Grisanti Capital Management

July 12, 2016

Dear Clients and Friends of Grisanti Capital Management:

The High Income Equity Portfolio (HIEP) performed well in the second quarter, rising 5% compared to a 2.5% gain for the S&P 500. The quarterly gain stemmed largely from successful investments in healthcare, energy and insurance as well as the redemption of our 12% position in **Royal Bank of Scotland** preferred shares at par value.

As we enter July, financial markets appear to have stabilized following the immediate post-Brexit reaction of a 6% decline in global stock markets. While Brexit commanded headlines and produced stock market volatility, your portfolio companies continued to grow sales, generate stable profits and returned growing cash flows to shareholders in the form of rising dividends. In other words, it was business as usual for companies like **CVS Healthcare, Verizon, Aflac** and **Comcast** before, during and after the Brexit vote.

We believe the market reaction in the aftermath of Brexit was less about the implications of nationalism in the U.K. than a refocusing on a growing number of negative macro indicators. Over the past 18 month, economic momentum has decelerated globally, owing to declining corporate earnings, slowing employment, and falling industrial production. What has us most worried, though, is the market barometer that captures all these things: ever-lower interest rates. Usually higher interest rates are a bad thing for stocks. But now, when clients ask, in fear, whether the Fed will raise rates, our answer is that we sure hope so. More accurately, we would prefer conditions that would warrant higher rates – stronger economic growth, full employment, wage growth, even some inflation. If we had those things, slightly higher interest rates would be a small price to pay.

Instead, bond yields have moved to generational lows. To us, this signals a worldwide fear of slowing growth and possible deflation, not a good backdrop for equities. Worse, there is a severe disconnect between the recently rising stock market and record-low bond yields. **The chart below shows the market (represented by the S&P 500 Index) and the 10-year U.S. Treasury yield.** As the market plunged in the fall, and then again in the winter, so did bond yields, as both seemed to predict a slowing economy. That's the normal correlation. As the market rebounded in March, so did bond yields. Again, as expected. But then something happened that we find troubling: Yields started to drop again, even as the market approached new highs. This week (early July), the 10-year yield fell to a *record low* of just 1.38%. Yields in Germany, Switzerland and Japan are all *negative* (i.e., bondholders in those countries pay the government to own their bonds).

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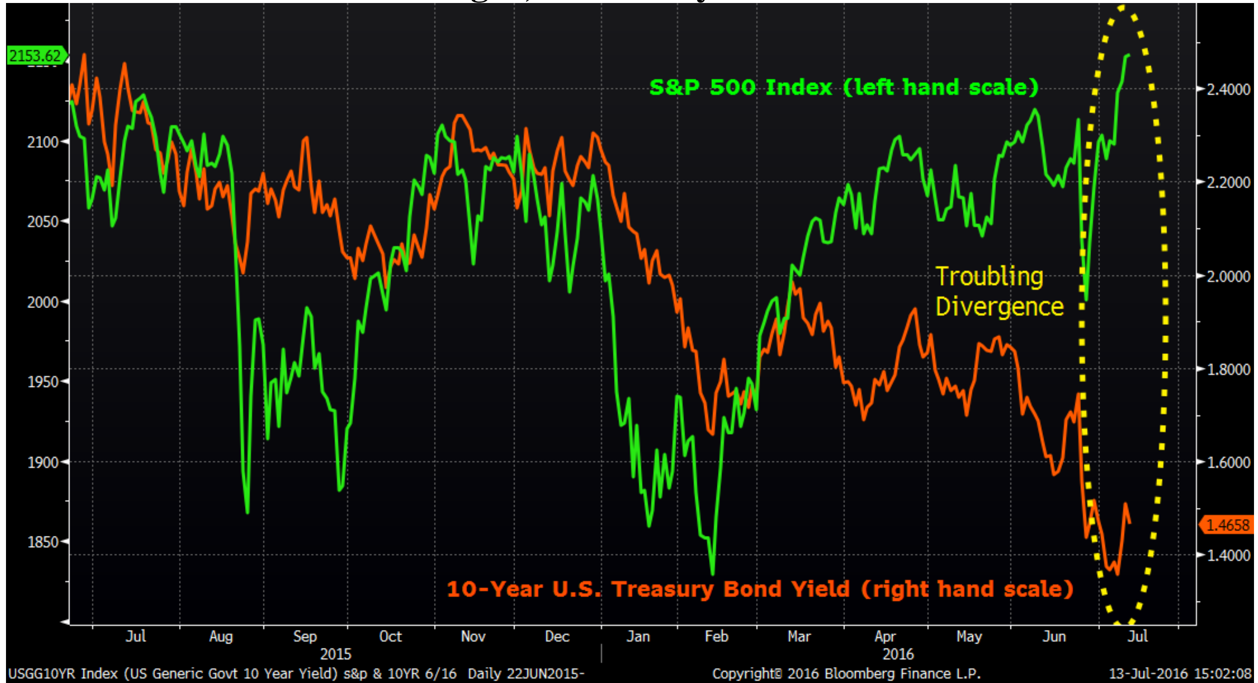
Something's wrong with this Picture:

Market nears record highs, but bond yield hit record lows



The stock and the bond markets are sending two very different messages, one of strength, the other of weakness. Some people might say a higher market is a natural reaction to the economic stimulus that lower yields will provide in the future. The argument is that business and consumers can now borrow at (even) lower rates than six months ago, and this will spur economic growth. Maybe. But we think that seven years of low rates have fostered little in the way of growth, and that ever-lower bond yields are a sign of pushing on a string rather than green shoots of growth ahead. We don't doubt that higher rates would be worse, but the question is whether record low rates will bring about decent growth. With earnings and employment slowing, we think the answer is no.

