Grisanti Capital Management

January 12, 2017

Dear Clients and Friends of Grisanti Capital Management:

Your High Income Equity Portfolio (HIEP) provided steady capital appreciation and income throughout 2016, rising 3.0% during the fourth quarter and 8.0% for the year.[1] The year-to-date gain was accomplished despite taking 30% less risk than the market[2] and generating a yield of 3.7% (outpacing the S&P's 1.8% yield). Recall that the goal of the HIEP is to combine positive risk-adjusted returns with stability and above-market income. We believe we executed well on this mandate in 2016 and are optimistic as we enter 2017. The coming year is filled with concerns about a new administration and an aging economic cycle, just the type of uncertain backdrop for which the HIEP was created.

Following the Presidential election, the caution that characterized U.S. equity markets for the first ten months of 2016 quickly gave way to enthusiasm, as investors cheered the pro-growth, pro-business policies potentially ushered in by the newly elected Republican administration. Despite our relatively defensive positioning, we managed to capture a good portion of the upside move during the fourth quarter as well as the full year.

Our largest portfolio weighting in the HIEP consists of high-yielding preferred stock issued by financial and utility bellwethers like **J.P. Morgan**, **Bank of America** and **Dominion Resources**. At year end, our preferred stock holdings equaled 25% of the portfolio with an average yield of nearly 6.5%. These notes pay out significantly higher yields than government debt and are less volatile than the average common stock. **Further, our preference for floating-rate notes helped protect your capital from a spike in interest rates during the fourth quarter. While the value of our preferred holdings rose modestly, *fixed-rate* preferred notes on average declined 5%-10% during the same time period.**

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[1] The performance shown is for the GCM High Income Equity Portfolio composite. Your actual performance is enclosed with this letter, and may be higher or lower.

[2] As measured by Beta, a commonly used statistic for accessing volatility compared to the market.

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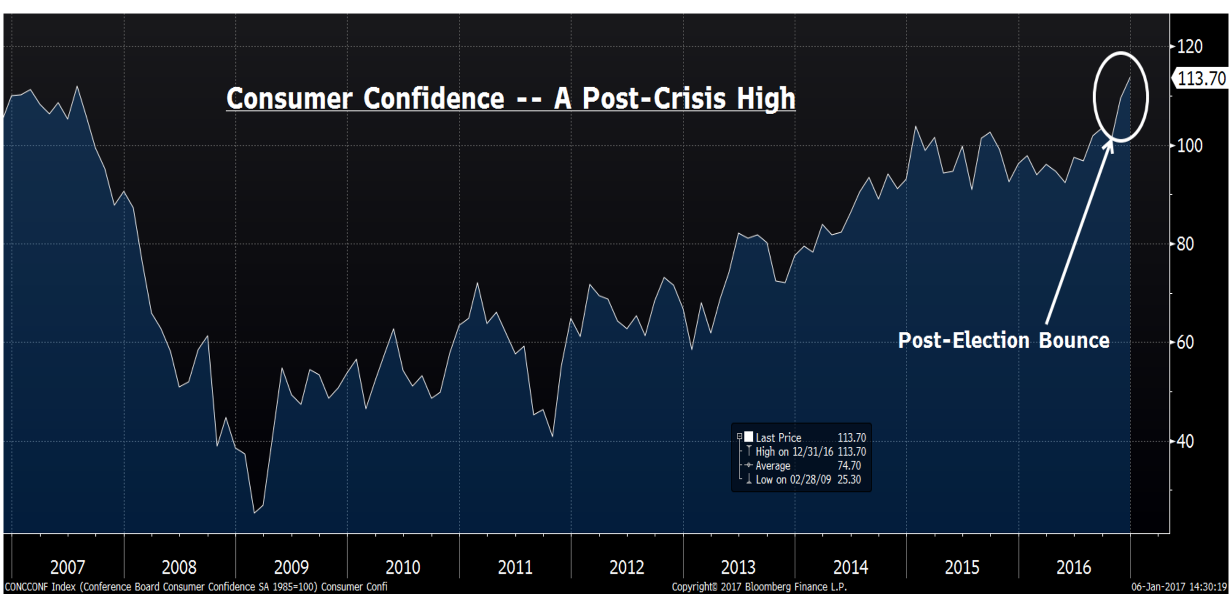
Our largest portfolio holding, **Wells Fargo Inc.**, which we wrote about in detail in our third quarter letter, was the portfolio's strongest performer in the final quarter of 2016. The stock rose 25% as headlines related to the account opening scandal faded and investors focused on the company's substantial earnings leverage to higher interest rates. Shares also received a boost from hopes that President-elect Trump would make good on campaign promises to reduce the corporate tax rate and lower the regulatory burden for large financial companies. Our second-best performer in the fourth quarter was long-time portfolio holding **Time Warner Inc.,** which rose 19% on a takeout offer from telecom giant AT&T. We believe the premium paid by AT&T better reflects the value of Time Warner's superior media assets.

