Grisanti Capital Management

January 3, 2017

Dear Clients & Friends of Grisanti Capital Management:

> *"After all, the chief business of the American people is business. They are profoundly concerned with producing, buying, selling, investing and prospering in the world. I am strongly of the opinion that the great majority of people will always find these the moving impulses of our life."*
>
> --Calvin Coolidge

Not since "Silent Cal" almost a hundred years ago have we had a president that was as business-centric as Donald Trump. We realize there is much more going on in the markets than the U.S. election, but we regard the ascension of Trump as a milestone event. His administration will propose seismic shifts in U.S. tax policy, spending priorities, trade regimes, fiscal policy, foreign affairs, immigration, and financial and environmental regulations. With the exception of national security matters, when the new administration weighs a change in policy, it will do so almost solely through an *economic* lens – Will the change be pro-growth? Will it add to the profitability of American business? It is not our job here to argue the merits of such a one-issue approach – after all, one man's myopic tunnel vision is another's admirable single-focus – but rather to focus on its consequences for your portfolio.

Before we get to our analysis of what's ahead, let's briefly review 2016. Cautious about the markets and the elections, we entered the fourth quarter with almost 20% cash. Due to our overweighting in financial stocks, we were still able to keep up with the rising market – both your portfolio and the market rose 3.8% in the quarter.[1] I believe the market has turned to favor our concentrated portfolio. We were up 5.6% for the year, and as you know, we have been cautious for much of 2016 holding significant cash positions. We preferred to give up performance for the protection afforded us by the cash position, and we did. In the fourth quarter, we made several attractive new investments (discussed below), and lowered our cash position to about 2%, becoming fully invested.

In 2016, we also invested in sectors that we regarded as attractive, like healthcare that did not participate in the market's rise. In our experience, as long as those investments are in quality companies – and they are – the best thing to do is stay the course. Often our worst performers in one year emerge as the leaders in the next. For example, our worst performing companies of 2015 were in the energy sector, and they became our best performers in 2016. (In fact, our best investment in 2016 was Devon Energy, a domestic, investment-grade oil company that was up

[1] The performance noted is for the GCM composite, which follows our model portfolio. Due to tax considerations or other factors such as cash position or deposits and withdrawals, the performance of your actual portfolio may differ, and is included with this letter.

Grisanti Capital Management

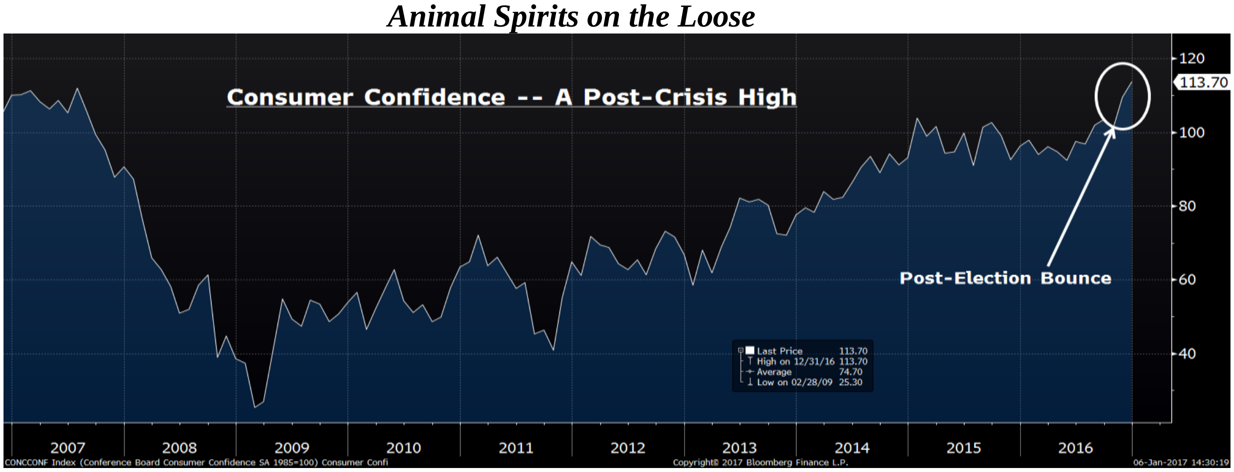
126% from our purchase in February.) Our investment in financial companies hurt us most of the year, but performed superbly in the fourth quarter. Rates are rising meaningfully for the first time in years, and banks should be able to make money again in the lending business. **Morgan Stanley** and new investment **Wells Fargo** were up 32% and 25% respectively for the quarter.

