Grisanti Capital Management

October 5, 2016

Dear Clients and Friends of Grisanti Capital Management:

Your High Income Equity Portfolio (HIEP) provided steady appreciation and income thus far in 2016, rising 1% during the third quarter and roughly 5% through the first nine months of the year. The year-to-date gain was accomplished despite taking 25% less risk than the market (measured by beta) and generating a yield of 3.4% (versus 2.1% for the S&P 500). Recall that the goal of the portfolio is to offer positive returns with less risk and higher income than the market. That goal is becoming more difficult as record low interest rates compelled investors to chase yield. Dividend stocks, as a result, have been bid up to record valuations, making investment in these normally staid companies riskier than in the past.

In this letter, we lay out the reasons why our current investments skew toward relatively defensive sectors (healthcare, insurance, cable/telecom and energy) and high-yielding preferred securities. Entering the fourth quarter, we continue to believe that the economic backdrop presents an asymmetric risk/reward proposition. In our view, the business cycle has been artificially prolonged by well-intentioned but indulgent central banks around the world. This monetary stimulus has led to excess supply in the face of lackluster demand. Absent stronger growth, we think it will be difficult for equity markets to continue to make new highs.

As seen in the chart below, profit margins in the U.S. hit an all-time high nearly two years ago. This data point has our attention largely because recessions (shaded in gray) typically follow once profit margins peak.

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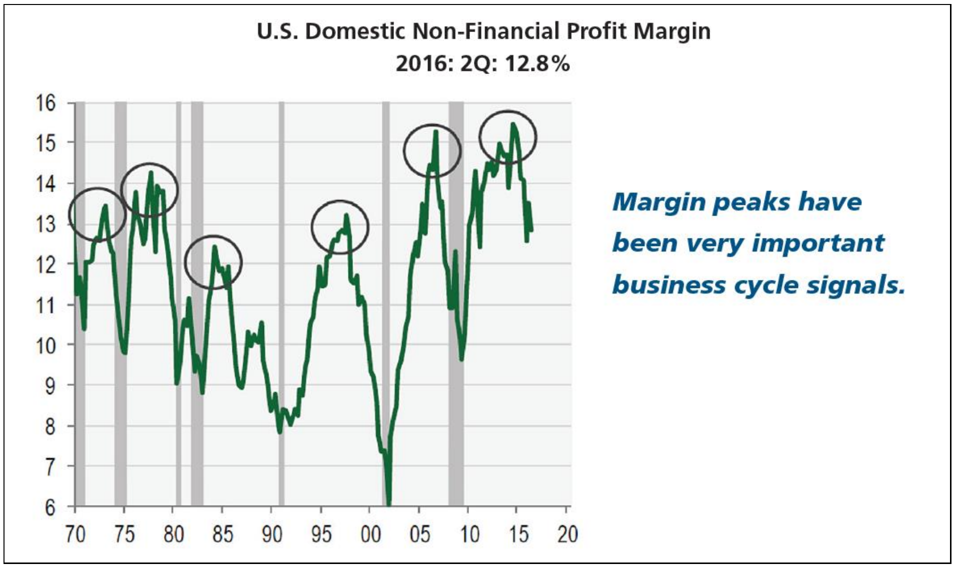

This is not to suggest the sky is falling – at nearly 13%, U.S. profit margins remain elevated, and a strong employment picture should sustain modest U.S. GDP growth for the time being. But we are now in the eighth year of economic expansion, with each year a bit slower than the last. The Federal Reserve seems poised to raise interest rates, and most other world economies have already slowed substantially. Add to this backdrop other events -- the unnerving U.S. presidential election, a December referendum in Italy, a rise in protectionism and potential terror attacks. Risks to the U.S. growth outlook are increasing, and our threshold for risk has accordingly been reset lower.

An economic slowdown, like Carl Sandberg's fog,[1] comes on little cat feet. It arrives quietly and on its own timetable, so it is possible that the market will continue to rise even if a slowdown is on the horizon. If that's the case, we remain invested in solid, growing companies, and your portfolio will participate in the appreciation, but perhaps not as much as the market. Conversely, if the fog rolls in, you are prepared. Our holdings in **CVS Healthcare, Verizon, Comcast** and **Berkshire Hathaway** have historically proven defensive in choppy markets given their resilient profit streams, stable free cash flows, advantaged business models and strong, shareholder-friendly management.