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

The Opportunities. We group the potential benefits from an all-Republican government into two categories: direct and sentiment-driven. In the first category, proposed corporate tax cuts and the repeal of onerous regulations will likely add to the bottom line of many U.S. companies. Take for example, **CVS Health**, which generates all of its sales in the United States. Unable to shelter any of its income abroad, CVS is saddled with a full 38% tax rate. Assuming Mr. Trump's promise of a 15% corporate tax rate, CVS' after-tax earnings would grow by $2 billion, *an increase of 37%,* without processing another prescription or selling an extra tube of toothpaste. Likewise, life insurers, banks and refiners would all benefit from specific regulations being eliminated or reduced, which could add billions of dollars to their bottom line.

The second category of opportunities is *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. A sustained rise in confidence could propel consumers to spend money more freely, businesses to approve new hires and/or large capital expenditures and, in a virtuous cycle, accelerate economic activity.



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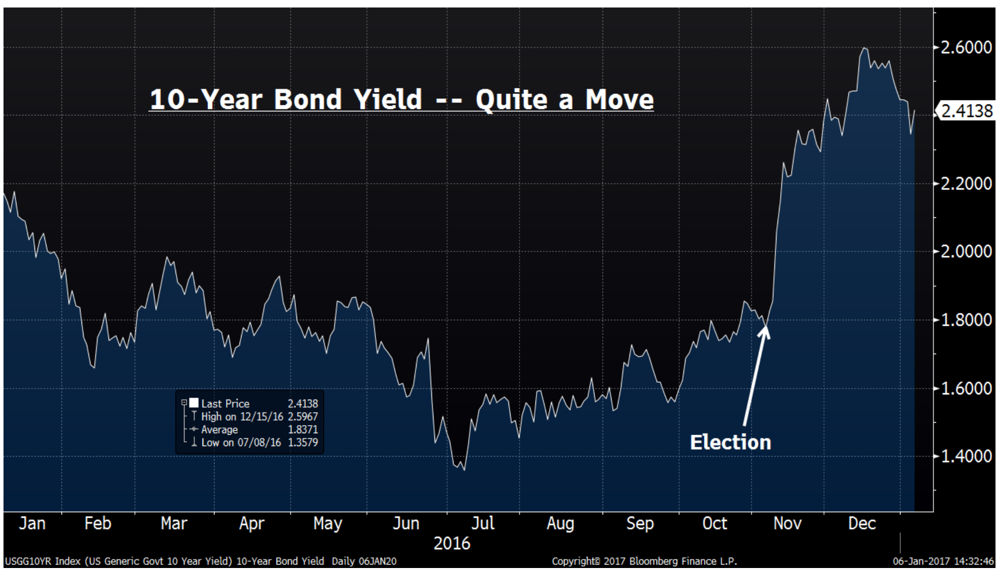
<u>The Risks</u>. While few would disagree that President-elect Trump is pro-business, he has also proposed a number of policies on the campaign trail that could harm the already fragile global GDP growth outlook. Given Mr. Trump's campaign rhetoric regarding global trade, it does not take much imagination to envision a trade war during his administration. At this point, we think his stance is mostly posturing, as the President-elect's appointed economic advisors (Steven Mnuchin, Wilbur Ross, Gary Cohn et al.) are practical businessmen, and (with the exception of Ross) ardent supporters of free trade. Mr. Trump himself has stated that his goal is "fair" trade deals, not a trade war. But protectionism remains a real and significant risk to the economic outlook.

Another potential risk 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 from all-time lows in July, and rose at its quickest pace in more than 20 years after the election. Why? For those who think rampant government spending and aggressive fiscal policy will do little to boost economic growth, *inflation expectations* are driving bond yields higher. For those who think higher rates reflect renewed optimism and a return to days of GDP above 3%, *growth expectations* are responsible for higher bond yields. Is it inflation or growth that is driving rates? We don't know for sure but as the answer is made clear over the next couple of years, it will have implications for both stocks, bonds and economic growth.

<u>The Bottom Line</u>. There are many cross currents at play, but on balance, we believe there are more opportunities than risks as the new year begins. In the positive scenario, we see the potential for lower taxes and regulations to lift corporate earnings, boost capital expenditures and keep the job growth engine humming. However, we remain alert for signals that fiscal policy maneuvers are ineffective in resuscitating an aging business cycle, which is now entering its ninth year of expansion.

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In an industry that can guarantee very little, we can promise 2017 will bring more surprises. While we work to foresee some of them, surprises by nature are difficult to anticipate, so we have structured the portfolio with that in mind. Our primary focus remains delivering on the stated goal of the HIEP: provide above-average income and lower-than average volatility along with some capital appreciation. Since inception in 2010, the portfolio has largely delivered on this objective, with the HIEP returning 7.8% per annum with below average risk, while generating an average yield of 4%.

We thank you for entrusting us with your capital, and look forward to updating you on our progress in the year to come.

Very truly yours,

Christopher C. Grisanti