The Election of 2016: Why It's Important to Your Portfolio

The Opportunities. We would group the potential opportunities created by the new administration into two categories, direct and sentiment-driven. In the first category, there is a very good chance that we will see lower corporate tax rates and the repeal of individual pieces of regulation that will add to the bottom line of many U.S. companies. For example, portfolio company **CVS** (the drugstore chain) does all its business in the United States, and is therefore unable to shelter any of its income abroad and is saddled with a 38% corporate income tax rate (versus, say, internationally-focused Microsoft, which has a 14% tax rate). Trump proposes cutting that to 15%. That would add about $2 billion to CVS's after-tax earnings, *an increase of 37%,* without selling an extra tube of toothpaste. Likewise, companies like refiners, banks and pipelines would all benefit from specific regulations being eliminated or reduced, which could add billions of dollars to their bottom line. These are the *direct* opportunities potentially created by a Trump presidency. While they are measurable, they do not accrue to each company in equal measure, and in fact, some companies may be hurt by them. (For example, Microsoft, with its already low tax rate, may see some of its deductions taken away.)

The second category of opportunities are *sentiment-driven*. These are less quantifiable, but can benefit the entire economy. Perhaps the best example of this is the jump in both business and consumer confidence since the election. Consumers feel more like spending money; companies feel more comfortable hiring and making large capital expenditures.

Animal Spirits on the Loose



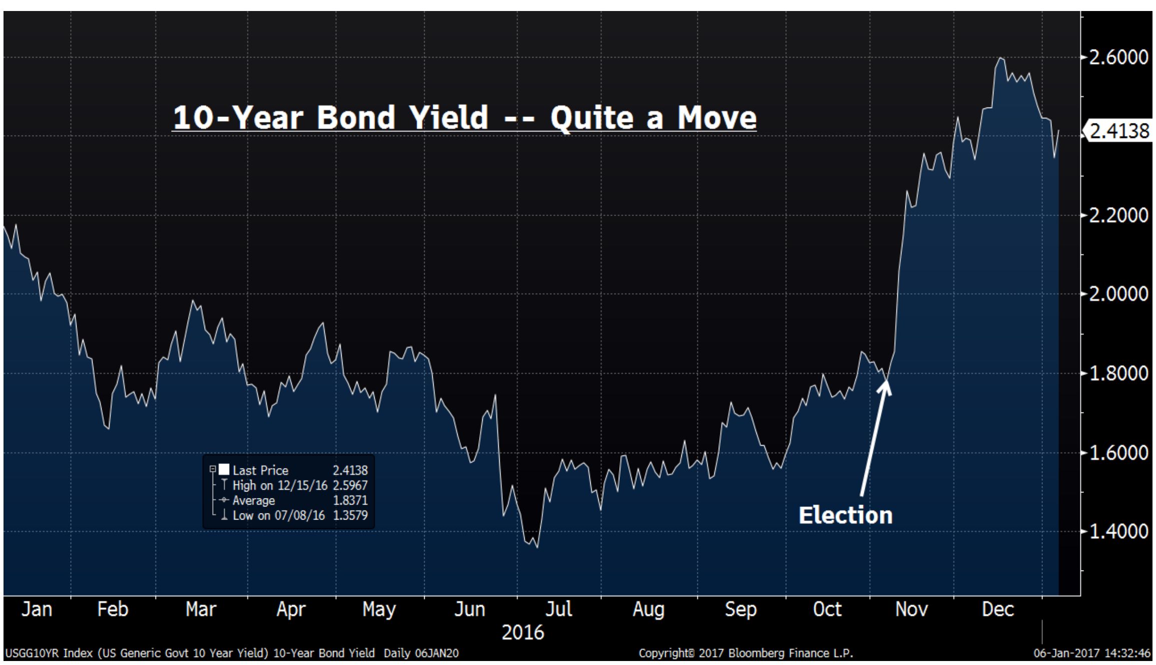
Other *sentiment-driven* advantages like housing starts or business formations all have to do with animal spirits being released and entrepreneurs feeling more optimistic. Whatever doubts anyone has with Trump, you cannot argue he is anti-business.

