Grisanti Capital Management

October 5, 2016

Dear Clients and Friends of Grisanti Capital Management:

Your portfolio appreciated nicely in the third quarter, up almost 3%.[1] Still, we continue to believe that the global economic backdrop carries more risk than the market appreciates. The current business cycle has been artificially prolonged by well-intentioned but indulgent central banks around the world. This easy money has led to an excess supply of goods and services in the face of lackluster demand. As we detail below, in this environment profit growth is hard to come by, and since rising profits are the lifeblood of higher equity prices, we remain cautious.

In this letter, we lay out our case for why we have been slow to reinvest our profits, and therefore maintain a higher-than-normal cash position. Further, we explain why the money we have put to work is disproportionately invested in less economically sensitive stocks. Gone are the airlines, oil refineries and auto makers we successfully owned earlier in this cycle. In lieu of those cyclical stocks, companies in the healthcare sector (and cash) are now our largest portfolio weightings.

That's not to say we expect Armageddon – after all, even with our cash position we remain about 80% invested. But we do see an abundance of asymmetric risk. As we survey the companies for sale, the great majority appear to have limited upside, due to high valuation or mediocre prospects, outweighed by significant downside if the economy slows. But we also know from past experience that even when the overall market is unattractive, good investments can still be found. This quarter, we managed to find a small number of companies where the risk profile was more attractive. In fact, one of these, **Apple**, was among our best investments for the quarter (up 15% since purchase in July). So, we're still hunting for good ideas; we're just taking aim with a rifle rather than blasting away with a shotgun. And we're also saving our ammunition for what may be more attractive prices ahead. Because our cautious stance is a departure from our usual optimistic philosophy, we want to explain the reasons for our restraint.

In 2014 profit margins for all U.S. non-financial companies peaked. This is an ominous indicator, because, as the chart below shows, recessions (shown in grey) typically follow a decline in profit margins. All this does not mean that we sell everything and head for a shack with canned goods. Even though profit margins are down, at 12.8% they are still relatively high.

[1] The GCM Large Cap Value Composite was up 2.7% for the third quarter. Your specific performance, which may be slightly higher or lower than that figure, accompanies this letter.

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The economy continues to grow, albeit anemically. But we are now in the eighth year of economic expansion, each year a bit slower than the last. The Federal Reserve seems poised to