Of course, at the end of the day, it's our job to make money in the equity markets. As the old saying goes, it's not a 'stock market,' but a 'market of [individual] stocks' and it is possible to find value, even in an otherwise vulnerable environment. To stress this point, it's illustrative to revisit the performance of GCM's primary Large Cap Value portfolio during the 2000-2001 period. (Recall that the HIEP was created in 2010 as an option for investors valuing safety and income in the wake of the 2009 financial crisis). The market dropped 28% during the early aughts, whereas our LCV portfolios grew 20%. Stock selection becomes crucial in a turbulent market. At quarter end, we held more cash than usual, but we prefer having "dry powder" to be ready for the episodic market pullbacks (such as Brexit) that do not alter the fundamental outlook of our portfolio holdings.

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While the economic outlook has caused us to become more defensive, we are able to find some pockets of value and one of these areas is Energy. There is a great deal of research underlying our oil and gas investments, but our call on the space can be summarized by saying that energy has already had its bear market and we are picking among the ruins to find value. Our energy holdings include **Chevron and Occidental Petroleum**, two diversified, investment-grade companies that will benefit from the oil market moving from the current state of oversupply towards equilibrium (and thus higher prices). The success of these investments are dependent on two outcomes: a rebound in the price of oil, and the maintenance of cash flows to sustain our stocks' 4%+ dividend yields. Throughout 2016, oil production has steadily declined, and oil prices have reacted, rising nearly 85% from the February lows. In addition, we have sold all our investments in the refining sector, which we held for almost five years. It was a tremendously profitable sector for us, but now, with oil prices rising and refiners caught with extra gasoline and diesel, profit margins are suffering. The value proposition in energy has definitely shifted back to the producers.

Another sector we think can succeed in a turbulent market is healthcare, where demographic trends should spur earnings growth no matter the economic outlook. Healthcare was the best performing sector in the portfolio during the quarter and also year-to-date. We are seeing strong returns from recent investments in **Labcorp Holdings** (up 22% since initial February purchase), **Pfizer** (up 9% since initial May purchase), as well as long term holding **Medtronic** (up 16% year-to-date). We have tried to focus on those companies that are sheltered from government scrutiny on pricing, and in fact we believe some of our investments will benefit from the move towards increased health insurance coverage: more coverage means more prescriptions filled (CVS, Pfizer), more pacemakers installed (Medtronic), and more blood tests completed (Labcorp).

In addition, individual ideas, like **Chubb** (up 7% since initial April purchase), an insurance company that merged in January with ACE Limited, represents an attractive opportunity to enjoy merger synergies and strong management at an attractive price. This company is in the financial sector, which could suffer more than most in a downturn, but insurance is safer than banking, and we believe the merger story will provide a strong tailwind of earnings growth. **Time Warner** (up 19% year-to-date) is another company-specific story, with great content (e.g., HBO, Warner Brothers, CNN in an election year) that can buck the trend of a declining economy, especially at its current valuation of only 12 times next year's earnings (a 17% discount to the market, while earnings are growing at twice the market rate). Finally, an investment in **Hershey**, the recession-resistant maker of Reese's Peanut Butter Cups, Kit Kats and other treats, "sweetened" returns for the quarter. In June, Mondelez (maker of Oreo cookies and Cadbury crème eggs) offered to buy Hershey for $107, about 20% above our April purchase price.

Recall that the High Income Equity 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 securities to provide stability and income, but also invest in contrarian, deep value investments that have the potential for greater than average capital appreciation.

Our safety goal is achieved largely by stocking the portfolio with companies who possess superior business models, an ability to weather various macro storms and strong financial flexibility at attractive valuations. We seek to buttress the portfolio’s yield via income producing securities, whether it be high-yielding preferred stock or shares of businesses with a history of above-average dividend increases. With the callback of our RBS preferred notes, you will note that the portfolio’s yield at quarter end is lower than normal.

Given the macro risks noted above, we are in period where we need to be more patient in finding investments. We are confident we will find money-making ideas in the upcoming months, but we will also use your capital judiciously, mindful that there is a time to reap and a time to sow. We thank you for entrusting us with your capital and look forward to reporting back to you after the third quarter.

Very truly yours,

Christopher C. Grisanti

cc: «CCstart»
«CC1»
«CC2»
«CC3»
«CC4»