a two-year collapse in industry valuations.

[1] Specifically, we use the accounting convention Tangible Book Value per Share as our estimate for the liquidation value of a financial firm, which typically does not have depreciating assets like factories or large capital items. We believe using tangible book value is a conservative valuation measure, as it gives no credit for the reputational value of a Morgan Stanley, simply valuing the firm for the assets on its balance sheet, ignoring intangibles like goodwill or intellectual property.

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If our energy weighting appears contrarian – and it is – remember that our investments assume a 24-36 month time horizon. We believe strongly that the ongoing weakness in the energy patch is due to a *temporary* mismatch of supply and demand. In light of increasing energy consumption globally, we expect aggressive actions taken since 2014 to curtail U.S. supply should bring global oil markets back into balance over the next two to three years. For these reasons, we added a position in **Chevron** to complement our existing holding **Occidental Petroleum**.

Encouragingly indications that the industry is putting in a bottom have begun to appear. What's our evidence? Exhibit A is the U.S. rig count, which is down 77% from June 2014. Exhibit B is U.S. oil production, which has fallen in 10 of the last 11 weeks, the longest downward move in more than seven years (i.e., since the shale revolution began). And exhibit C is a nascent rebound in oil prices, which have rallied almost 50% from February's on signs of reduced supply. As prices rebound further, sales, profits and valuations for our energy holdings are likely to follow. In the meantime, we take comfort that Chevron and Occidental's 4% dividend yields and strong balance sheets offer a measure of downside protection as we wait for our thesis to play out.

As evidenced by our investing activity in the first quarter, we think investors remain too pessimistic about an economy that, while not great, isn't disastrous either. Combine that with a benign interest rate environment, moderate valuations and low expectations for corporate profits (which should therefore be easy to beat), and you have a formula for attractive returns in 2016. Moreover, recent additions to your portfolio argue for a less volatile ride than the market, with higher yields to bolster income generation.

We thank you for entrusting us with your capital and look forward to reporting back to you after the second quarter.

Sincerely yours,

Christopher C. Grisanti