



Grisanti Capital Management

April 18, 2017

Dear Clients & Friends of Grisanti Capital Management:

*Errors like Straws upon the Surface Flow;
Who would search for Pearls must Dive Below.*
-- John Dryden, 1678

Your investments performed well in the first quarter of 2017, with the GCM portfolio up more than 5%, finishing ahead of 89% of all large cap value managers.¹ That's two strong quarters in a row, and on the surface, it appears that the Trump Rally continues apace. But diving below, the reality is more nuanced. We see important differences between this quarter's performance and the market strength that began after the election. While the broad averages were up in both cases, entirely different economic sectors drove the returns. The shift in market leadership tells us something about what may lie ahead for the economy – or, more accurately, what the market *thinks* lies ahead. Whether correct or not, the market is currently sending signals that the economy is poised to slow. For reasons discussed below, we are more optimistic, but it is always important to understand what's occurring beneath the surface.

During the end of year, post-election rally, value stocks led the way, with financial and energy sectors posting strong gains. For example, our new investment in **Wells Fargo** soared 21% in the seven weeks between the election and year end. Bond yields rose sharply, another sign that investors were optimistic about the economy, in part because they believed the Trump administration would adopt pro-growth tax and business policies. Your portfolio performed well in the fourth quarter because we have substantial investments in those economically sensitive areas. Value managers like us outperformed growth managers, as investors assumed that businesses that usually don't grow quickly – like banks or oil companies – would lead a resurgence. Animal spirits were abroad in the land.

¹ The performance noted is for the GCM Large Cap Value 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. The average U.S. large cap value mutual fund was up 3.7% in the first quarter, and the performance of the GCM large cap value composite this year (up 5.1% net of fees) would place us in the top 11% of the 1,197 U.S. large capitalization value funds tracked by Morningstar. While we are not a mutual fund, we compare our net results (after fees) to those of publicly traded mutual funds with similar styles (U.S. large cap value equity) because we believe it is a fair comparison and the data is publicly available.



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But the sectors that led the way in the first quarter of 2017 were distinctly different. Technology companies surged, a sector in which we, like most value managers, are underweight. The S&P Technology Index was up over 12% for the quarter, twice the overall market's return, and 4% better than the second best group, consumer growth stocks. The first quarter's ascendancy of growth stocks – technology, consumer growth (think Amazon, Tesla) -- is synonymous with a market that is concerned about the economy slowing. Like any other commodity, you pay up for growth when you're afraid growth will be in short supply. Bond yields *fell* during the quarter, another sign of slowing growth. Financials and energy stocks went from being market leaders after the election to a drag on performance. **Wells Fargo**, our hero of the fourth quarter, was up only 1% in the first. Finally, value managers lagged growth managers by a lot. (We happily bucked that trend – more below.)

So, where do we come out? Our best bet is that the market is over-extended after a good run and is taking a well-earned rest. We continue to believe that President Trump will endorse policies that will lead to higher interest rates.² We also do not see a recession in 2017. We are mindful of the market's uncertainty and we respect it, but there's an old saying that the market has predicted eight of the last two recessions. Often investors get skittish and at the end of the day are proven wrong. While we believe this is one of those cases, events can change – these days, quickly. For that reason, we have always concentrated the portfolio on a few undervalued companies that can perform well even in a market that isn't consistently rising.

Our strong performance in the growth-driven first quarter underscores the benefits of that approach. We don't own "the market," we own interests in about 20 attractive companies. It very much matters which ones we choose. For example, we don't own much technology – only three companies – but two of them, **Apple** and **Skyworks**, represent over 10% of the portfolio, and they surged 24% and 32% respectively in the first quarter, greatly helping performance. Similarly, our concentrated positions in **Viacom** (the media company) and **Allergan** (the pharmaceutical company) rose 33% and 13%. Of course, the math works in both directions: Our large exposure to the energy sector, which was our best performing group in 2016, cost us about a percent in the quarter as oil prices fell and the stocks declined in a rising market.

The performance of our current holdings (22 in all at quarter-end) has been strong since the market bottom in February, 2016. Since this time, the equity portion of the portfolio is up 33.3% versus a strong S&P 500 Index return of 32.4%. 16 out of the 22 holdings in the portfolio have outperformed the market since their initial purchase date. We added three new stocks in the quarter. Rather than being part of an overall theme, each represents an attractive opportunity because of company-specific circumstances. **Lowes**, the home improvement retailer, sold off last year because of an ill-fated Canadian acquisition. That left it at a record-wide discount from its arch rival Home Depot, even though the economy remains strong and housing starts have a way to go before fully recovering from the 2008 disaster. The stock is up 13% from our January purchase, after it reported strong earnings in the quarter.

² Higher rates come about whether you are a Trump fan or not: If you like Trump, you think rates will go up because he will spur economic growth. If you think less of him, it's because he will cause inflation. Either way, lock in your mortgage now.



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Mylan is a pharmaceutical company that makes generic drugs. Like its competitors, it is suffering the triple-whammy of possible healthcare regulation, fewer branded drugs going off patent this year, and cut-throat competition. This has driven the price of **Mylan** down 45% from its high in 2015, even as the market has risen 16%. It retains an investment grade balance sheet, and sells at only seven times earnings (less than half the market's valuation). Moreover, if the economy does slow, **Mylan** is the sort of investment that won't be affected, as people will still buy generic drugs. Admittedly, we see no immediate catalyst, but that's why we believe the price is so low. If **Mylan** returned only to its average valuation of the last ten years, the stock would rise 65%.

Finally, perhaps the caffeine got to us, but we purchased shares of **Starbucks** late in the quarter. **Starbucks** shares have been a mediocre investment lately. Since October 2015, the stock has fallen 14%, even as the market has risen 16%, as the company has bungled its online ordering process. This has caused long lines in the morning rush and a slight slowing of sales growth (it's still growing, just not as fast as before). We believe in management's ability to fix this problem, and we love being able to purchase a strong brand at a discount to its typical (albeit never cheap) valuation. While there may seem to be a **Starbucks** on every corner in New York, the capacity for foreign growth is enormous – we don't believe there has been an American food brand this compelling to foreign markets since McDonalds.

All of these investments are multi-year projects. Recall that our average holding period is three to four years. **Starbucks** won't fix its ordering system overnight, and investors probably won't think more highly of **Mylan** in a quarter, but that type of adversity is what presents opportunity. We have begun to sell our **Morgan Stanley**, which we bought in 2011 when the U.S. was downgraded by Standards & Poor's. At the time, panic arose in financials shares and we paid \$13.50 for the shares of **Morgan Stanley**, or barely half the firm's book value. Now the shares sell for \$41.50, more than three times what we paid. It took six years, during which we had two presidential elections, many terrorist attacks overseas, decent employment growth and an anemic overall economy. The point is that specific opportunities take time to mature but can be extremely lucrative.

Value investors are a quirky, contrarian breed. When the market plunges, we get excited about opportunities presented by fear. But now, after two strong quarters, good performance makes us more cautious. Eight years into an economic expansion, we see more greed than fear. We intend to avoid pockets of euphoria, and stick to our long-term outlook.

We look forward to reporting back to you at the end of the second quarter.

Very truly yours,

Christopher C. Grisanti