<u>The Risks</u>. The problem with animal spirits, untamed by definition, is that they can turn on you. What might cause them to switch from friend to foe? We don't think the answer is hard to see – Trump has proposed a number of policies in the heat of the campaign that would upset the apple cart. We believe the number one risk is protectionism. Just a few days ago, Trump sent the following Tweet:

> *General Motors is sending Mexican made model of Chevy Cruze to U.S. car dealers, tax- free across border. Make in U.S.A. or pay big border tax!*

Imagine you are a GM executive and you read that. You've just spent several billion dollars building a Chevy Cruze plant in Mexico. Or imagine you're the President of Mexico. In any event, it does not take a lot more imagination to get to a trade war. At this point, we think this is mostly bluster. The incoming economic team (Mnuchin, Cohn, Ross et al.) are practical businessmen, and (with the exception of Ross) have been ardent free traders. Trump himself has often stated that his goal is "fair" trade deals, not a trade war. But the risk remains real and significant.

The second big threat is higher interest rates. If the last chart of consumer confidence is encouraging, the one of ten-year bond yield is less so:



The 10-year bond yield has practically doubled since July, and rose at its quickest pace in more than 20 years after the election. Why? The answer you get to that question tells you perhaps more about the responder than about interest rates. Those who think Trump's new policies will end in disaster believe the jump in rates is due to a fear of coming *inflation* caused by tax cuts without spending restraints, increased infrastructure and defense spending, etc. Those who think we are finally on the right track believe higher rates reflect renewed optimism and a return to days of GDP *growth* above 3%, which would merit a more normal (i.e., higher) interest rate environment. Is it *inflation* or *growth* that is driving rates? No one knows, or maybe neither materializes. As the answer is made clear over the next couple of years, it will have implications for the market.

The Bottom Line. Obviously, there are many cross currents, but, as one of our former colleagues used to say, "this is not a debating society." We need to choose a way forward, and on balance we believe there are more opportunities than risks right now. Taxes and regulations will certainly get cut, companies will earn more as a result, and confidence will probably continue to increase. Of course, Trump could do any number of things to interrupt this virtuous progression. In addition, even he can't repeal the business cycle, which is now entering its ninth year of expansion. But in the current environment we feel comfortable using cash to buy undervalued companies, which we will hold an average of three years. These are companies that usually get things right and for one reason or another are currently undervalued.

A great example of this is our new investment in **Nike**, which was down 18% in 2016 (prior to our purchase in December). Competition is growing and the dollar is rising, but the company still manages to show 8% revenue growth. If you exclude the effects of the stronger dollar, it would have been 11%. Earnings probably grew about 8% in 2016, their slowest pace in years, but should grow double-digits next year, pretty impressive for a company of Nike's size ($86 billion market cap). Nike has the strongest brand, marketing force and reach of any sporting goods company in the world (not to mention the strongest balance sheet at AA-). This is an example of a high quality company that is temporarily out of favor.

In addition to Nike, we added shares of **Citigroup, DaVita Inc., Gilead Sciences, Skyworks Solutions** and **Viacom** in the fourth quarter. With the exception of Citigroup, all of these stocks were down in 2016. (Citi was up, but still sells at a discount to tangible book value.) All are investment grade, with strong proprietary products, and they sell at an average 35% discount to the market. We believe we are buying value.

Fourth Quarter Investments – Buying Value

	2016 Performance	**Discount (Premium) to Market Based on Earnings**	**Discount (Prem) to its 5 Year Valuation**
CITIGROUP	14%	43%	(4%)
DAVITA	-8%	22%	30%
GILEAD SCIENCES	-30%	69%	72%
NIKE	-20%	(9%)	26%
SKYWORKS	-6%	28%	40%
VIACOM	-14%	54%	37%
Average		**35%**	**34%**

Grisanti Capital Management

In a business that can guarantee very little, we can promise 2017 will bring surprises. We are working to foresee some of them, but there will be others no one will have forecast. We are fully invested, but with more investments (24) than usual, because we believe the wider range of possible outcomes in 2017 requires greater diversification. We will of course continue to monitor all our portfolio companies' investments closely, and look for new investments that are shunned for invalid or short term reasons.

Active investment management – the use of analytical skill to choose which businesses will succeed and which will struggle – makes enormous sense as we undergo a myriad of economic and political shifts. We have been in business for 17 years and have navigated through a wide array of market cycles with strong long term results.[2] I cannot think of a more thought-provoking time.

Very truly yours,

Christopher C. Grisanti

[2] For the 17 year period ended December 31, 2016, the GCM Composite was up 175% (net of fees) as compared to the S&P which was up 112% for the same time period.