Given our overarching concerns about the economic outlook, our investment process has become more selective. But even in this environment we know from experience that individual securities are often mispriced. Below are a few examples of the opportunities that arose during the third quarter:

In July, we invested in **Apple Inc.** after shares sold off on fears of a disappointing iPhone 7 launch and a slowdown in Chinese smartphone sales. We don't know whether the new iPhone will be a smash hit like its predecessors; what we do know is that the Apple ecosystem is

[1] The fog comes/on little cat feet.
It sits looking/over harbor and city/on silent haunches /and then moves on.

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differentiated from peers and if you already have an iPhone you are very unlikely to 'leave the family.' Further, we think investors underestimate the ability of Apple's services business (which includes offerings like iTunes and iCloud) to drive sales growth. Apple's service segment grew 20% annually over the past 5 years and by itself will soon be as large as a Fortune 100 company.

We were pleasantly surprised when early consumer adoption of the iPhone 7 (launched in late September) exceeded expectations.[2] Despite appreciating 15% from our initial purchase, Apple remains inexpensive at 13 times next year's earnings. Moreover, a potentially more audacious product launch next year – the iPhone 8 (with an all-glass case!) – remains a looming catalyst. While we wait for that technological marvel, Apple rewards us handsomely via robust cash flows, a 2.5% dividend and nearly $50 billion of cash earmarked for share buybacks.

We also added to our **Wells Fargo** stake during the quarter. We view Wells Fargo and JP Morgan as the two highest-quality, best-managed major banks in the United States. Not surprisingly, they typically trade together. Here's how the stocks have done over the past year:

Wells Fargo shares dropped sharply in September on news that the company was fined $185 million by the government for opening millions of unauthorized customer accounts. The company may sacrifice market share due to the negative headlines, but given the strength of Wells' banking franchise, we think the issues will prove short-term in nature. Meanwhile, Wells' share price dropped 25% from its 2015 high, destroying *$65 billion* of market value. While the scandal is certainly a black eye for Wells' reputation, we do not believe it diminished the entity's long-term earnings power. We relish buying high quality companies during a crisis *if* we believe the crisis has not permanently affected their long term profit making ability.

[2] iPhone 7 sales also received a boost when its best-selling competitor – the Samsung Galaxy 7 – started spontaneously bursting into flames. The Galaxy was recalled last month.

We also initiated a position in **Royal Dutch Shell**. A collapse in the price of oil, management's shift to deepwater oil and natural gas production and concerns over the sustainability of the dividend have all conspired to knock RDS shares down 43% from its July 2014 high. Assuming oil remains in the mid-$40s, we believe management has multiple levers at its disposal to improve financial performance. Non-core asset sales, cost synergies associated with the 2016 acquisition of British Gas, and incremental production from high-margin projects will all enhance cash flow beginning in late 2016. Royal Dutch sports a 7.5% yield while peers in the group with similar free cash flow improvement stories are trading at 5.7%. We think shares are mispriced; further, a proposed production cut by OPEC puts a short-term floor, in our view, on oil prices.

Finally, we substantially increased the yield during the quarter by investing in three high-quality preferred securities, issued respectively by **American Express**, **Ally Financial** and **Wells Fargo**. These notes offer high yields, are far less volatile than the average common stock, and given their predominantly floating rate structure, are insulated from a spike in interest rates. At quarter end, our preferred holdings equaled 18% of the portfolio with an average yield of over 6%.

While we believe 2017 will be a more difficult year for the global economy, given our defensive positioning, we have structured your portfolio with that backdrop in mind. As we see it, your high-income equity portfolio is poised to deliver on its goals to judiciously grow capital and generate above-market income with less volatility than the market.

We thank you for entrusting us with your capital, and welcome any questions or comments you may have.

Very truly yours,

Christopher C. Grisanti