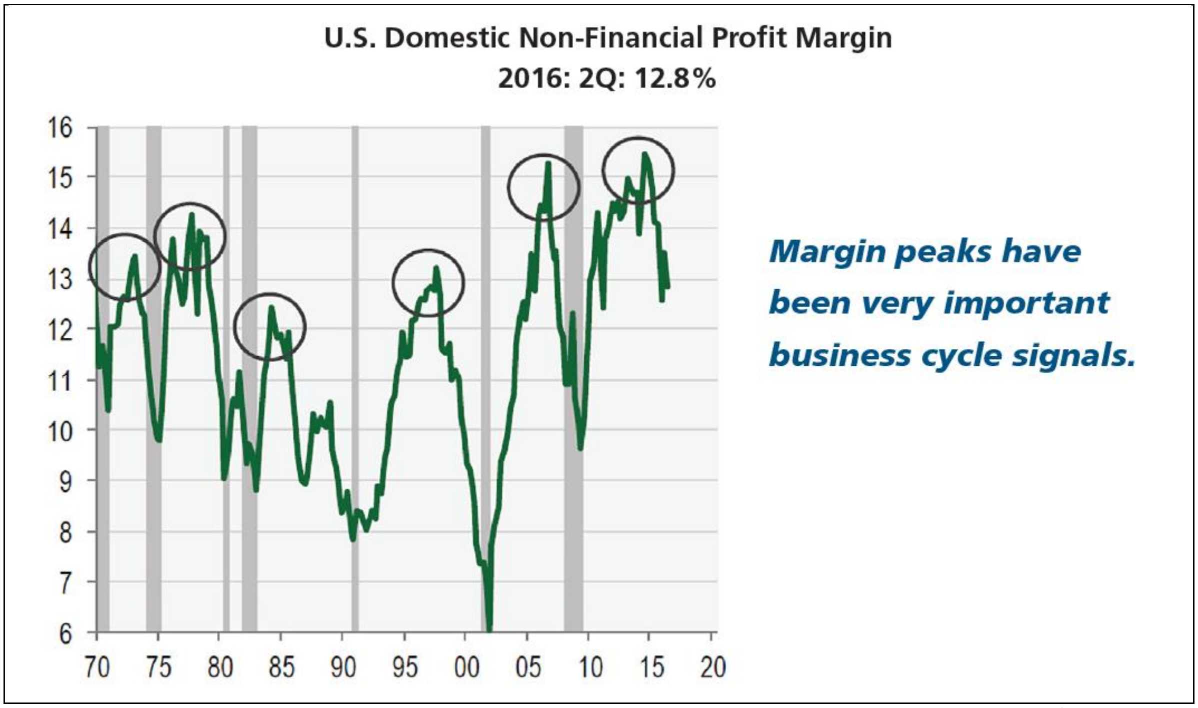

Chart courtesy of Cornerstone Macro

raise interest rates, and most other world economies have already slowed substantially. Add to this other potential sources of volatility: the U.S. presidential election, a December referendum in Italy, a rise in protectionism and potential terror attacks. While we're not omniscient – in fact, *because* we're not omniscient – we think this environment demands caution.

An economic slowdown, like Carl Sandberg's fog,[2] comes on little cat feet. It arrives quietly and on its own timetable, surrounding you before you are aware of its approach. It is thus possible that the market will continue to rise to new highs in the fourth quarter before having trouble in 2017. If that's the case, we remain invested in solid companies, and your portfolio will participate in the appreciation, but probably not as much as the market. Conversely, if the fog rolls in sooner, you are prepared. And besides, even with our caution, we continue to find good investment opportunities. Here are two examples from the quarter just ended:

As mentioned earlier, we bought **Apple** for your portfolio in the third quarter. In July, shares became attractive as investors believed that the upcoming iPhone 7 would disappoint. We don't know whether the new iPhone will be a smash hit, but we do know that the Apple ecosystem remains differentiated from peers and if you already have an iPhone you are unlikely to 'leave the family.' We also think the market is underestimating the value of Apple's services business, which include offerings like iTunes and iCloud. That segment has grown 20% annually over the past 5 years and by itself will soon be as large as a Fortune 100 company. We

[2] 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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were pleasantly surprised when early consumer adoption of the iPhone 7, launched in late September, exceeded expectations. (It also didn't hurt iPhone 7 sales when its best-selling competitor – the Samsung Galaxy 7 – started spontaneously exploding in flames and was recalled last month.) Despite appreciating, the stock remains inexpensive at 13 times next year's earnings. Moreover, a potentially more audacious product launch next year – the iPhone 8 (with a rumored all-glass case) – remains a looming catalyst. While we wait for that technological marvel, Apple rewards us handsomely via robust cash flows, a 2.3% dividend and $50 billion of annual share buybacks.

We also bought **Wells Fargo** in the last week of September, as its CEO was enjoying an intensive congressional grilling. The terrible publicity was deserved – thousands of employees opened millions of unauthorized accounts for depositors. Employees were fired, fines are being levied, and executives are having millions of dollars of compensation clawed back. The company has been ordered to pay a $225 million fine, but the share price has fallen almost 25% from its 2015 highs, destroying *$65 billion* of market value. We think that's an over-reaction that presents calmer investors with an opportunity. We believe the bank is being appropriately punished (with more fines on the way), but we also anticipate that by the end of our three-year investment horizon this will be just a memory (albeit a painful one).

We made a lot of money investing in JP Morgan when the "London Whale" controversy struck in 2012 -- and if you're saying 'what's the London Whale controversy?' that shows investors tend to eventually forgive high quality companies. JP Morgan's share price has more than doubled in the four years since a trading error cost the bank $6 billion (an amount multiples larger than the Wells Fargo liability, at least to this point). We view Wells Fargo and JP Morgan as the two highest-quality, best-managed major banks in the United States. They typically trade together, but recent events have led Wells Fargo to significantly underperform over the last year:

Wells Fargo is as cheap as it has been since the financial crisis on a couple of measures (relative price-to-earnings and price-to-tangible-book). In addition, while we wait for management to

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gain forward momentum again, the company pays a 3.5% yield, double that of the market. We relish buying high quality companies during a crisis *if* we believe the crisis has not permanently affected their long term profit making ability.

While we suspect 2017 will be a more difficult year for the economy, we have intentionally structured our investments with that backdrop in mind. For example, when you buy a company like Wells Fargo already down 25% from its highs, and selling at a historically low valuation, there is some built-in downside protection if the economy slows. In addition, we have a cash cushion, we are avoiding cyclical companies, and we are slow to reinvest profits. In each of these ways we are taking risk off the table. It has not yet paid to do that, but we think it will relatively soon.

We appreciate your patience with our prudence, and welcome any questions or comments you may have.

Very truly yours,

Christopher C. Grisanti